– WHITEPAPER –

Federal Reserve Actions Under the Trump Administration Have Significantly Weakened Post-Crisis Banking Protection Rules

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The lost jobs, homes, savings, retirements and dreams of tens of millions of Americans due to the financial crisis of 2007-2009 highlight the critical importance of having strong banking regulations combined with effective and assertive supervisory oversight to ensure the largest banks are both financially resilient and safely run. Pre-crisis banking rules for the largest banks were woefully deficient and ineffective. Weak standards for liquidity and capital sufficiency in particular allowed large banks to take on too much risk, contributing to a crisis that had devastating effects on Main Street families and businesses. At the same time, banking supervision—the day-to-day oversight of these firms that should complement and fill in potential gaps in rules to ensure banks are not dangerously run—failed dramatically, and combined with the weak rules, created a particularly fragile banking system with disastrous consequences.

As a result of the many lessons painfully learned from the financial crisis, Congress passed the Dodd-Frank Act (DFA) in 2010 and directed banking regulators to implement tougher standards for "systemically important" banks—those that can pose a substantial risk to financial stability and the broader economy. Although these tougher standards were relentlessly opposed by the financial industry, regulators did implement them. Those post-crisis banking sector reforms have worked largely as intended during the pandemic and, so far, have prevented a banking and financial crisis, even if those reforms did not go far enough in some important areas, as we detailed in a recent paper.[1]

While these reforms have not come close to ending the too-big-to-fail problem as some had hoped, they have strengthened the U.S. banking system substantially. Indeed, post-crisis banking sector reforms are ***the*** key reason the largest banks entered the COVID-19 pandemic in relatively strong financial condition, and they have so far been able to serve as a source of support for the economy rather than contributing to and exacerbating the downturn as they did in the last crisis.

Nevertheless, many of the reforms have been under attack by the industry from the start, and, under the Trump administration's deregulatory efforts, a number have been weakened over the past several years by legislation and rulemaking. For example, in 2018 Congress passed the bipartisan Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). The new law changed the definition of systemically important banks, raising the asset size-based threshold for the required application of stronger

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[1] DENNIS KELLEHER & TIM CLARK, BETTER MARKETS, NO FINANCIAL CRASH YET THANKS TO DODD-FRANK AND BANKING REFORMS (Jul. 8, 2020), *available at* https://bettermarkets.com/resources/white-paper-no-financial-crash-yet-thanks-dodd-frank-and-banking-reforms. The massive and unprecedented actions taken by the Federal Reserve beginning early on in response to the COVID pandemic played a critical role in forestalling an even worse financial meltdown, which has also helped the banks. The need for those actions underscores that there is a lot more work needed to strengthen the US financial system, and much of it will require stronger financial protection rules.

rules and standards for bank holding companies from $50 billion to $250 billion. The law eliminated the legislative requirement that enhanced standards be applied to bank holding companies with between $50 billion and $100 billion in assets. Importantly, EGRRCPA also gave the Federal Reserve broad discretion to determine whether it should continue to apply the stronger, "enhanced prudential standards" to bank holding companies with assets of between $100 billion and $250 billion.

While many of the post-crisis reforms remain largely intact for the very biggest banks (those classified as Global Systemically Important Banks or GSIBs), there have been significant changes that undermine the value of what is perhaps the most important post-crisis initiative: the Federal Reserve's stress testing program and related banking supervision efforts. The stress tests apply to all banks with over $100 billion in assets. The lowering of other key standards has been most notable for those large banks with assets between $100 billion and $700 billion. Congress did not require the Fed to ease standards for these large banks, but, with Trump's regulators in charge, it nonetheless exercised its discretion to do so, over detailed dissents.[2] Importantly, banks in this range represent a large share of the U.S. banking system, and problems at such banks could well represent a threat to the system in a downturn, particularly for any one of those at the upper end of this range[3] or if problems occurred at many of them at the same time, which is most likely to occur during a severe downturn.

Together, these changes made by the Fed (often with other regulators) undermined the progress that had been made since the crisis. They have made the economy more vulnerable to the threats large banks can present and have reduced the confidence taxpayers can have that the banking system is resilient enough to withstand a severely stressful period without requiring another taxpayer-supported bailout.

Key Fed Changes Since 2018 that Have Weakened Financial Protection Rules

The most important deregulatory changes made by the Fed over the past several years that weakened the financial protections put in place are:

1) capital standards, including those associated with the Federal Reserve's stress testing program;

2) a weakening of what had been more assertive post-crisis banking supervision;

3) liquidity standards for large banks with less than $700 billion of assets;

4) reducing the frequency at which large banks must prepare resolution plans ("living wills");

5) eliminating margin requirements for certain derivatives positions transacted between banks and their affiliates; and

6) changes in the Volcker Rule that ease restrictions on banks' proprietary trading and other risky investments (e.g., hedge funds and private equity).

