VI. How the Federal Reserve and Large Financial Institutions Scored in the COVID Stress Test—A Look into Capital Preservation and Stability

A. Introduction

Banks are incentivized to engage in risky behavior while maintaining the lowest amount of capital reserves legally permissible—risky assets are profitable and, in the moment of financial crisis when they are not, banks can rely on government backstops.[1] Because of this, banks do not internalize the risk of systemic economic collapse that their risk-taking contributes to, and the level of risk-taking banks engage in (without regulation) is higher than the optimal level of risk for a society that wants to avoid financial crises.[2] However, banks need leverage to perform an essential role in the nation's economy: creating liquidity by funding illiquid loans (assets) backstopped by liquid assets (capital).[3] Policymakers must balance these conflicting priorities to ensure banks can perform liquidity-creating activities while also not taking on too much risk or maintaining a small capital-asset ratio.[4] In the early to mid-1900s, they combated this problem by requiring banks to hold certain levels of capital (minimum capital

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[1] *See* John Walter, *US Bank Capital Regulation: History and Changes Since the Financial Crisis*, 105 ECON. Q. 1, 3 (2019) (explaining the economic theory as to why policymakers impose minimum capital requirements on banks—left to themselves, banks would hold too little capital and invest in too many risky investments because of government bailouts).

[2] *See id.* at 3 (explaining how "banks hold less capital than is ideal from a societal point of view" because they do not account for systemic risk when deciding how much capital to hold).

[3] *See* Allen N. Berger & Christa H. S. Bouwman, *Bank Liquidity Creation*, 22 REV. FIN. STUD. 3779, 3780 (2009) (accepting as a basic premise the longstanding theory that banks perform a socially positive service, creating liquidity, through transforming liquid assets into illiquid assets and holding, in comparison, few assets).

[4] *See* Walter, *supra* note 1, at 4 ("[P]olicymakers must balance the failure-reduction benefits of higher capital requirements with the cost of reducing valuable maturity transformation and the availability of bank-provided deposit services.").

requirements) because forcing banks to hold more capital reduces systemic risk when demand for liquid assets increases during a crisis.[5]

In the post-2008 Recession landscape, minimum capital requirements have been a major focus of regulation. The minimum capital requirements for banks before the 2008 Recession face special scrutiny because the big banks that teetered on failure had met their minimum capital requirements, had smaller capital-asset ratios than smaller banks, and were highly leveraged.[6] In other words, big banks that took significant amounts of risk could still meet their legal requirements. This is in stark contrast to big banks before the Great Depression, which exceeded the minimum capital requirements, had larger capital-asset ratios than small banks, and deleveraged during the boom.[7] Because big banks operated on the notion that they were "too big to fail," they aimed only to meet their bare legal requirements, held even less capital leading up to 2008 than the Great Depression, and had no capital or liquidity to meet their needs when risk-taking precipitated the 2008 crisis.[8] After the 2008 crisis, the Federal Reserve (the Fed) overhauled big banks' capital requirements and liquidity measures so their legal requirements would *actually* reduce systemic risk.

B. Overview of the Fed's Capital and Liquidity Requirements

The Fed uses 'stress tests,' formally known as 'Comprehensive Capital Analysis and Review' (CCAR), to test large banks annually, ensure they have enough capital to stay afloat during

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[5] *See* Walter, *supra* note 1, at 5 ("[B]y the early and mid-twentieth century many of the main features of today's capital requirements had shown up, though in some cases only temporarily, such as minimum capital requirements based on a proportion of deposits or assets (1939), risk-weighted capital requirements (mid-1940s), and the inclusion of off-balance-sheet activities in capital measures (1956).").

[6] *See* Christoffer Koch, Gary Richardson & Patrick Van Horn, *Bank Leverage and Regulatory Regimes: Evidence from the Great Depression and Great Recession*, 106 AM. ECON. REV. 538, 539 (2016).

[7] *See id.* at 539.

