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United States Senate

WASHINGTON, DC 20510

June 1, 2011

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

Dear Chairman Bernanke,

Thank you for your thoughtful responses to my questions regarding the Comprehensive Capital Analysis and Review (CCAR). I found the information provided in your responses helpful, however, some of your answers raised the following questions that I believe require further elaboration:

1) *Why did you purposefully design an opaque test?*

You note that the CCAR was not designed to disclose firm-specific evidence. This is unfortunate. As you stated last year, "more information about the status of both individual banks and of the banking system as a whole should be confidence-enhancing."[1] The Government Accountability Office (GAO) noted that, "the lack of transparency about potential losses from certain assets contributed significantly to the instability in financial markets during the [global financial] crisis."[2] As you have acknowledged, the Supervisory Capital Assessment Program (SCAP) and its transparency, "helped restore confidence in the banking system and broader financial system, thereby contributing to the economy's recovery."[3] The GAO has agreed that, "publicly releasing the methodology and results of the stress test helped strengthen market confidence."[4]

Some of the assertions contained in your letter require Congress and the public to simply trust your judgment over conflicting indicators. For example, you state that banks are "better positioned to withstand unanticipated stresses." Your conclusion appears to conflict with a January report by Standard & Poor's (S&P) that "banks' capital adequacy remains neutral to negative for our ratings on the large U.S. banks."[5] In its recent report on the fiscal outlook for the United States, S&P stated that "the risks from the U.S. financial sector are higher than we considered them to be before 2008," and that "fiscal cost to the U.S. government on

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[1] Ben S. Bernanke, "The Supervisory Capital Assessment Program—One Year Later," speech delivered at the Federal Reserve Bank of Chicago 2010 46th Annual Conference on Bank Structure and Competition (May 6, 2010).
[2] GAO, *Troubled Asset Relief Program: Bank Stress Test Offers Lessons as Regulators Take Further Actions to Strengthen Supervisory Oversight*, GAO-10-861 (Sept. 29, 2010) *at* 13.
[3] Bernanke, *supra*.
[4] GAO, *supra*.
[5] Heather Landy, *Banks Have More Capital; How Much Is Enough, and by What Measure?*, Am. Banker, Feb. 15, 2011.

resolving potential financial sector asset impairment in a stress scenario at 34% of GDP compared with [S&P's] estimate of 26% in 2007."[6] This appears to conflict with your assessment and, in the absence of greater disclosure, it is impossible to compare the two.

Greater transparency also improves bank oversight and supervision. As Federal Reserve Governor Daniel Tarullo has said, "the release of details about assumptions, methods, and conclusions would expose the supervisory approach to greater outside scrutiny and discussion." Such scrutiny and discussion is appropriate in light of the numerous regulatory failures that led to the financial crisis.

2) *Do you believe that efficient markets require transparency?*

Greater disclosure improves market behavior, enhances market stability, and increases market confidence. According to Governor Tarullo, "market discipline … will be most effective if market participants have adequate information with which to make informed judgments about the banks."[7] As I noted in my initial letter, the recent experience in Europe has shown that less than fully transparent stress tests are not helpful, and may even worsen market confidence. Giving the market more information will allow market signals to be more informative, enabling the market, consumers, and policymakers to better discern the strength and stability of these banks.

Regulators can also learn valuable information from the market's reaction to information. For example, your letter notes that CCAR was designed to measure firms' ability to manage capital and risk, and ensure thorough and robust processes for managing their capital resources. Information concerning banks' risk management is essential to the market given the overwhelming evidence that banks incorrectly measured their risk exposures prior to the financial crisis. Indeed, the GAO concluded that SCAP shed light on areas for further improvement in the regulators' supervision processes, including oversight of banks' risk management practices.[8]

The GAO found that SCAP loss estimates varied significantly by institution.[9] One of the largest U.S. banks was denied the ability to issue a dividend, while another was allowed to issue a nominal dividend of $0.01. One presumes that this is due to projected mortgage losses, but it is impossible to know the nature and extent of these projected losses. In written responses to my questions from a Senate Committee on Banking, Housing, and Urban Affairs hearing in December, Governor Tarullo noted that current loss estimates stemming from second lien writedowns and investor put-back suits have varied widely between market analysts and banking supervisors. Letting market participants evaluate the CCAR data to determine each institution's exposure and assess their financial position will greatly eliminate this uncertainty.

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[6] Standard & Poor's, *Research Update: United States of America 'AAA/A-1+' Rating Affirmed; Outlook Revised To Negative*, Apr. 18, 2011 *at* 4-5.
[7] Daniel K. Tarullo, "Lessons from the Crisis Stress Tests," speech delivered at the Federal Reserve Board 2010 International Research Forum on Monetary Policy (Mar. 26, 2010).
[8] *See* GAO, *supra*, at 40, 48-49.
[9] *See id.*, at 29.