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[2] See, e.g., Votes of Federal Reserve Board, available at https://www.federalreserve.gov/aboutthefed/boardvotes.htm, including in particular votes and statements of Governor Brainard, e.g., *Statement by Governor Brainard* (Oct 20, 2020) available at https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20201020a.htm.

[3] Bear Stearns and Lehman Brothers, two firms whose collapses were a particularly important source of destabilizing the system in 2008, had total assets of $395 billion and $650 billion, respectively. The failure of thrift bank Indy Mac, with total assets of only about $40 billion, sent waves of fear through the banking system in the summer of 2008 and contributed to the general uncertainty that spilled over to all commercial banks.

Weakening Capital Standards and De-stressing Stress Testing

The Stress Capital Buffer

In March 2020, the Federal Reserve Board changed what had been a highly successful stress testing program and implemented the Stress Capital Buffer (SCB) in its capital rules, effective October 2020.[4] This change integrated the Fed's stress test directly into the capital rules for the large banks subject to the Fed's Comprehensive Capital Analysis and Review program (CCAR)—those with assets of over $100 billion. It is important to note that the capital requirements of the SCB/CCAR remain tremendous improvements over pre-crisis bank capital standards and assessments for the largest banks. However, while this is better than it might have been given the focus of the Trump administration on extreme deregulation, being better than the woefully insufficient pre-crisis standards is not the right measure. Capital standards should be strengthened even further than they were before the SCB change weakened them again, as has been noted by a number of studies.[5]

Unfortunately, in implementing the SCB, the Fed also made major changes to various aspects of the stress testing program and how it works that undermine its value and weaken the effective capital requirements for large banks from what they would otherwise have been. Four unnecessary changes made while implementing the SCB rule are of particular concern:

1) eliminating the requirement that banks meet minimum leverage ratio standards in the stress test;

2) changing the stress test assumptions to no longer require banks to capitalize for possible growth under stress (which was a very reasonable assumption as has been highlighted by the rapidly growing size of many large banks during the COVID-19 pandemic);

3) reducing the amount of planned capital distributions banks are required to prefund by only requiring that banks have in place, in advance, enough capital to meet the stress tests capital requirements including 4 quarters of planned dividend payments. Prior to the implementation of the SCB, the stress test included banks' actual planned common stock dividends and share buybacks for the full 9 quarters of the stress scenario timeframe. In addition to lowering the amount of capital banks are required to hold, this change weakens the forward-looking nature of the stress test and undermines the countercyclical approach of requiring banks to build capital during good times in preparation for an extended downturn.

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[4] Press Release, Federal Reserve Board approves rule to simplify its capital rules for large banks, preserving the strong capital requirements already in place (Mar. 4, 2020) *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200304a.htm

[5] *See,* Jihad Dagher et al., BENEFITS AND COSTS OF BANKER CAPITAL IMF Staff Discussion Notes No. 16/04 (Mar. 3, 2016) *available at* https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/Benefits-and-Costs-of-Bank-Capital-43710, 2016 finds capital requirements could be in the range of 15-23%; Fabrizio Perri and Georgios Stefanidis, CAPITAL REQUIREMENTS AND BAILOUTS Federal Reserve Bank of Minneapolis Staff Report 554 (Aug. 31, 2017) *available at* https://doi.org/10.21034/sr.554 and The Federal Reserve Bank of Minneapolis THE MINNEAPOLIS PLAN TO END TOO BIG TO FAIL (Dec. 2017) *available at* https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-final.pdf, both point to a range of 20-30% to prevent 'public recapitalizations'; Simon Firestone, Amy Lorenc and Ben Ranish, AN EMPIRICAL ECONOMIC ASSESSMENT OF THE COSTS AND BENEfiTS OF BANK CAPITAL IN THE US*,* Finance and Economics Discussion Series 2017-034 (2017) *available at* https://doi.org/10.17016/FEDS.2017.034, a study by three Federal Reserve Board economists who find the 'optimal range' is between 13-26 percent. *See also* Anat R. Admati and Martin Hellwig, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT*,* Princeton University Press (2013)

4) substantially weakening capital planning requirements for the largest banks by a) getting rid of the strongest penalty for banks with dangerously bad capital planning practices, the CCAR "qualitative objection" (discussed below), and b) eliminating the requirement that banks get prior approval from the Fed if they want to distribute more capital than they had projected in the annual capital plans they submit to the Fed.

In what should have been a substantial strengthening of capital standards, the SCB rule for the first time implemented the GSIB capital surcharge as part of the Fed's post-stress capital thresholds. However, the apparent higher top-line capital requirements for GSIBs resulting from this change will be significantly offset by the other steps taken to weaken the stress tests as noted above. But that's not all: for those banks not subject to the GSIB surcharge, the changes discussed simply lowered stress testing-related requirements across the board.

