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United States Senate

WASHINGTON, DC 20510

March 18, 2011

The Honorable Timothy F. Geithner
Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Benjamin S. Bernanke
Chairman
Board of Governors of the Federal Reserve
20th and Constitution Avenue, N.W.
Washington, D.C. 20001

Mr. William C. Dudley
President and Chief Executive Officer
Federal Reserve Bank of New York
33 Liberty Street
New York, N.Y. 10045

Dear Secretary Geithner, Chairman Bernanke, and Mr. Dudley,

As the Chairman of the Subcommittee on Financial Institutions and Consumer Protection of the Senate Committee on Banking, Housing, and Urban Affairs, I am concerned that the new round of so-called "stress tests" seems to be paving the way for the largest banks that received assistance through the Troubled Asset Relief Program (TARP) to resume paying higher dividends.

Higher dividend payouts are of course good news for shareholders, but they create a risk that taxpayers' investment in these financial institutions will be squandered. Experts are questioning the prudence of this decision: Professor Anat Admati was recently joined in opposition by 15 other top professors in the field. They point out that every dollar that is paid out in dividends is a dollar that is unavailable to creditors. This increases the shockwaves to the economy in the event of a failure. The increasing size of the largest U.S. banks – the top 10 banks now hold 77 percent of all U.S. bank assets – and the lack of any meaningful cross-border resolution mechanism for complex, international institutions creates substantial risk for taxpayers through another round of bailouts.

As the largest holders of bank stocks, some Wall Street executives would profit quite handsomely – some as much as $6 million according to an article in yesterday's *New York Times*. However, we need to preserve our long-term economic stability and protect United States

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taxpayers. Every dollar paid out in dividends is also a dollar of capital that is not available to support lending to consumers or small businesses. Our economy is still fragile as a result of dragging residential and commercial real estate values, climbing commodity prices, and instability in the Middle East and Asia. It is not clear whether our financial sector has stabilized, and further underscoring the risks involved in allowing banks to issue higher dividends at this time.

In light of these concerns, and now that you have completed the stress tests and approved some dividends, I would like to know:

1. *Will you make available to the public the details, methodology, and institution-by-institution results of the stress tests?*

   One of the greatest benefits of the first stress tests was their transparency. That reduced uncertainty and helped restore confidence in the market. They also resulted in banks raising $125 billion in new equity. The European bank stress tests have been criticized for lacking transparency and credibility. Since those tests, there have been challenges for Irish and other European banks. There is no reason for the public stress tests of 2009 to be followed by concealed results in 2011. These latest stress tests being conducted by the Federal Reserve should parallel the successful model of the first round of tests, not the failed European model.

2. *Why, in this time of economic uncertainty, is it necessary for the largest TARP recipients to issue dividends, when those institutions are most prone to moral hazard?*

   Federal Reserve Bank of Boston President Eric Rosengren has argued that regulators should take a more proactive approach to capital retention through reduced dividends. Admati and her colleagues have observed that the easiest way for banks to raise equity is to retain their earnings. Allowing banks to resume dividend payments only after they are clearly capitalized to withstand any potential shocks is sound financial and fiscal policy.

3. *If the international community is moving toward increased capital requirements under the Basel III framework, shouldn't the United States do the same?*

   Many of our international competitors are moving toward higher capital rules. A study by the Bank for International Settlements suggests an optimal capital ratio of about 13 percent. A government-sponsored panel in Switzerland has said that massive banks UBS and Credit Suisse should hold a 19 percent capital buffer. The Bank of England is reportedly considering capital ratios as high as 20 percent. We would be wise to follow their lead.

4. *What capital requirements will you apply to Systemically Important Financial Institutions under the Dodd-Frank Act?*

   There is growing consensus around the need for increased capital at the largest banks. In December, Kansas City Federal Reserve President Thomas Hoenig argued in the *New York Times* that reducing the scope and size of banks, combined with statutory debt-to-equity

requirements, would "restore the integrity of the financial system and enhance equity of access to credit for consumers and businesses."

While the New York Fed has released a working paper arguing that increased capital requirements will reduce economic output, many experts disagree with their findings. David Scharfstein and Jeremy Stein of Harvard University argued in September that increased capital will make institutions safer, and actually reduce the risk of a credit crunch. Economists from Gene Fama and Allan Meltzer, to Joseph Stiglitz, are arguing for higher capital requirements. In his recent testimony before the Congressional Oversight Panel of TARP, Professor Meltzer noted that large banks in the 1920s held capital equal to 15 to 20 percent of their assets.

The range of experts engaged on this issue demonstrates that it is not one of politics or partisanship. It is an issue of financial safety and fiscal soundness.

Thank you for your attention to this important matter, and I would appreciate your prompt response to my questions.

Sincerely,

Sherrod Brown
United States Senator