3) *What steps has the Federal Reserve taken to address existing and potential market distortions created by undercapitalized banks?*

You note that capital formation is an important part of well-functioning private capital markets, and I agree. Returning capital to investors is not something with which supervisors should interfere. But when banks are dangerous for the economy, it is critical to do so.

In most industries, dividends are payouts to one class of investors, equity holders, at the potential future expense of another, debt holders. The banking industry is exceptional in that taxpayers have become investors, protecting debt and equity holders. Requiring banks to enhance their funding through equity would ensure that this never happens again. Doing otherwise provides a market-distorting subsidy inhibiting the functioning of healthy market mechanisms that allocate scarce resources, including talent.

4) *Are U.S. banks compliant with Basel III?*

Federal Reserve Bank of Kansas City President Thomas Hoenig has previously noted that the 20 largest financial institutions hold an average 3.5 percent equity capital, as compared to an equity capital ratio of 6 percent held by the second tier of institutions.[10] In response to my previous letter, Treasury Undersecretary Jeffery Goldstein states that the 19 bank holding companies held 9.4 percent Tier One Common Capital in the Fourth Quarter of 2010. We do not know whether all 19 banks currently meet all of the Basel III standards. We do know that, in the wake of the SCAP, banks' Tier One Common Capital varied widely from 4.85 percent to 15.59 percent.[11]

You say that there is a plan to make U.S. banks compliant with the Basel III requirement that they hold 7 percent common equity and 8.5 percent Tier One Capital. If all of the banks currently meet the standard, it seems that the easiest way to ensure that they will remain at this level is for them to maintain current levels of equity funding. If this continues to be the case, then they are more likely to reach the Basel III benchmarks if they retain their equity and build upon it. In either case, policy considerations – at the present time – weigh in favor of banks retaining their equity rather than paying it out in dividends.

5) *Do you believe that enhanced capital requirements will make U.S. banks less competitive?*

You state that regulators are developing plans whereby banks comply with Basel III to ensure safety and soundness while also remaining internationally competitive. The premise that improving equity funding hampers U.S. banks' competitiveness assumes that holding higher levels of capital is expensive and burdensome. Surely, U.S. banks' ability to compete with foreign institutions does not require that they be undercapitalized.

To be sure, requiring banks to hold more equity will dampen institutions' return on equity and decrease compensation for some executives. As I noted in my letter, the academic near-consensus is that equity is not expensive. In response to written questions pursuant to a February hearing in the Senate Banking Committee, FDIC Chairman Sheila Bair stated, "we

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[10] Thomas M. Hoenig, "Leverage and Debt: The Impact of Today's Choices on Tomorrow", speech delivered to the Kansas Bankers Association 2009 Annual Meeting (Aug. 6, 2009).
[11] *See id.*, at 22-23.

do not agree that the new [capital] requirements will reduce the availability of credit or significantly raise borrowing costs."

When considering the consequences of holding additional equity, it is important to remember the high costs associated with excessive leverage and insufficient capital reserves. What are the costs of increasing banks funding through equity? Does the Federal Reserve have any evidence suggesting that the costs of additional equity funding outweigh the costs associated with undercapitalization at rates below those required by Basel III?

6) *How can you determine that banks are holding adequate capital when the capital requirements that will apply to Systemically Important Financial Institutions (SIFIs) are unknown?*

Dr. Hoenig has said that the Basel III standards "will not prevent the next crisis and will not adequately prepare institutions for the next crisis."[12] Therefore, enhanced capital requirements for SIFIs – which will apply to all of these institutions – are expected and appropriate. Yet you stated in your testimony last week before the Senate Committee on Banking, Housing, and Urban Affairs that you "anticipate putting out a package of proposed rules for comment this summer."[13] Your letter implicitly acknowledges that you do not yet know what capital requirements will apply to SIFIs. Without knowing what these heightened standards will be, it is impossible to say whether banks will meet these requirements.

As you know, the issue of bank capital was front and center during the financial reform debate. Thank you again for your prompt response to my questions, and I appreciate your further attention to this important matter.

Sincerely,

Sherrod Brown

Sherrod Brown
United States Senator

Cc: The Honorable Timothy Geithner, Secretary, United States Department of the Treasury

The Honorable Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System

Mr. William C. Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York

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[12] Steve Matthews, *Hoenig Says Basel Capital Standards Too Weak to Avert Future Bank Crises*, BLOOMBERG, Apr. 12, 2011.

[13] Statement by Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., May 12, 2011.