In addition, in conjunction with the implementation of the SCB, the Fed changed a key definition in its capital rules to make any automatic restrictions on bank capital distributions resulting from the SCB requirements take effect more slowly.[6] In other words, as banks enter a period of stress, limitations on their ability to distribute capital to shareholders would take effect at a slower pace, giving them more latitude to deplete capital through common dividends, share buybacks and discretionary bonuses to executives ***even when*** losing money and clearly facing further stress.

One danger associated with this rule change has already materialized. The CCAR rules were designed to give the Fed needed authority to more easily require banks to immediately suspend capital distributions when facing clear and severe deterioration in the operating environment. The Fed could have, and was widely expected to, use this authority to require CCAR banks to stop common dividends and share buybacks once it was clear the COVID pandemic would cause a "material change" in the environment that would undermine their financial condition. The Fed declined to take this action, however, and instead allowed them to deplete capital even in the face of the severe downturn caused by the pandemic, while making it easier for them to continue to deplete capital through the mechanics of this rule change.

Changes to Supervisory Stress Test Modeling[7]

In 2019, the Fed made changes designed to make the stress test more transparent by providing more detailed information to banks and the public about the modeling the Fed uses in its stress tests. This increased disclosure of details about Fed stress testing models can potentially undermine the value of the stress test in two ways. First, giving the banks too much information on how the Fed is estimating losses may allow banks to reverse engineer the test to make it less effective at capturing the banks' risks. In other words, banks may design products or structure their balance sheets in ways that carry the same risks they did before

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[6] Better Markets Comment Letter on Eligible Retained Income (May 11, 2020) *available at* https://bettermarkets.com/sites/default/files/Better_Markets_Comment_Letter_on_TLAC_of_Systematically_Important_Bank_Holding_Companies_and_Foreign_Banking_Corporations.pdf

[7] For more on stress tests, see Fed Conference on "Stress Testing: A Discussion and Review," including in particular the remarks of Dennis Kelleher on the panel "Stress Tests as a Policy Tool," available at: https://bettermarkets.com/resources/conference-%E2%80%9Cstress-testing-discussion-and-review%E2%80%9D-panel-one-%E2%80%9Cstress-tests-policy-tool%E2%80%9D; *See also* comments from this conference by Tim P. Clark on the panel "Dynamism and Transparency in Stress Testing", *available at* https://bettermarkets.com/sites/default/files/dynamism-and-transparency-in-stress-testing-paper-clark.pdf

but are less likely to be picked up as clearly during the stress test, which would allow them to hold less capital without reducing their risks. Armed with too much information on the Fed's modeling, banks may be able to lower or even avoid capital charges on some risks, undermining the value of the stress test and weakening banks' financial resilience.

Second, increased disclosure on modeling increases the risk that banks will simply use the Fed's models rather than focusing on developing their own independent and robust measurement techniques specifically designed to capture their own idiosyncratic risks. It makes the system riskier if the Fed and the banks are all focusing on the exact same measurement techniques because it makes it more likely they could all miss the same risks in the same way and at the same time (so-called "model monoculture"). A diversity of approaches is best and greater disclosure of Federal Reserve modeling techniques risks reducing that diversity.

Weakening Federal Reserve Supervision of Large Banks

An important feature of post-crisis banking reforms was the Fed's redesign of its supervision program for the largest banking organizations and the use of more assertive supervision that included consequential actions against banks with significant weaknesses in the practices needed to run a complex bank safely. The crisis underscored that, for those banks that can threaten financial stability and the broader economy when they get in trouble, the margin for error is quite small. It is not good enough to hold them accountable only after such bad practices have shown themselves to represent survival-threatening problems. At that point, it may already be too late, as was made clear in 2008.

Thus, a post-crisis goal was to promote a forward-looking approach to assessing financial resilience and to ensure banks have solid practices in critical areas. This included, most importantly, assessing how much capital and liquidity they need to withstand stress and continue to operate and lend to businesses and households. To be successful, this needs to be combined with an incentive structure created by assertive banking supervision that is strong enough to compel banks to spend the substantial time, effort, money and executive attention it takes to run themselves safely.