[8] *Id.* at 541 ("If anything, their capital ratios converged to the minimum allowed by law, and they sought new ways to shift risky investments off their balance sheets. When the US housing market decline turned into the Global Financial Crisis, these banks needed capital and liquidity support of unprecedented magnitude to remain in operation.").

financial crises, and have steps in place for future risks.[9] In addition to CCAR, the Fed has implemented several minimum capital requirements specifically targeting large banks.[10]

The Globally Systemically Important Bank (GSIB) surcharge is a capital requirement targeting large banks, and it "varies in size depending on a bank's systemic importance."[11] The GSIB surcharge is specific to GSIBs and is an additional capital requirement to those (discussed below) that apply to large banks that are not GSIBs.[12] The surcharge decreases when a GSIB holds less risky assets, incentivizing it to engage in less risky behavior.[13] Both the Fed and market analysts have found this exact result—banks decreased their exposure to the derivatives market to lower their GSIB surcharge.[14]

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[9] *See Stress Tests and Capital Planning*, FED. RSRV. (Aug. 10, 2020), https://www.federalreserve.gov/supervisionreg/stress-tests-capital-planning.htm ("[CCAR] is an annual exercise by the Federal Reserve to assess whether the largest bank holding companies operating in the United States have sufficient capital to continue operations throughout times of economic and financial stress and that they have robust, forward-looking capital-planning processes that account for their unique risks.").

[10] *See* Thomas L. Hogan, *A Review of the Regulatory Impact Analysis of Risk-Based Capital and Related Liquidity Rules*, J. RISK & FIN. MGMT., Jan. 6, 2021, at 15 ("The Fed proposed several smaller rules that adjust large banks' capital requirements.").

[11] Jeremy Kress, *Don't Weaken the G-SIB Surcharge*, AM. BANKER (July 10, 2020, 10:14 AM), https://www.americanbanker.com/opinion/dont-weaken-the-g-sib-surcharge.

[12] *See* Jared Berry, Akber Khan & Marcelo Rezende, *How Do U.S. Global Systemically Important Banks Lower Their Capital Surcharges?*, FED. RSRV. (Jan. 31, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/how-do-us-global-systemically-important-banks-lower-their-capital-surcharges-20200131.htm ("G-SIB surcharges are an amount of capital that G-SIBs must hold in excess of minimum requirements and that increases with banks' systemic importance indicators.").

[13] *See id.* ("G-SIB surcharges incentivize banks to lower their indicators, which may decrease the risks that G-SIBs impose on financial stability ….").

[14] *See id.* ("U.S. bank managers have lowered surcharges to a large extent by compressing OTC derivatives …."); Kress *supra* note 11, at 3 ("In an effort to limit its capital burden, Chase simplified itself by shedding derivatives exposures and illiquid assets.").

GSIBs also face another capital requirement: an enhanced supplementary leverage ratio (eSLR).[15] While originally set at 3% or 6% depending on the bank's capitalization, the rule was revised in 2018 down to half the GSIB surcharge.[16] This revision reduced the capital requirements of banks by about $400 million.[17] The supplementary leverage ratio (SLR), the capital requirement for non-GSIBs, was initially proposed at a rate of 3%, and certain thresholds in its calculation have since been adjusted.[18]

In late 2016, the Fed finalized its rule regarding total loss absorbing capital (TLAC) requirements for GSIBs, which require large banks to set aside capital and long-term debt to absorb losses during crisis.[19] Under this rule, GSIBs must set aside either the greater of 18% of their risk-weighted assets (RWA) or 7.5% of the total leverage exposure, as well as either a 2.5% buffer if using the RWA measure or a 2% buffer if using the total leverage exposure measure.[20] There is

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[15] *See* Hogan, *supra* note 10, at 15 ("The proposal also introduced an additional *enhanced* supplementary ratio (eSLR) for banks with USD 700 billion in [sic] more in total assets or custody assets of USD 10 trillion or more.").

[16] *Id.* ("The eSLR was originally set at 3% for adequately capitalized bank [sic] and 6% for well-capitalized banks, but it was revised by the OCC and Fed (2018) and set equal to half of the GSIB surcharge.").

[17] *Federal Reserve Board Approves Rule to Simplify Its Capital Rules for Large Banks, Preserving the Strong Capital Requirements Already in Place*, FED. RSRV. (Aug. 10, 2020) [https://perma.cc/H9HD-89NE].

[18] Hogan, *supra* note 10 at 15 ("[T]he proposals by the OCC and Fed (2013) and the FDIC (2013) proposed a supplementary leverage ratio (SLR) of 3% for all banks … Three of these proposals contain [regulatory impact analysis]: the revised SLR and eSLR ….").

