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United States Senate

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

WASHINGTON, DC 20510-6075

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Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Dear Governors:

As you know, systemic vulnerabilities like excessive leverage exacerbated the recent financial crisis, and many financial institutions did not have sufficient capital to withstand the economic shock. In fact, the quality of capital at large U.S. commercial bank holding companies declined leading up to the financial crisis.¹ Former Federal Reserve Chair Bernanke noted in testimony to the Financial Crisis Inquiry Commission that, “in the crisis, true loss-absorbing capital was often much lower than accounting measures suggested.”² As a result of the excessive borrowing and lack of loss-absorbing capital, American taxpayers were left to bail out the biggest banks in what was the most severe financial crisis in generations.

Since then, regulators have gained an invaluable mechanism to address these risks to the financial system before an economic crisis ensues. In October 2016, the Federal Reserve Board of Governors (Fed) issued their final policy statement implementing the Basel III Countercyclical Capital Buffer (CCyB). In the policy statement, the Fed outlined how the CCyB, a supplemental, macroprudential tool, could be used to “increase the resilience of large banking organizations when the Board sees an elevated risk of above-normal losses” by increasing it during periods when systemic risk is increasing and reducing it as risks decline, “moderating fluctuations in the supply of credit over time.”³ In other words, the CCyB is designed precisely to require banks to increase capital during economic expansions so they are better positioned to provide credit and liquidity during economic contractions.

The Fed last considered the CCyB’s requirements in December 2017 and, at that time, voted to leave it at zero percent.⁴ According to the Fed, “circumstances in which the Board would most likely use the

¹ Chairman Ben S. Bernanke. “Causes of the Recent Financial and Economic Crisis.” Testimony before the FCIC, September 2, 2010. Available at: <https://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm>.

² *Id.*

³ Federal Reserve Board of Governors, “Regulatory Capital Rules: The Federal Reserve Board’s Framework for implementing the U.S. Basel III Countercyclical Capital Buffer.” *Press Release*, September 8, 2016. Available at: <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908b1.pdf>.

⁴ Federal Reserve Board of Governors, “Federal Reserve Board announces it has voted to affirm Countercyclical Capital Buffer (CCy) at current level of 0 percent.” *Press Release*, December 1, 2017. Available at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171201a.htm>.

CCyB (...) would be to address circumstances when systemic vulnerabilities are somewhat above normal.”⁵ Under the policy statement, the Board will consider a number of financial system vulnerabilities, including asset valuation pressures and risk appetite and leverage in the nonfinancial sector.⁶

These systemic vulnerabilities are becoming more apparent. At a time when the largest banks in the U.S. are reporting record profits⁷—more than \$100 billion in annual profits—now is precisely the time to require additional capital buffers that large banks could draw upon to mitigate a large adverse financial shock.⁸

Recently, former Federal Reserve Chair Yellen urged “the Federal Reserve Board to carefully consider raising the CCyB at this time.”⁹ She noted elevated asset valuations in the real estate sector, the large volume of leveraged lending with a significant weakening of underwriting standards, and the high debt burdens of nonfinancial companies as threats to economic stability during the next downturn.

These concerns are justified. Fed researchers last October noted that banking supervisors have observed material loosening of terms and weaknesses in risk management of the leveraged loan market, which reached a record of \$1.3 trillion in loans outstanding last year—more than double just six years ago.¹⁰ The Fed’s latest Monetary Policy Report also noted elevated asset valuations and borrowing among highly-levered and lower-rated businesses in the private nonfinancial sector.¹¹

Credit rating agency Moody’s Investor Service explained that weak lending practices and increased lending to lower quality corporate borrowers “are creating credit risks that portend an extended and meaningful default cycle once the current expansion ends”.¹² Moody’s envisions more defaults than the last downturn and lower recoveries.

In addition, other Fed officials, including Federal Reserve Board Governor Brainard, Cleveland Federal Reserve Bank President Loretta Mester, Boston Federal Reserve Bank President Eric Rosengren, and Minneapolis Federal Reserve Bank President Neel Kashkari have advocated for

⁵ Federal Reserve Board of Governors, “Regulatory Capital Rules: The Federal Reserve Board’s Framework for implementing the U.S. Basel III Countercyclical Capital Buffer.” *Press Release*, September 8, 2016. Available at: <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908b1.pdf>.

⁶ *Id.*

⁷ Levitt, Hannah and Max Abelson. “It’s Official: Wall Street Topped \$100 Billion in Profit.” *Bloomberg*, January 16, 2019. Available at: <https://www.bloomberg.com/news/articles/2019-01-16/it-s-official-wall-street-just-made-100-billion-for-first-time>.

⁸ Rosengren, Eric S. “Monetary, Fiscal and Financial Stability Policy Tools: Are We Equipped for the Next Recession.” *Tenth Conference of the International Research Forum on Monetary Policy*, March 23, 2018. Available at: <https://www.bostonfed.org/news-and-events/speeches/2018/monetary-fiscal-and-financial-stability-policy-tools.aspx>; and Brainard, Lael. “Safeguarding Financial Resilience Through the Cycle.” *Speech at the Global Finance Forum*, Washington, D.C. April 19, 2018. Available at: <https://www.federalreserve.gov/newsevents/speech/brainard20180419a.htm>.