A more direct link between supervisors' qualitative assessments and meaningful consequences for banks with weak practices in critical areas was a major change from the failed lighter touch, "banks-generally-know-best" approach to pre-crisis supervision. That approach had mistakenly assumed that banks, acting in their own supposedly well-informed self-interest and constrained by the discipline of market forces, would not take on excessive risks or otherwise engage in activities that could threaten their financial condition or the stability of the financial system.[8] The failure of supervision exposed by the financial crisis proved that approach to have been dangerously wrongheaded and woefully inadequate. Rules and supervisors have to force banks to have sufficient capital and liquidity as well as effective practices that make it possible to run them in a safe manner. Banks won't do these things voluntarily; their overriding goal is to maximize profits, and internalizing these costs—which they so effectively externalized pre-crisis—is expensive.[9]

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[8] *See*, *e.g.,* Edmund L. Andrews, "Greenspan Concedes Error on Regulation," The New York Times, Oct. 23, 2008, *available at* https://www.nytimes.com/2008/10/24/business/economy/24panel.html.

[9] *See,* Dennis Kelleher, "No Evil Required: Just the Siren Song of Market and Competitive Pressures," in Ten Years of Dodd-Frank and Financial Reform, at pps. 13-14, *available at* https://bettermarkets.com/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf.

Given the lack of transparency in banking supervision, in the absence of formal public enforcement actions against a bank (which are rare unless a law or rule has already been broken), it is nearly impossible for the public to determine how rigorously bank supervisors are holding bank boards of directors and managers accountable for ensuring banks have the practices they need to manage themselves safely. The elimination of the Fed's strongest post-crisis supervision tool (the CCAR "qualitative objection," discussed further below), among other actions, indicate the general direction since 2018 has been to materially weaken the more assertive stance of post-crisis supervision. Public statements by the Fed's Vice Chairman for Banking Supervision—quoted by the Wall Street Journal in an article entitled "Banks Get Kinder, Gentler Treatment Under Trump: Regulators are asking examiners to adopt less aggressive tone when flagging risky practices"—are particularly concerning:

> "Changing the supervision culture 'will be the least visible thing I do and it will be the most consequential thing I do,' … the Fed's vice chairman for supervision and regulatory point person said…."[10]

This will undoubtedly make oversight of the largest banks less effective, and it will be harder for supervisors to get banks to fix dangerous practices and to hold them accountable when they do not. In short, it will make it much more difficult to police the nation's biggest banks and have confidence that they have effective practices and systems needed to minimize the risk of collapse.

This change is most evident with respect to the Fed's CCAR program. In 2019 the Fed effectively eliminated the CCAR qualitative objection for most banks and provided a path for all banks subject to the CCAR capital plan qualitative evaluation to ultimately be free from this possible action.[11] The CCAR qualitative objection gave the Federal Reserve Board the authority to restrict banks' capital distributions to common equity shareholders when banks' risk management and other practices were found to be so deficient as to render the capital plans they are required to submit annually not credible. The desire on the part of banks' boards and senior management teams to avoid both the restrictions on capital distributions and the public disclosure of deficiencies that led to the restrictions proved extremely powerful and was instrumental in making the system safer by promoting better risk management and capital planning practices, as the Fed itself has trumpeted.[12] The Fed was never under any obligation to object to capital distributions on qualitative grounds; it simply had the authority to do so, which, along with an exhibited willingness to use it (albeit sparingly), was all that was needed to get the attention of bank management and directors. By eliminating that option, the Fed has tied its own hands for no apparent reason other than to appease the largest banks, which for many years since the crisis have been pushing back on this more assertive supervisory approach (providing ample proof of how effective this was as a supervisory tool).

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[10] *See*, Better Markets *In Delivering a Speech That Could Have Been Written by Wall Street's Biggest Banks, the Fed's Vice Chair for Supervision Fails to Mention 2008 Crash or the Fed's Widespread Supervisory Failures in Contributing to It*, (Jan. 17, 2020) *available at*: https://bettermarkets.com/newsroom/delivering-speech-could-have-been-written-wall-streets-biggest-banks-federal-reserve-vice.
See also, Lalita Clozel *Banks Get Kinder, Gentler Treatment Under Trump*, WALL STREET JOURNAL, Dec. 12, 2018, *available at* https://www.wsj.com/articles/banks-get-kinder-gentler-treatment-under-trump-11544638267.

[11] *See,* Tim P. Clark, *Is the Fed in Retreat?,* POLITICO Apr. 9, 2019, *available at* https://www.politico.com/agenda/story/2019/04/09/federal-reserve-stress-tests-banks-000889/

[12] *A New Chapter in Stress Testing,* speech by Vice Chairman for Supervision Randal K. Quarles at the Brookings Institution, Washington, D.C., Nov. 9, 2018, *available at* https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm.

It is telling, we believe, that the Fed's stated desire for greater transparency is, at best, unevenly applied and, at worse, appears to be driven by industry interests rather than the public interest. For example, regarding the qualitative objection, the Fed has made the CCAR program *less* transparent to the public by changing the qualitative assessment process in a way that reduces public disclosure of information about risk management and capital planning weaknesses at specific banks. However, as discussed above, the Fed did the exact opposite regarding the steps to increase modeling transparency in ways that could make the stress test both easier for banks and less effective at promoting resiliency. What is the common theme? The biggest banks lobbied relentlessly for both changes.