[19] *See Federal Reserve Board Adopts Final Rule to Strengthen the Ability of Government Authorities to Resolve in Orderly Way Largest Domestic and Foreign Banks Operating in the United States*, FED. RSRV. (Dec. 15, 2016), federalreserve.gov/newsevents/pressreleases/bcreg20161215a.htm ("The complementary TLAC requirement will set a new minimum level of total loss-absorbing capacity, which can be met with both regulatory capital and long-term debt. These requirements will improve the prospects for the orderly resolution of a failed GSIB and will strengthen the resiliency of all GSIBs.").

[20] Oliver Ireland & Anna Pinedo, *Understanding TLAC*, INT'L FIN. L. REV. 42, 42 (2017) https://www.iflr.com/pdfsiflr/Webinar/Understanding-TLAC.pdf ("The final rules set the TLAC requirement at not less than the greater of: 18% of the covered BHC's total risk-weighted assets (RWAs), and 7.5% of the covered BHC's total leverage exposure."); *Federal Reserve's Final Rule on Total Loss-Absorbing Capacity and Eligible Long-Term Debt*, DAVIS POLK slide 17 (Jan. 11, 2017).

also a minimum amount of long-term debt required: either the greater of 6% (plus GSIB surcharge) of total RWA or 4.5% of the total leverage exposure.[21] Operating in tandem with the other capital and liquidity requirements, the TLAC requirements ensure a large bank's stability or instability do not drastically impact systemic risk.[22]

The Countercyclical Capital Buffer (CCyB) is another minimum capital requirement, and the Fed can use the CCyB as an option to increase the amount of capital a large bank must hold.[23] The Fed would increase the CCyB in an expansion—just as how the banks in the boom leading up to the Great Depression had excess capital reserves—and it would decrease the CCyB in a recession, when capital is in short order.[24] While this is a tool in the Fed's toolbox, it is one they have not yet used; the CCyB has remained at zero percent since it was introduced, meaning large banks have not been required to keep more capital than is otherwise required, even during a boom period.[25] In 2019, the Fed was in prime position to raise the CCyB—exactly a year before the COVID downturn—but failed to do so, much to the chagrin of the dissenting Fed Governor Brainard, known for her strong support for capital requirements and fierce dissents regarding the

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[21] Ireland, *supra* note 20 ("Under the Federal Reserve final rules, all covered BHCs must maintain outstanding eligible external LTD in an amount not less than the greater of: 6% (plus the applicable G-Sib surcharge) of total RWAs; and a minimum ratio of common equity tier 1 capital to RWAs of 4.5% (total leverage exposure).").

[22] *See* Lael Brainard, *Statement on the Long-Term Debt and Total Loss-Absorbing Capacity Proposal by Governor Lael Brainard*, FED. RSRV. (Oct. 30, 2015), https://www.federalreserve.gov/newsevents/press/bcreg/brainard-statement-20151030.htm ("Today's long-term debt requirement, together with rigorous resolution planning and preparedness, the GSIB surcharge, the capital stress tests, and the liquidity requirements will decrease substantially the risk that a large financial institution's distress could pose to the broader financial system and ensure that no banking institution is too large and too complex to fail.").

[23] *See* Kaitlyn Hoevelmann, *What's a Countercyclical Capital Buffer? Here's a Rundown*, FED. RSRV. BANK OF ST. LOUIS (Feb. 26, 2020), https://perma.cc/6S25-4PR8 (discussing how forcing banks to hold more capital in a boom period gives banks a buffer if the value of the booming assets falls).

[24] *See id.* (discussing how banks can use the buffer during a recession to continue to lend, preventing worse recessions).

[25] Ann Saphir & Dan Burns, *Fed Keeps Countercyclical Capital Buffer at Zero*, REUTERS (Dec. 18, 2020, 5:06 PM) [https://perma.cc/5D6T-F7CR].

changes to the Stress Capital Buffer (SCB), the Net Stable Funding Ratio (NSFR), and June 2020 Stress Test response, discussed below.[26]

The Stress Capital Buffer (SCB) requires large banks to hold capital based on their CCAR results, individualizing the capital a bank must hold in a non-crisis period based on how well or poorly the bank is projected to do in a time of financial stress.[27] The Vice Chair for Supervision Quarles, speaking for those approving the SCB rule, found the rule would lead to a $46 billion *increase* of capital requirements for large banks.[28] However, Governor Brainard dissented, finding the "SCB rule will reduce current required tier 1 capital by roughly $100 billion or 7 percent [sic] for large banks overall."[29] Law firms and analysts have interpreted the SCB rule to allow firms to pass CCAR when they otherwise would have failed, due to the change removing the requirement that banks keep their capital levels above leverage requirements.[30] Other critics assert that the final version of the SCB rule "substantially weakens the underlying stress tests on which it is based."[31]

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[26] *See infra* text accompanying notes 29, 39, 71.

