United States Senate
WASHINGTON, DC 20510

July 28, 2020

The Honorable Jerome H. Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Randal K. Quarles
Vice Chairman for Supervision
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chair Powell and Vice Chair Quarles,

We write regarding the results of the Federal Reserve's (Fed) sensitivity analyses that accompanied the recent bank stress tests. These additional analyses were designed "to assess the resiliency of large banks under three hypothetical recessions, or downside scenarios, which could result from the coronavirus event," and the results were used to inform your decisions regarding banks' capital distributions.[1] We have serious concerns about the Fed's opaque decision-making and its failure to take the necessary steps to keep our banking system stable in light of the coronavirus disease 2019 (COVID-19) pandemic. These concerns are especially disturbing in the context of recent reports that the Fed is urging Congress to give regulators the authority to roll back critical capital requirements that were put in place to keep our financial system stable after the last financial crisis.[2]

When the financial system crashed in 2008, regulators did not have a solid understanding of the extent to which banks were exposed to different types of risks. The stress tests were developed as part of the post-crisis framework to provide regulators with vital information regarding the health of the banking sector and to ensure the sector's resilience to shocks. More specifically, these tests examine how banks perform under various adverse economic scenarios and whether the banks are able to withstand substantial losses, while continuing to provide credit and financial services to support families and small businesses.

The scenarios for this year's tests were announced this February,[3] before the extent of the economic damage associated with COVID-19 became clear. The scenario that was designed to model "severely adverse" economic conditions, for example, included the unemployment rate

[1] Board of Governors of the Federal Reserve System, "Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event," press release, June 25, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm.
[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, https://www.nytimes.com/2020/07/27/business/bank-regulations-rollback-stimulus-bill.html.
[3] Board of Governors of the Federal Reserve System, "Federal Reserve Board releases hypothetical scenarios for its 2020 stress test exercises," press release, February 6, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200206a.htm.

peaking at ten percent and quarterly Gross Domestic Product (GDP) declining by a maximum of 9.9 percent.[4] By comparison, the April 2020 unemployment rate was 14.7 percent and certain estimates show second quarter GDP declining by 35 percent.[5] As a result, it became clear in March that the stress tests would be unable to accurately measure the impact on the banking system of a severely adverse COVID-19 related economic scenario. Moreover, the February stress testing scenario was set to test bank balance sheets as they stood on December 31, 2019.[6] The size, composition, and risk profile of bank balance sheets changed significantly over the following months, as the economic effects of COVID-19 took hold.

To try to capture the effects of COVID-19 on the banking system, the Fed conducted additional "sensitivity analyses" to examine how banks could fare in three forward-looking hypothetical economic scenarios stemming from COVID-19.[7] These analyses and the actions the Fed has taken based on their results are incomplete, insufficient, and lack the transparency and analytical rigor that is necessary to understand and address the risks of this pandemic to financial stability.

The results of the Fed's "W-shaped" recovery scenario, the most severe of the three, painted a deeply concerning picture of the banking system's present ability to absorb potential losses. Under this scenario, the Fed reported that 25 percent of the big banks tested saw their common equity tier 1 (CET1) capital ratios decline below 4.8 percent, dangerously close to the minimum capital requirement of 4.5 percent.[8] But the results are actually more concerning when factoring in the puzzling decision not to account for the capital distributions banks made in the first half of 2020. Accounting for this capital that has already been depleted, "would have resulted in a reduction in aggregate capital ratios of approximately 50 basis points," meaning that on a disaggregated basis, multiple banks likely breached their regulatory minimums under this scenario.

Despite these troubling results, the Fed inexplicably announced that it would not suspend dividend payments. Instead, banks are allowed to continue paying their dividends, albeit at a capped amount calculated by looking backward to banks' previous net income—contradicting the forward-looking purpose of a normal stress test.[9] The failure to take this action is a grave

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[4] Board of Governors of the Federal Reserve System, "Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Results," June 2020, https://www.federalreserve.gov/publications/files/2020-dfast-results-20200625.pdf.
[5] Bureau of Labor Statistics, U.S. Department of Labor, "Unemployment rate rises to record high 14.7 percent in April 2020," May 13, 2020, https://www.bls.gov/opub/ted/2020/unemployment-rate-rises-to-record-high-14-point-7-percent-in-april-2020.htm?view_full; Federal Reserve Bank of Atlanta, GDPNow Estimate, https://www.frbatlanta.org/cqer/research/gdpnow.
[6] Board of Governors of the Federal Reserve System, "The Adaptability of Stress Testing," Vice Chair for Supervsion Randal K. Quarles, June 19, 2020, https://www.federalreserve.gov/newsevents/speech/quarles20200619a.htm.
[7] Board of Governors of the Federal Reserve System, "Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event," press release, June 25, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm.
[8] Board of Governors of the Federal Reserve System, "Assessment of Bank Capital during the Recent Coronavirus Event," June 2020, https://www.federalreserve.gov/publications/files/2020-sensitivity-analysis-20200625.pdf.
[9] Board of Governors of the Federal Reserve System, "Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event," press release, June 25, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm.