Deregulating and Lowering the Standards for Large Banks and Foreign Banking Organizations

In 2019, the Fed issued rules addressing the application of enhanced standards for large U.S. banks and large foreign banking organizations (FBOs) operating in the U.S. Deregulating further than required by Congress through EGRRCPA, the Fed lowered some regulatory requirements for most banks in the $100 billion to $700 billion range, and most significantly for those at the lower end of that range.[13]

Capital-related Changes

The primary impact of those actions on capital standards was on banks with less than $700 billion in total assets. They also weakened requirements that these banks run "company-run stress tests" using the Federal Reserve's "supervisory scenarios", which was a requirement stemming from the Dodd-Frank Act in 2010. The rule significantly scaled back DFA requirements for large banks to run their stress tests, reducing the frequency at which many are now required to run them while eliminating the requirement for others.

These rules also curiously scaled back the annual supervisory stress test for banks between $100 billion to $250 billion of assets, which under the rule are only required to undergo supervisory stress tests every other year. However, there is some inconsistency with the SCB requirement discussed above that the Fed will now have to address since, under the SCB rule, some bank capital requirements are set through annual supervisory stress testing, and banks over $100 billion in assets are subject to the SCB.

The Fed recently released a misguided proposal to address this inconsistency by allowing banks in this group ("Category IV banks") to either use the same stress test results for two years in calculating the SCB or elect to have a new test carried out in the alternate year, which they would only do if it reduces their capital requirement. Given the uncertainty this proposal would create by creating an inconsistent approach to capital standards across large banks and potentially even within this particular group of banks, the Fed needs to rethink this proposal. All banks subject to the Fed's SCB capital requirement should be subject to the same

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[13] The Fed's actions (referred to as the "tailoring rules") created four categories of large banks: Category I firms are any domestic US banking organization designated as a globally systemically important bank ("GSIB"). Category II banking organizations are those with $700 billion or more in total consolidated assets or $75 billion or more in "cross jurisdictional activity," that are not also GSIBs. Category III banking organizations are those with $250 to $700 billion in consolidated assets and to firms with $100 to $250 billion in consolidated assets that also have at least $75 billion in any of the following: (i) nonbank assets; (ii) weighted short-term wholesale funding; or (iii) off-balance sheet exposures. Category IV banking organizations are those with at least $100 billion in total consolidated assets that do not meet any of the thresholds for Categories I, II or III. Foreign banking organizations (FBOs) are never considered category I firms under the Tailoring Rules since they are not domestic US GSIBs, while in general the same asset size classifications and many similar requirements for category II, III and IV also apply to FBOs.

basic stress tests run concurrently and every year using the annually updated "severely adverse" supervisory scenario. [14]

Another weakening of capital standards relates to capital treatment of potential "unrealized losses" from securities held in banks' investment portfolios that are not required to be marked to market.[15] This is important because large unrealized losses were an important feature of the rampant uncertainty about banks' financial soundness that contributed to the financial crisis. To make sure that did not happen again, post-crisis capital rules required large banks to reflect these unrealized gains and losses in capital measures. While GSIBs and other banks bigger than $700 billion will still have to include this, those between $100 billion and $700 billion are now allowed to "opt out" of reflecting unrealized losses in regulatory capital. While this was estimated to have only a small impact at the time of finalizing this rule change, it could become increasingly material under stressful conditions when unrealized losses on securities are most likely to be at their largest.

Finally, in 2018, the Federal Reserve and OCC proposed a revised version of the "enhanced Supplemental Leverage Ratio" requirement (eSLR), which applies only to those banks identified as GSIBs. By way of background, the Supplemental Leverage Ratio (SLR) minimum requirement is 3% and applies to most large U.S. banks. It complements the more traditional Tier 1 Leverage Ratio, which is based on banks' total balance sheet asset size, by also including in the SLR denominator banks' off-balance-sheet exposures and positions. The eSLR uses the same denominator as the SLR and applies a 2% "eSLR buffer" requirement on top of the 3% SLR to GSIBs for a total supplemental leverage ratio requirement of 5%. Currently, the highest GSIB surcharge in the U.S. is 3.5% (JP Morgan Chase).

However, under the 2018 proposal, which has yet to be finalized, the fixed 2% eSLR buffer requirement for every GSIB would be changed to a variable buffer equal to 50% of each bank's risk-based GSIB surcharge. For example, if a GSIB had a risk-based surcharge of 2%, the eSLR buffer would be 1%, a reduction of 50% in the eSLR buffer relative to current requirements. This change would mean in practice that no U.S. GSIB would currently have an eSLR of 2%, and most U.S. GSIBs would have a significantly lower requirement, a dramatic lowering of the capital cushion at the country's largest and most systemically significant banks.