[27] *See Rule Proposed to Tailor 'Enhanced Supplementary Leverage Ratio' Requirements*, FED. RSRV. (Apr. 11, 2018), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm.

[28] Press Release, Fed. Rsrv. Bd., Statement by Vice Chair for Supervision Quarles (Mar. 4, 2020), https://www.federalreserve.gov/newsevents/pressreleases/quarles-statement-20200304a.htm ("As a result, the SCB rule adopted today will lead to an *increase* in the Board's common equity capital requirements for large banking firms, as measured through the cycle, of approximately $11 billion, including an approximately $46 billion increase for the U.S. global systemically important banks.").

[29] Press Release, Fed. Rsrv. Bd., Statement by Governor Brainard (Mar. 4, 2020), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200304a.htm ("The SCB rule will reduce current required tier 1 capital by roughly $100 billion or 7 percent [sic] for large banks overall.").

[30] *See Federal Reserve Finalizes "Stress Capital Buffer,"* CLEARY GOTTLIEB (Mar. 16, 2020), https://www.clearygottlieb.com/-/media/files/alert-memos-2020/federal-reserve-finalizes-stress-capital-buffer.pdf ("[If] a CCAR firm's Tier 1 capital fell below the Tier 1 leverage or SLR requirements under the prior CCAR regime, it would have "failed" CCAR on quantitative grounds …."); Kress *supra*, note 11 ("The stress buffer is sensible in theory, but the Fed's final rule substantially weakens the underlying stress tests on which it is based …. Additionally, the final rule eliminated the proposed stress-leverage buffer—[sic] effectively removing the leverage ratio as a potential constraint in the stress tests.").

[31] Kress *supra*, note 11.

On the liquidity side, the Fed developed the Liquidity Coverage Ratio (LCR) requirement in response to the 2008 Financial Crisis.[32] Before the LCR, there was no explicit liquidity requirement for banks.[33] Instead, the main liquidity tools consisted of deposit insurance and the Fed acting as a lender of last resort, both encouraging banks to rely on the government for liquidity and disincentivizing banks from ensuring they remain liquid during crisis.[34] With the LCR, banks are mandated to "hold enough high-quality liquid assets (HQLA) to cover expected net cash outflows during a 30-day stress period."[35] During a financial crisis, banks should have enough liquidity to weather a short-term run on the bank without relying on government intervention.[36]

On October 20, 2020, the Fed finalized the Net Stable Funding Ratio (NSFR) to bolster liquidity requirements, especially in regards to long-term funding, and to work in tandem with the LCR, which focuses on short-term funding.[37] The NSFR requires large banks to

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[32] *See* Mark House, Tim Sablik & John R. Walter, *Understanding the New Liquidity Coverage Ratio Requirements*, FED. RSRV. BANK OF RICHMOND (Jan. 2016), https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_brief/2016/pdf/eb_16-01.pdf ("It is a response to the financial crisis of 2007–08, during which many banks found themselves suddenly cut off from short-term funding.).

[33] *See* Vladimir Yankov, *The Liquidity Coverage Ratio and Corporate Liquidity Management*, FED. RSRV. (Feb. 26, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/the-liquidity-coverage-ratio-and-corporate-liquidity-management-20200226.htm ("Prior to the 2007-2008 financial crisis, bank regulation did not have explicit quantitative liquidity requirements on banks.").

[34] *See* House, *supra* note 32 ("Deposit insurance can reduce the likelihood of runs by depositors by guaranteeing repayment up to a certain threshold in the event of bank failure. A central bank also can act as a 'lender of last resort,' providing emergency liquidity to solvent banks during a crisis.").

[35] *Id.*

[36] See *id.* ("As a result, the bank must always hold some liquidity in reserve to protect itself from a run and to demonstrate to depositors and creditors its ability to withstand a run.").

