The Systemic Risk Council

U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

SUBMITTED VIA FEDEX

October 3, 2018

Re: Jobs Act 3.0 Legislation

Dear Senators Crapo and Brown,

The Systemic Risk Council (SRC) writes to set out its concerns with two sections of the JOBS and Investor Confidence Act of 2018 (JOBS Act 3.0), which passed the U.S. House of Representatives on July 17, 2018 and may be taken up by this Committee.

While the SRC supports the desire to remove unnecessary or disproportionate regulatory burdens and to increase predictability, we strongly believe that this should not be attempted in ways that would deprive the Federal Reserve and other regulators of vital tools to mitigate systemic risk. The SRC's strong recommendation to you and your Senate colleagues is that the sections of the JOBS Act 3.0 that deal with Living Wills and Stress Tests should be dropped or amended in order to ensure that the financial services regulators have the capacity to respond adequately and promptly to systemic threats.

The SRC therefore urges the Committee to amend the JOBS Act 3.0 to preserve such discretion. Our reasons are set out below.

Resolution Planning

Under Title XII of the JOBS Act 3.0, entitled Financial Institution Living Will Improvement, the Federal Reserve (Fed) and the Federal Deposit Insurance Corporation (FDIC) would be prohibited from requiring bank holding companies to submit resolution plans with a greater frequency than once every two years.

This is too rigid. It makes no allowance for the possibility that circumstances might have changed requiring resolution plans to be revisited. Changes in the general environment might

include, for example, amendments to regulatory law, developments in the case law affecting bankruptcies, shifts in the policies and/or law of foreign authorities and courts, and revisions to international policy agreements. Nor does the draft law make allowance for material changes in the business or structure of financial groups, or lessons learned by the regulatory authorities from executing resolutions, observing bankruptcy proceedings, or conducting supervision. If a financial intermediary's failure inflicted costs on the economy that could have been reduced by off-cycle resolution planning, the blame would lie with legislators.

SRC recommends that the Senate either drop this provision or, alternatively, amend the current House version of the statute so as to allow the Fed and FDIC to require and conduct off-cycle resolution planning if warranted by material changes in the firm, market environment, or law, in the U.S. or in foreign jurisdictions. That would provide principled constraints on regulatory discretion, without eliminating it.

Stress Tests

The Dodd-Frank Act established stress testing regimes for bank holding companies, groups designated by FSOC as a systemically important financial institution (SIFI), and certain other financial companies.

The latter must conduct periodic stress tests if they have more than $250 billion in total consolidated assets and are regulated by one of the federal primary financial regulatory agencies.[1] Each primary federal financial regulator is required to establish methodologies and conditions for such company-run stress tests in coordination with the Fed (and with the Federal Insurance Office for companies subject to its jurisdiction). Any financial company required to conduct such stress tests must submit a report concerning its test to both the Fed and its federal primary financial regulator, containing such information as the federal primary financial regulator shall require. JOBS ACT 3.0 would make big changes to that regime.

Specifically, Title XV, entitled Alleviating Stress Test Burdens to Help Investors, would exempt from the company-run stress testing requirement those financial companies that are not primarily regulated by either a federal banking regulator (i.e., the Fed, the OCC, or the FDIC) or the Federal Housing Finance Agency. In practice, this exemption would include broker-dealers, investment advisers, and non-bank swap dealers that meet the $250 billion asset statutory threshold for being a potential SIFI but have not actually been so designated by the FSOC.

---

[1] *See* 12 U.S.C. § 5301(12) (defined to include the Fed, the Office of the Comptroller of the Currency (OCC), the FDIC, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the Federal Housing Finance Agency).

Although Title XV includes a provision permitting the SEC and the CFTC to issue regulations requiring firms to conduct their own periodic analyses of their financial condition under adverse economic conditions, it does not require the agencies to require such analyses. Moreover, even assuming the SEC or CFTC chose to take such a step, under Title XV the Fed would be entirely removed from the process, no longer having any legal right to be consulted on or receive information concerning any such company-run assessment. Title XV accordingly would represent a further broadening of the carve-out from Dodd-Frank Act stress testing introduced by the Crapo Act that passed earlier this year, which raised the total assets threshold from $10 billion to $250 billion.[2]

These proposed changes would materially weaken the regime for supervising the resilience of the U.S. financial system. Stress testing by the regulatory authorities or under their standards and oversight has been the most important and useful initiative in prudential supervision of the financial system as a whole since the Great Financial Crisis. The associated asset-quality reviews increase incentives for management and boards to value assets and exposures prudently, and the forward-looking stress tests force firms to contemplate the possibility of the good times not lasting forever. While these techniques will undoubtedly develop as experience is gained, they have already remedied some of the problems in the pre-crisis regime of supervision, reducing reliance on on-site examination and on firms' own sense of their resilience. Although many firms supervised by the SEC and CFTC did some stress testing in the years before the crisis, those tests did not reveal the firms' fragility, partly because firms do not have strong incentives to uncover their own weaknesses, and partly because they were carried away by easy credit conditions and exuberant asset markets. The permissive power the current version of the JOBS Act gives to the SEC and CFTC to choose whether or not to require regulated firms to conduct stress tests does not reflect the lessons of that failed regime.