Liquidity-related Changes

Stronger post-crisis liquidity standards have been a critical part of promoting the resilience of the largest banks and making the system safer. The liquidity coverage ratio (LCR), implemented in 2014, was the first truly meaningful quantitative minimum liquidity requirement. The LCR requires large banks to hold enough high-quality liquid assets—such as cash, Treasury securities or other securities that can be quickly turned into cash—to withstand 30 days of substantially increased liquidity outflows such as might occur under stress (as happened in 2008).

The LCR has been a frequent target of industry attacks because it cuts into bank profits by requiring banks to either hold more safe, lower yielding assets or to use more expensive longer-term funding rather than cheaper short-term funds. The Fed's EGRRCPA-related deregulatory rules unnecessarily weakened liquidity

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[14] *Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies, and Savings and Loan Holding Companies, 85 Fed. Reg. 63,222* (Oct. 7, 2020). *See* Better Markets' Comment Letter on Amendments to Capital Planning and Stress Testing Requirements (Nov. 20, 2020), *available at* https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20on%20Amendments%20to%20Capital%20Planning%20and%20Stress%20Testing%20Requirements%2011-20-2020.pdf.

[15] Press Release, *Federal Reserve Board finalizes rules that tailor its regulations for domestic and foreign banks to more closely match their risk profiles* (Oct. 10, 2019) *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191010a.htm

requirements for banks with less than $700 billion in total assets.[16] In addition, for some time, the Fed had been expected to implement strong quantitative liquidity standards to cover liquidity risks at U.S. branches of large FBOs—which proved to be a major source of liquidity vulnerability during the 2008 financial crisis and borrowed huge amounts from the Fed discount window. But in implementing this rule, it made clear it was declining to do so.[17]

When the Fed implemented the LCR requirement for large domestic banks in 2014, it signaled an intent to apply an LCR requirement to the combined U.S. operations of the largest FBOs.[18] However, in implementing EGRRCPA, the Fed carved out U.S. branches of FBOs from explicit quantitative regulatory requirements; thus, the LCR applies only to large FBO-owned U.S. holding companies.

Weakening Resolution Planning

In 2019, the Fed and FDIC revised resolution planning ("living wills") rules and weakened the resolution planning regime by requiring less frequent plans from some large banks and eliminating the requirement entirely for others. These changes were inconsistent with the spirit and intent of the Dodd-Frank Act, which placed a strong emphasis on the importance of the largest banks taking actions that are meant to make them better prepared to be resolved in a non-disruptive manner.[19] Given the critical importance of making large banks more resolvable, the loss of momentum of the resolution planning regime is a considerable and dangerous setback. Rather than scaling back the frequency of required resolution plans, the agencies should have strengthened the standards by, for example, putting in place clear rules governing elements of the plans, including for liquidity needs in resolution and simplifying banks' structures for key legal entities to allow them to be more easily broken apart and wound down.

These changes have weakened one of the core reforms to address the too-big-to-fail problem and to reduce the chance large banks could again require massive taxpayer-funded bailouts:

- **GSIBs** are now only required to prepare and file a complete resolution plan ***once every four years***, with the plans they must submit every two years alternating between 'targeted plans' (focused on certain key areas and areas where there have been major changes) and full-scope plans. While it remains to be seen how this will be implemented, the risk that arises when a bank only has to file a complete resolution plan every four years is significant. For example, depending on the cycle, Lehman Brothers in 2008 might have had a complete resolution plan that was as old as 2004, i.e., largely irrelevant to the circumstances it faced in 2008.

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[16] In a statement accompanying her vote against this rule, Federal Reserve Governor Lael Brainard estimated the loss of liquidity at the time of implementing the rule from the reduction or elimination of LCR requirements for category III and IV firms, respectively, at roughly $200 billion. Press Release, *Statement by Governor Lael Brainard* (Oct. 10, 2019) *available at* https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20191010.htm

[17] Liquidity requirements under these rules are as follows -- Category I and II banks: all liquidity requirements (LCR and Proposed NSFR) remain at 100%. Category III banks: for banks in this class with less than $75 billion of weighted short-term wholesale funding (WSTWF), the LCR and NSFR requirements were reduced to 85%; for those with greater than $75 billion of WSTWF these requirements remain in place at 100%. Category IV banks: for category IV banks with less than $50 billion of WSTWF, the LCR requirement was eliminated and there is no NSFR requirement. For category IV banks with greater than $50 of STWF, 70% of the full LCR requirement applies on a monthly basis and there is no NSFR requirement.