[37] *See* Press Release, Fed. Rsrv. Bd., Agencies Issue Final Rule to Strengthen Resilience of Large Banks (Oct. 20, 2020) https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201020b.htm ("The net stable funding ratio, or NSFR, final rule will require large banks to maintain a minimum level of stable funding, relative to each institution's assets, derivatives, and commitments … In particular, the calibration … matches the tailored calibration of the LCR.").

maintain enough funding, based on their levels of risk and assets, to account for "a minimum level of stable funding over a one-year period."[38] This one-year horizon is "intended to guard against the risks associated with funding higher-yielding long-term assets with cheaper and less stable short-term wholesale funding."[39] The rule was proposed and developed in 2016, so by the time of finalization, large banks were already in compliance with the NSFR.[40]

C. Capital and Liquidity Requirements and the Fed's Adjustments Leading to and during the COVID Downturn

In the months and years approaching March 2020, the Fed either relaxed capital requirements or removed requirements entirely. In 2018, when the economy was booming, the eSLR was revised to reduce banks' capital requirements.[41] In 2019, with the economy still booming, the Fed could have voted to use all the tools in their toolkit, namely the CCyB, and increase the CCyB rate from 0%—requiring no capital requirement—to 1% or higher, requiring banks to hold more capital, but they did not.[42] In March 2020, as the nation was about to face a financial downturn, the Fed passed the SCB, removing leverage requirements and weakening stress tests.[43] Of the capital requirements, only the GSIB surcharge lay untouched, and even that has faced scrutiny.[44] In short, the Fed, on the precipice of the COVID downturn, failed to increase large banks' capital requirements; instead, it worked

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[38] *Id.*

[39] Press Release, Fed. Rsrv. Bd., Statement by Governor Brainard (Oct. 20, 2020), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20201020a.htm.

[40] *See id.* ("Given that the largest banks were generally in compliance with the NSFR by early this year in anticipation of its finalization, along with other post-crisis requirements, the resilience of the banking system during the COVID-19 crisis can be seen as a validation of the new capital and liquidity framework.").

[41] *See Federal Reserve Board Approves Rule*, *supra* note 17.

[42] *See* Saphir, *supra* note 25.

[43] *See* Press Release, *supra* note 29.

[44] *See* John Heltman, *House Republicans Ask Fed to Lower Capital Requirements for Megabanks*, AM. BANKER (Jul. 30, 2018) https://www.Americanbanker.com/news/house-republicans-ask-fed-to-lower-capital-requirements-for-megabanks ("[L]awmakers argued that the surcharge goes beyond the international minimum requirements and is no longer necessary ….").

to reduce them. In fact, this trend was not limited to large banks—the Fed also relaxed capital requirements rules for smaller banks.

In October 2019, the Fed eased liquidity and capital requirements based mainly on the size of the bank (asset size) and, accordingly, risk (off-balance sheet exposure).[45] Those that voted for the change argued that the rules tailor "regulations for domestic and foreign banks to more closely match their risk profiles"—thereby reducing "compliance requirements for firms with less risk while maintaining the most stringent requirements for the largest and most complex banks"—and found the changes would only reduce the capital requirements for banks with $100 billion or more by 0.6% and reduce the required liquid assets by 2%, while not impacting the capital or liquidity requirements for the largest banks.[46] However, Governor Brainard, who generally rejects changes that reduce banks' liquidity and capital requirements, denounced this change.[47] Brainard found the changes reduced the liquidity requirement for banks with assets between $100 and $250 billion the most—by $167 billion in aggregate—while also reducing the requirement for banks between $250 and $700 billion by $34 billion in the aggregate.[48] While this rule aimed to reduce the burden for smaller and less risky banks, the changes allow banks between $250 and $700 billion to lower their capital requirements by $9 billion, without any real change to their size or risk, effectively weakening previously placed safeguards to prevent damage during a credit squeeze or financial crisis.[49] These reductions occurred right before the COVID downturn.[50]

As the COVID downturn hit, the Fed scrambled to temporarily adjust certain capital requirements to ensure that banks could

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[45] *See* Press Release, Fed. Rsrv. Bank, Federal Reserve Board Finalizes Rules That Tailor Its Regulations for Domestic and Foreign Banks to More Closely Match Their Risk Profiles (Oct. 10, 2019), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191010a.htm ("The rules establish a framework that sorts banks with $100 billion or more in total assets into four different categories based on several factors, including asset size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposure.").

[46] *Id.*

[47] *See* Press Release, Fed. Rsrv. Bd., Statement by Governor Lael Brainard (Oct. 10, 2019), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20191010.htm.