The SRC believes that conditions in the economy and financial markets sometimes shift too much or too quickly for the limits proposed by Title XV to be safe or prudent. In consequence, it would be a mistake for Congress to limit in advance the types of firms that are subject to regulatory stress testing, restricting it to banks and government housing agencies. Over several decades, problems in the U.S. financial system have erupted away from the core of the banking system, including in intermediaries and structures under SEC and CFTC regulation. At times, notably during the 2008/09 crisis, the fallout has badly hurt the American economy and people. It would be a mistake, therefore, to deprive regulators of the capacity to require timely and rigorous stress testing by a wide range of intermediaries.

[2] In its Comment letter of February 21, 2018, SRC argued that $250 billion was imprudently high, recommending $100 billion. Letter from the SRC to Senators Michael Crapo and Sherrod Brown (Feb. 21, 2018), https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2018/02/SRC-Comment-Letter-to-US-Senate-2.21.18.pdf.A.

Accordingly, we recommend that the Committee strip Title XV from the JOBS Act 3.0. Failing that, we recommend that the Committee amend Title XV to ensure that the SEC and the CFTC continue to regulate firms' stress tests or conduct their own stress tests to the extent they judge that such tests are warranted by economic or market circumstances. As with our proposal on resolution planning, this would place constraints on the exercise of regulatory discretion.

We also recommend that the Fed, which so far has led the world in this new field, should continue to have a right to be consulted on the stress testing methodologies employed by the other regulators and the firms concerned, and to be involved in assessing the results. In the judgment of the SRC, whose members include past chairs of each major agency, history strongly suggests that the necessary inter-agency cooperation among the various agencies will not occur without legislated provisions.

Conclusion

As the SRC has pointed out previously,[3] whenever the next recession comes, the adverse effects on borrowers and the financial system are likely to be worse than we are used to because the monetary policy arsenal is depleted and the scope for timely fiscal stimulus is likely constrained. Congress therefore should be careful not to make amendments that dilute or remove safeguards against systemic risk that are currently in place. Financial markets are not so polite that distress will hit the United States on a pre-determined statutory timetable or in a pre-specified sector. The SRC accordingly urges Congress to drop Title XII and Title XV of JOBS Act 3.0 in their present forms and to preserve the regulators' critical powers in the areas of resolution planning and stress testing.

Yours sincerely,

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
www.systemicriskcouncil.org

[3] The Systemic Risk Council, Statement to the Finance Ministers, Governors, Chief Financial Regulators, and Legislative Committee Leaders of the G20 Countries (Feb. 27, 2017), *available at* http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2017/02/Systemic-Risk-Council-Policy-Statement-to-G20-Leaders.pdf.

Systemic Risk Council Membership

Chair: Sir Paul Tucker, Fellow, Harvard Kennedy School and Former Deputy Governor of the Bank of England

Chair Emerita: Sheila Bair, Former Chair of the Federal Deposit Insurance Corporation

Senior Advisor: Jean-Claude Trichet, Former President of the European Central Bank

Senior Advisor: Paul Volcker, Former Chair of the Federal Reserve Board

Members:

Brooksley Born, Former Chair of the Commodity Futures Trading Commission

Baroness Sharon Bowles, Former Member of European Parliament and Former Chair of the Parliament's Economic and Monetary Affairs Committee

Bill Bradley, Former U.S. Senator

William Donaldson, Former Chair of the Securities and Exchange Commission

Peter Fisher, Tuck School of Business at Dartmouth, Former Under Secretary of the Treasury for Domestic Finance

Jeremy Grantham, Co-Founder and Chief Investment Strategist, Grantham May Van Otterloo

Richard Herring, The Wharton School, University of Pennsylvania

Simon Johnson, Massachusetts Institute of Technology, Sloan School of Management

Jan Pieter Krahnen, Chair of Corporate Finance at Goethe-Universität in Frankfurt and Director of the Centre for Financial Studies

Sallie Krawcheck, Chair, Ellevate, Former Senior Executive, Citi and Bank of America Wealth Management

Lord John McFall, Former Chair, UK House of Commons Treasury Committee

Ira Millstein, Senior Partner, Weil Gotshal & Manges LLP

Paul O'Neill, Former Chief Executive Officer, Alcoa, Former U.S. Secretary of the Treasury

John Reed, Former Chairman and CEO, Citicorp and Citibank

Alice Rivlin, Brookings Institution, Former Vice-Chair of the Federal Reserve Board

Kurt Schacht, Managing Director, Standards and Advocacy Division, CFA Institute

Chester Spatt, Tepper School of Business, Carnegie Mellon University, Former Chief Economist, Securities and Exchange Commission

Lord Adair Turner, Former Chair of the UK Financial Services Authority and Former Chair of the Financial Stability Board's Standing Committee on Supervisory and Regulatory Cooperation

Nout Wellink, Former President of the Netherlands Central Bank and Former Chair of the Basel Committee on Banking Supervision

* Affiliations are for identification purposes only. SRC members participate as individuals and this statement reflects their own views and not those of the organizations with which they are affiliated.