error that could have serious consequences for financial stability amidst a severe recession. Banks should be conserving capital to bolster their ability to withstand future losses and to support lending to businesses and households. And as Fed Governor Brainard noted in her dissent, allowing banks to deplete capital "raises the risk they will need to tighten credit or rebuild capital during the recovery."[10]

In fact, if banks breached their regulatory capital minimums in the sensitivity analyses, they should be required to raise additional equity now to mitigate their chance of economically devastating failure later. It is also troubling that the Fed decided to use the results of the February stress testing scenario that is completely incompatible with the current economic reality to set banks' capital requirements for the next year,[11] which will clearly lead to requirements that are lower than appropriate.

However, the issues with the analyses go far beyond the Fed's failure to implement this basic and common-sense step to preserve capital ratios at the largest financial institutions. Unlike the regular stress test results, the COVID-19 analyses did not include any information on how individual banks would fare in each of the scenarios. Instead, only aggregate results were released.[12] Furthermore, the aggregate results only show the impact of the scenarios on banks CET1 capital levels and do not include the impact on bank leverage ratios, measures that do not rely on uncertain risk-weights and that act as a critical safeguard.[13] Former FDIC Chair Sheila Bair and Vice Chair Tom Hoenig noted that even in the regular stress tests, which reflected a more optimistic economic outlook than the one we are currently facing, "some large banks would be operating with thin capital margins."[14]

Transparency is a fundamental pillar of the post-crisis stress tests. It is critical to ensuring public confidence in the banking system and in making sure that policymakers and analysts have access to all the information needed to address the ongoing public health and economic crisis. As former Fed Governor Dan Tarullo, who was largely responsible for designing the stress testing regime, noted, if the results of the analyses are so insufficient that they cannot be released on a bank-by-bank basis, they are also insufficient to inform decisions about banks' capital planning.[15]

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[10] Board of Governors of the Federal Reserve System, "Statement by Governor Brainard," press release, June 25, 2020, https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200625c.htm.

[11] Board of Governors of the Federal Reserve System, "The Adaptability of Stress Testing," Vice Chair for Supervsion Randal K. Quarles, June 19, 2020, https://www.federalreserve.gov/newsevents/speech/quarles20200619a.htm.

[12] New York Times, "Fed Limits Bank Payouts and Suspends Share Buybacks as Pandemic Grinds On," Jeanna Smialek, Peter Eavis, and Kate Kelly, June 25, 2020, https://www.nytimes.com/2020/06/25/business/economy/fed-dividend-buyback-limits.html.

[13] It is important to note that while the Federal Resere Board made the misguided decision to eliminate leverage requirements as post-stress minimums in the stress capital buffer (SCB), it still released bank-by-bank leverage results of this year's stress tests based on the February scenario.

[14] Bloomberg Opinion, "Banks' Risks During the Pandemic Aren't Clear," Sheila Bair and Thomas Hoenig, July 7, 2020, https://www.bloomberg.com/opinion/articles/2020-07-07/fed-s-bank-stress-tests-weren-t-transparent-about-pandemic-risk?sref=S5RPfkRP.

[15] Brookings Institution, "Are we seeing the demise of stress testing?" Daniel K. Tarullo, June 25, 2020, https://www.brookings.edu/blog/up-front/2020/06/25/stress-testing/.

The safety of our financial system is at risk if the Fed uses or draws the wrong conclusions from inadequate analyses, and policymakers and the public deserve full transparency regarding the health of the banking sector. We urge you to reverse the decision to allow banks to continue to pay their dividends, and we ask that you immediately provide the following information to the public by no later than August 11, 2020:

- The estimated changes in all capital ratios, including leverage ratios, for individual banks in each of the different COVID-19 related scenarios—accounting for all projected capital distributions over the planning horizon;
- Whether or not the Fed has identified deficiencies in individual firm's capital planning, including whether their economic outlooks are more optimistic than the realistic scenarios given the current conditions;
- A detailed summary of the Fed's plans to require banks to resubmit their capital plans, the extent of the additional sensitivity analyses or stress tests that will be conducted when those plans are resubmitted, and how the Fed will use the results of the analysis; and
- An explanation as to why banks that breached their regulatory minimums in the sensitivity analyses are not being required to raise additional equity;
- An explanation as to why banks' common equity distributions from the first half of 2020 were not included in the analyses; and
- An explanation as to why post-stress leverage ratios were not included in the analyses.

Sincerely,

Elizabeth Warren
United States Senator

Brian Schatz
United States Senator