[48] *Id.*

[49] *Id.*

[50] *Id.*

continue to lend to meet demand during the crisis. For TLAC, the Fed loosened restrictions to enable banks to "support the U.S. economy" and "continue lending to creditworthy households and businesses."[51] Under normal TLAC calculations, how much a bank can distribute is a function of its eligible retained income over the last four quarters *net* of any distributions and tax effects not already reflected in net income, which prevents banks from distributing all their net income but also incentivizes banks to limit their lending during downturns.[52] The interim rule loosens the eligible retained income calculation, allowing banks to calculate it as the average of its net income over the previous four quarters, which allows the bank to have more capacity to lend.[53] This revised calculation also applies to other capital requirements—the fixed 2.5% capital conservation buffer under TLAC, the GSIB surcharge, and the eSLR—to allow banks to use the very capital the Fed required the banks to hold in case of a crisis.[54] Because the capital

[51] Press Release, Fed. Rsrv. Bd., Federal Reserve Board Announces Technical Change to Support the U.S. Economy and Allow Banks to Continue Lending to Creditworthy Households and Businesses (Mar. 23, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200323a.htm.

[52] *See Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations: Eligible Retained Income*, FED. REG.NOTICE (Mar. 23, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200323a1.pdf ("The original definition of eligible retained income under the TLAC rule, as under the capital rule, was four quarters of net income, *net* of distributions and associated tax effects not already reflected in net income. Under a benign business environment, some covered companies may decide to distribute all or nearly all of their net income … In light of these developments, covered companies may realize a sudden, unanticipated drop in capital ratios. This could create a strong incentive for covered companies to limit their lending and other financial intermediation activities in order to avoid facing abrupt limitations on capital distributions.").

[53] *See id.* ("To better allow a covered company to continue lending during times of stress, the Board is issuing the interim final rule to revise the definition of eligible retained income in the TLAC rule to the greater of (1) a covered company's net income for the four preceding calendar quarters, net of any distributions and associated tax effects not already reflected in net income, and (2) the average of a covered company's net income over the preceding four quarters.").

[54] *See US Agencies Revise Definition of Eligible Retained Income for Banks*, MOODY'S ANALYTICS (Mar. 20, 2020), https://www.moodysanalytics.com/regulatory-news/Mar-20-20-US-Agencies-Revise-Definition-of-Eligible-

requirements discussed above created a source of capital buffers in big banks, this capital was a tool the Fed could use to prop up the economy during the COVID downturn.[55]

The Fed also temporarily reduced banks' capital requirements (which had served their purpose of being built up as capital buffers during the boom) so the banks could use the buffers to lend during the demand for credit.[56] For the SLR, the Fed temporarily allowed banks to "exclude U.S. Treasury securities and deposits at Fed Banks from the calculation of the supplementary leverage ratio," in effect allowing banks to access their capital reserves to fulfill the rushed demand for credit and to "continue to serve as financial intermediaries" rather than hoarding capital when capital is needed.[57] The change decreased capital requirements by 2% in aggregate.[58] Governor Brainard, who generally votes against attempts to reduce capital and liquidity requirements, voted in favor of this change, likely because this change is not a true reduction in a capital or liquidity requirement but the Fed

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Retained-Income-for-Banks ("This definition will apply with respect to all of a banking organization's buffer requirements, including the fixed 2.5% capital conservation buffer, and, if applicable, the countercyclical capital buffer, the global systemically important bank holding companies (G-SIB) surcharge, and enhanced supplementary leverage ratio standards.").

[55] *See Fed Revises TLAC Rule to Support Lending*, ABA BANKING J. (Mar. 23, 2020), https://bankingjournal.aba.com/2020/03/fed-revises-tlac-rule-to-support-lending/ ("The rule is being issued to align with other regulatory actions encouraging banks to use their capital and liquidity buffers to support the economy during the coronavirus pandemic.").

[56] *See* Pete Schroeder, *Federal Reserve Temporarily Eases Some Bank Leverage Requirements*, REUTERS (Apr. 1, 2020) https://www.reuters.com/article/us-health-coronavirus-fed-banks/federal-reserve-temporarily-eases-some-bank-leverage-requirements-idUSKBN21J6VN ("The vote to ease the rule, which generally applies to banks with over $250 billion in assets, was unanimous as Democratic Fed Governor Lael Brainard supported the change after opposing pre-pandemic efforts by the Fed to ease bank rules.").