[18] Press Release, *Statement by Governor Lael Brainard* (Oct. 10, 2019) *available at* https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20191010.htm

[19] Better Markets Comment Letter on Resolution Plans Required (June 21, 2019) *available at* https://bettermarkets.com/sites/default/files/Better%20Markets%20CL%20FRS%20FDIC%20Resolution%20Planning%206-21-2019.pdf

- **Banks with assets greater than $250 billion that are not GSIBs** are now only required to file a full resolution plan ***every six years***, alternating between full and targeted plans every three years. While these huge banks are often not as complex as some of the GSIBs, there could still be tremendous challenges associated with resolving a bank of this size. Most importantly, the slim possibility of a non-disruptive resolution of such a bank is further reduced by weakening the requirement for periodic development of up-to-date resolution plans.
- **Banks with between $100 – $250 billion in assets** are no longer subject to resolution planning requirements at all. This is a mistake and should be rectified. There are substantial challenges associated with resolving banks of this size that could be addressed at least in part through a more effective resolution planning process.

Eliminating Initial Margin on Interaffilitate Swaps[20]

In 2020, the Fed and four other agencies finalized new regulatory exemptions that eliminate initial margin requirements on qualifying transactions between banks and their derivatives-dealing affiliates. These actions run directly counter to the DFA requirement that there be initial margin on "all" such derivatives transactions[21] and removed key credit-risk protections for the U.S.'s too-big-to-fail depository institutions. The result is that those gigantic banks, their depositors, and the U.S. taxpayers are vulnerable to potential losses from unregulated and less regulated derivatives transactions between foreign affiliates of U.S. banks and their foreign counterparties.[22] In addition, the new exemptions invite legal-entity structuring and cross-border booking gimmicks that permit the largest derivatives dealers to avoid or evade U.S. derivatives markets reforms.[23]

These deregulatory actions substantially reduce the amount of collateral protecting U.S. banks from the derivatives risks of their affiliated derivatives dealers. The most recent survey published by the derivatives dealers' primary trade association, the International Swaps and Derivatives Association ("ISDA"), found that the 20 largest dealers alone posted at least $44 billion in inter-affiliate initial margin as of year-end 2019. That represents about 42% of all regulatory initial margin.[24] Thus, these little noticed exemptions reduce regulatory initial margin by more than 40% across the largest derivatives dealers, the top four of which are the largest Wall Street banks that represent 87% of all derivatives in the U.S. banking system.[25]

[20] See Better Markets Comment Letter on Capital Requirements of Swap Dealers and Major Swap Participants (Mar. 3, 2019) *available at* https://bettermarkets.com/sites/default/files/Better_Markets_Inc._Comment_Letter_on_Capital_Requirements_for_Swap_Dealers_and_Major_Swap_Participants_RIN_3038-AD54_%28March_3_2020%29.pdf.
[21] *See* 7 U.S.C. § 6s(e)(2)(A)(ii); 15 U.S.C. § 78o–10(e)(2)(A)(ii).
[22] *See Press Release, Statement by Governor Brainard* (June. 25, 2020) *available at* https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200625c.htm
[23] *See Press Release, Statement by Governor Brainard* (June. 25, 2020) *available at* https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200625c.htm
[24] *See* ISDA, Research Study: ISDA Margin Survey Year-End 2019, at 1, 11 (April 2020), *available at* https://www.isda.org/a/1F7TE/ISDA-Margin-Survey-Year-end-2019.pdf.
[25] *See also* Statement of Martin J. Gruenberg on Notice of Proposed Rulemaking: Swap Margin Requirements, Sept. 17, 2019, *available at* https://www.fdic.gov/news/speeches/spsep1719.pdf and Statement of Martin J. Gruenberg on Final Rule: Margin and Capital Requirements for Covered Swap Entities, June 25, 2020, *available at* https://www.fdic.gov/news/speeches/spjun2520c.pdf.

Weakening the Volcker Rule's Prohibition on Proprietary Trading[26]

The "Volcker Rule" was enacted to stop taxpayer-backed banks from engaging in high-risk, speculative, proprietary trading ("prop trading") that essentially amounts to little more than gambling.[27] The Volcker Rule prohibits both direct inside-the-bank proprietary trading as well as indirect outside-the-bank proprietary trading through investments in risky ventures, including hedge funds and similar types of private funds.

Under the initial Volcker Rule regulatory framework, banks were required to adopt compliance and controls frameworks to reasonably ensure and demonstrate that they were engaging solely in "permitted" activities—like market-making, underwriting, and risk-mitigating hedging—as opposed to prohibited proprietary trading. Thus, in addition to reducing, if not eliminating, proprietary trading risks across the U.S. banking system, the Volcker Rule has enhanced oversight of trading activities by banks' senior management and regulators. The result has been increased discipline with respect to bank risk taking and risk measurement, improved identification and monitoring of banks' trading positions, and enhanced risk controls and governance. In short, the Volcker Rule has made the U.S.'s largest too-big-to-fail trading banks more resilient.