⁹ Yellen, Janet L. “Seven Questions for Janet Yellen on Financial Stability.” *Brookings Institution Up Front Blog*. Available at: <https://www.brookings.edu/blog/up-front/2019/01/03/seven-questions-for-janet-yellen-on-financial-stability>.

¹⁰ Vermilyea, Todd. “Perspectives on Leveraged Lending.” *Loan Syndications and Trading Association 23rd Annual Conference*, October 24, 2018. Available at: https://cdn.ymaws.com/www.iib.org/resource/resmgr/weekly_bulletin/10-24fedspeech_leveraged_len.pdf.

¹¹ Federal Reserve Board of Governors, *Monetary Policy Report* (July 13, 2018). Available at: <https://www.federalreserve.gov/monetarypolicy/2018-07-mpr-summary.htm>.

¹² Moody’s Investors Service, *Convergence of Bonds and Loans Sets Stage for Worse Recoveries in the Next Downturn* (August 16, 2018); Chappatta, Brian. “Leveraged-Loan Lovefest Will End in Heartbreak.” *Bloomberg*, August 22, 2018. Available at: <https://www.bloomberg.com/opinion/articles/2018-08-22/leveraged-loan-lovefest-will-end-in-heartbreak>.

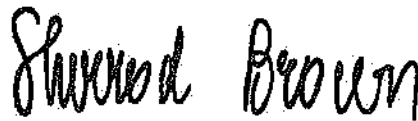
the Fed to activate the CCyB.¹³ Former Council of Economic Advisers Chair Jason Furman has also supported using the CCyB.¹⁴

While capital quality and levels have increased since the crisis, capital levels are below the optimal amount needed to insulate American taxpayers from future bailouts.¹⁵ A comprehensive examination by Fed economists found that current Basel capital surcharges for GSIBs are less than half the size than would be economically justified by an “expected impact” framework based on the economic effect of large bank failure.¹⁶ The same study also suggests that U.S. large bank surcharges currently set by the Federal Reserve, while larger than the Basel surcharges, are likely still considerably lower than the economically optimal level.¹⁷ Instead of increasing capital, it appears the Fed is heading in the wrong direction as it has started to take steps to *reduce* certain capital requirements.¹⁸

Vice Chair Quarles, in response to a question for the hearing record four months ago argued against the use of the CCyB stating, “The financial system is substantially stronger than at similar points in previous cycles (...) I believe that the financial system is quite resilient, with the institutions at the core of the system well capitalized and less risky.”

We have heard that before. Financial crises are caused by excessive optimism on the part of bankers and their watchdogs when times are good. We cannot repeat the mistakes of the recent past. In light of the current market conditions and emerging risks that are indicators of increasing systemic vulnerabilities, the Board should use all of its prudential authorities, including the CCyB, to strengthen the resiliency of our financial system and protect working families from the next economic downturn.

Sincerely,



Sherrod Brown
Ranking Member

¹³ Brainard, *supra* note 8; Rosengren, *supra* note 8; Mester, Loretta, “Interview with Cleveland Fed’s Loretta Mester, *Wall Street Journal*, July 13, 2018. Available at <https://www.wsj.com/articles/transcript-wsj-interview-with-cleveland-feds-loretta-mester-1531502473>; Kashkari, Neel (neelkashkari). “Endorse. ‘It’s high time for the Fed to raise countercyclical capital-buffer rates, writes @jasonfurman <https://www.wsj.com/articles/the-fed-should-raise-rates-but-not-the-ones-youre-thinking-1534803795>.” August 21, 2018, 5:33 AM. Tweet. Available at <https://twitter.com/neelkashkari/status/1031882045423853569?lang=en>.

¹⁴ Furman, Jason. “The Fed Should Raise Rates, but Not the Ones You’re Thinking.” *Wall Street Journal*, Aug. 20, 2018. Available at: <https://www.wsj.com/articles/the-fed-should-raise-rates-but-not-the-ones-youre-thinking-1534803795>.

¹⁵ Weigand, Robert A. “The Performance and Risk of Banks in the U.S., Europe and Japan Post-Financial Crisis.” *Investment Management and Financial Innovations* 13(4). Available at: https://businessperspectives.org/images/pdf/applications/publishing/templates/article/assets/7969/imfi_en_2016_04_Weigand.pdf.

¹⁶ Passmore, Wayne and Alexander H. von Hafften. “Are Basel’s Capital Surcharges for Global Systemically Important Banks Too Small?” *FEDS Notes*, February 27, 2017. Available at: <https://www.federalreserve.gov/econresdata/notes/feds-notes/2017/are-basels-capital-surcharges-for-global-systemically-important-banks-too-small-20170223.html#f4>.

¹⁷ *Id.*

¹⁸ Board of Governors of the Federal Reserve System. “Federal Reserve Board seeks comment on proposal to simplify its capital rules for large banks while preserving strong capital levels that would maintain their ability to lend under stressful conditions.” *Press release*, April 10, 2018. Available at: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm>.