[57] Press Release, Fed. Rsrv. Bd., Federal Reserve Board Announces Temporary Change to Its Supplementary Leverage Ratio Rule to Ease Strains in the Treasury Market Resulting from the Coronavirus and Increase Banking Organizations' Ability to Provide Credit to Households and Businesses, FED. RSRV. (Apr. 1, 2020) https://www.federalreserve.gov/newsevents/press-releases/bcreg20200401a.htm ("Liquidity conditions in Treasury markets have deteriorated rapidly, and financial institutions are receiving significant inflows of customer deposits along with increased reserve levels.").

[58] *See id.* ("The change would temporarily decrease tier 1 capital requirements of holding companies by approximately 2% in aggregate.").

using its tools as imagined to leverage the capital buffers to curb the financial downturn.[59] The Fed later approved this same change for depository institutions.[60] While these reductions in capital requirements allowed banks to use their capital buffers during high demand for liquidity (arguably their main purpose), some commentators viewed the reduction as creating higher levels of financial systemic risk.[61]

The Fed also eased liquidity requirements in relation to a bank's participation in relief programs to ease the financial burden of COVID. With the LCR, banks are mandated to "hold enough [HQLA] to cover expected net cash outflows during a 30-day stress period."[62] Therefore, a bank providing PPP loans through the Fed's Paycheck Protection Program Liquidity Facility (PPPLF) would need to also maintain liquid assets to match those outflows over a 30-day period, potentially reducing their participation in relief programs aimed to provide loans to cash-strapped organizations.[63] Under the temporary

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[59] *See* Schroeder, *supra* note 54.

[60] *See* Press Release, Fed. Rsrv. Bd., Regulators Temporarily Change the Supplementary Leverage Ratio to Increase Banking Organizations' Ability to Support Credit to Households and Businesses in Light of the Coronavirus Responses (May 15, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200515a.htm ("The agencies are providing this temporary exclusion to enable depository institutions to expand their balance sheets as appropriate to serve as financial intermediaries and serve their customers.").

[61] *See* Kress, *supra* note 11 ("[T]he Fed gutted the supplementary leverage ratio by temporarily excluding U.S. Treasury securities and reserves from a bank's total exposures. The Fed's stated purpose was to alleviate market stresses during the coronavirus crisis, but this misguided decision could reduce bank capital levels by up to $76 billion during the pandemic, putting the financial system at greater risk.").

[62] *See* House *supra*, note 32.

[63] *See* J. Paul Forrester, Jeffrey P. Taft & Matthew Bisanz, *US Banking Regulators Modify Liquidity Coverage Ratio for COVID-19 Stimulus Effects*, MAYER BROWN (May 6, 2020), https://www.covid19.law/2020/05/us-banking-regulators-modify-liquidity-coverage-ratio-for-covid-19-stimulus-effects/) ("Absent a modification, under the LCR requirement, banking organizations would be required to recognize outflows for MMLF and PPPLF loans with a remaining maturity of 30 days or less and inflows for certain assets securing the MMLF and PPPLF loans. As a result, a banking organization's participation in the MMLF or PPPLF could affect its total net cash outflows, which could potentially result in an inconsistent, unpredictable, and more volatile calculation of LCR requirements.").

rules, banks do not need to comply with the LCR requirement and do not need to counterbalance PPP loans with HQLA.[64]

When the NSFR was finalized in October 2020, it included several changes from its initial 2016 proposal that weakened the liquidity requirement.[65] The Fed reduced the NSFR requirements for banks—for banks with $250–$700 billion in assets, the rule reduced the requirement from 100% to 85%, and, for small banks with assets of $100–$250 billion, the requirement was eliminated *entirely*, as opposed to a 70% requirement from the proposed rule.[66] Smaller banks do not need to 100% match the maturity profile of their assets for a one-year funding horizon, only 70% of the funding requirements, and even large banks only need to hold 85%.[67] The final rule also changed the required stable funding (RSF) requirement for Treasuries and Treasury reverse repos, eliminating required funding for those assets entirely.[68] These changes were at the behest of complaints by those regulated—the banks—who not only sought more lenient liquidity requirements but also lobbied to remove the NSFR entirely.[69] As a whole, banks that "questioned the need for the regulation" received the change in RSF for Treasuries as a positive.[70] Amid a liquidity squeeze,

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[64] *See id.* ("The modification neutralizes the effect of the LCR requirement by excluding cash flows from MMLF and PPPLF funding and assets securing such funding from the calculation of a banking organization's total net cash outflow amount.").