The Volcker Rule has been under attack by banks since it was first proposed during the Dodd-Frank legislative process. That is not a surprise given that the ban on proprietary trading is a direct threat to the outsized bonuses that executives at Wall Street's biggest banks have come to expect. That opposition has continued and been successful during the Trump administration in the agency rulemaking processes. The result has been regulatory rollbacks of key provisions of the Volcker Rule.[28] In the last 12 months, the Fed and other regulators have enacted hundreds of pages of revisions, exceptions, exclusions, and definitional loopholes that all but eliminate meaningful oversight of bank internal prop trading and investment activities.[29] These revisions

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[26] *See* Better Markets Comment Letter on Proprietary Trading and Certain Interests in and Relationships With Covered Funds (Sep. 21, 2017) *available at* https://bettermarkets.com/sites/default/files/OCC%20-%20CL%20-%20Volcker%20Rule%20-%209-21-17.pdf, Better Markets Comment Letter on Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Oct, 17, 2018) *available at* https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20on%20New%20Volcker%20Rule%20Proposal.pdf, and Better Markets Comment Letter on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (Apr. 1, 2020) *available at* https://bettermarkets.com/sites/default/files/Better_Markets_Inc._Comment_Letter_on_Prohibitions_and_Restrictions_on_Proprietary_Trading_and_Certain_Interests_in_and_Relationships_With_Hedge_Funds_and_Private_Equity_Funds.pdf

[27] See, e.g., Better Markets Comment Letter on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (Feb. 13, 2012), *available at*: https://bettermarkets.com/sites/default/files/documents/SEC-%20CL-%20Volcker%20Rule-%202-13-12_1.pdf and Better Markets Comment Letter on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (Apr. 16, 2012) *available at* https://bettermarkets.com/sites/default/files/documents/CL%20CFTC%20FINAL%20Volcker%20Rule%204-16-12.pdf.

[28] See, e.g., Jesse Hamilton *Banks Get Easier Volcker Rule and $40 Billion Break on Swaps*, BLOOMBERG, June 25, 2020, *available at* https://www.bloomberg.com/news/articles/2020-06-25/banks-get-easier-volcker-rule-and-40-billion-reprieve-on-swaps?sref=mQvUqJZj

[29] *See, e.g.,* Better Markets Comment Letter on Proprietary Trading and Certain Interests in and Relationships With Covered Funds (Sep. 21, 2017) *available at* https://bettermarkets.com/sites/default/files/OCC%20-%20CL%20-%20Volcker%20Rule%20-%209-21-17.pdf, Better Markets Comment Letter on Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Oct, 17, 2018) *available at* https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20on%20New%20Volcker%20Rule%20Proposal.pdf, and Better Markets Comment Letter on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (Apr. 1, 2020) *available at*

have the effect of making the Volcker Rule largely unenforceable, creating unprecedented "presumptions of compliance" with permitted activities restrictions (e.g., market-making limitations) and eliminating previously required documentation and analyses necessary to effectively supervise bank hedging practices. They also roll back some of the restrictions and limitations on too-big-to-fail Wall Street banks' investments in hedge funds and similar trading vehicles. These rollbacks threaten to resurrect the trading culture and risky practices that brought the U.S. financial system to the brink of collapse just 12 years ago.

Conclusion

The substantial deregulation of large U.S. banks and foreign banking organizations described herein has paved the way for a significantly less resilient banking system, rolling back the still-unfinished progress in critical areas that had been made since the global financial crisis. While the weakening of rules on its own has undermined the financial resiliency that was built up over a number of years, when this is combined with a change to a more accommodating, bank-friendly supervisory oversight of the large banks, the potential for damage is substantially amplified.

While it is accurate that the deregulatory actions have had the largest impact for non-GSIB large banks, the weakening has been material even for the very largest. Along with the "kinder, gentler" approach to supervision that has reportedly emerged over the past few years,[30] these changes have significantly reduced the confidence American taxpayers should be able to have that these massive banks will not again precipitate a crisis or exacerbate a downturn, causing tremendous damage to the economy, hurting millions of people, and requiring another taxpayer-supported rescue.

December 3, 2020

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https://bettermarkets.com/sites/default/files/Better_Markets_Inc._Comment_Letter_on_Prohibitions_and_Restrictions_on_Proprietary_Trading_and_Certain_Interests_in_and_Relationships_With_Hedge_Funds_and_Private_Equity_Funds.pdf.

[30] Lalita Clozel *Banks Get Kinder, Gentler Treatment Under Trump*, WALL STREET JOURNAL, Dec. 12, 2018, *available at* https://www.wsj.com/articles/banks-get-kinder-gentler-treatment-under-trump-11544638267.

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