[65] *See* Press Release, Fed. Rsrv. Bd., Statement by Governor Brainard (Oct. 20, 2020), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20201020a.htm ("Unfortunately, the final NSFR rule goes beyond the statutory requirements and weakens the NSFR relative to the proposed rule".).

[66] *Id.*

[67] *Id.*

[68] *See id.*

[69] *See Agencies Finalize Net Stable Funding Ratio Despite Criticism*, CLEARY GOTTLIEB (Nov. 2, 2020), https://www.clearygottlieb.com/-/media/files/alert-memos-2020/agencies-finalize-net-stable-funding-ratio-despite-criticism.pdf ("Many commenters questioned the need for the NSFR given the implementation of other U.S. regulations which similarly support stable funding and liquidity … However, the Final Rule did make certain changes that reflect commenters' calls for significant modification to the proposed NSFR, in particular by generally excluding U.S. Treasury securities and U.S. Treasury-backed repurchase agreements from stable funding requirements ….").

[70] Coryann Stefansson, *Finalized NSFR: Could Have Been Better, Could Have Been a Lot Worse*, SIFMA (Oct. 22, 2020) https://www.sifma.org/resources/news/finalized-nsfr-could-have-been-better-could-have-been-a-lot-

when the liquidity rules in place worked to curb an even worse downturn, the Fed's actions to *reduce* liquidity requirements—the very ones that worked—are concerning in terms of future bank and systemic stability.[71]

D. June 2020 and December 2020 Stress Tests

In June of 2020, the Fed conducted a stress test designed before the COVID downturn and provided additional analysis in response to COVID.[72] While the pre-COVID stress test showed that "all large banks remain strongly capitalized," in two of the additional scenarios, several firms "would approach minimum capital levels," and, in three of them, "the unemployment rate peaked at between 15.6 percent [sic] and 19.5 percent [sic], which is significantly more stringent than any of the Board's pre-coronavirus stress test scenarios."[73] As a result, the Fed implemented several measures to ensure banks preserve capital.[74] Firms could not repurchase shares, could only pay dividends if they had enough recent earnings, and the dividend payments would be capped to what was paid in the second quarter.[75] Governor Brainard dissented to this decision, finding that *allowing* for shareholder payouts to continue would give a "green light for large banks to deplete capital" despite the Fed's own scenarios suggesting "that many banks could be operating within their stress capital buffers,

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worse/ ("Generally, the final rule included some positive refinements, resulting in an NSFR which is not grossly objectionable, although we continue to question the need for the regulation.").

[71] *See* Brainard, *supra* note 39 ("Given that the largest banks were generally in compliance with the NSFR by early this year in anticipation of its finalization, along with other post-crisis requirements, the resilience of the banking system during the COVID-19 crisis can be seen as a validation of the new capital and liquidity framework … A small RSF requirement is warranted to mitigate systemic fire-sale risks and reduce the need for central bank emergency intervention at times of stress.").

[72] *See* Press Release, Fed. Rsrv. Bd., Federal Reserve Board Releases Results of Stress Tests for 2020 and Additional Sensitivity Analyses Conducted in Light of the Coronavirus Event (June 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm.

[73] *Id.*

[74] *See id.*

[75] *See id.*

and one quarter could be close to their minimum requirements."[76] While the Fed's scenarios suggested that banks were reaching the end of their capital buffers, the Fed improperly gave a go-ahead for banks to use their capital buffers to pay shareholders, not to assist in alleviating the credit crisis during the COVID downturn.[77] Commentators concerned about financial systemic risk agreed with Brainard, arguing that the Fed, to shore up capital and increase lending capacity, "should order banks with assets greater than $100 billion to preserve capital by retaining earnings and halting all payouts, including dividends, share buybacks, and discretionary executive bonuses."[78] Others observed how the Fed lost credibility by allowing big banks to benefit their shareholders at the expense of capital during a time of crisis.[79] Nevertheless, the Fed did still maintain a base level of capital requirements after the June stress tests, with a 4.5% minimum capital requirement, an SCB of at least 2.5%, and GSIB surcharge of at least 1%, so banks faced a minimum 7% capital requirement.[80]

In December 2020, the Fed conducted additional stress tests, finding losses would increase, but the capital ratios would only "decline from an average starting point of 12.2 percent [sic] to 9.6 percent [sic] in the more severe scenario, well above the 4.5 percent [sic] minimum. All firms' risk-based capital ratios would remain

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[76] Press Release, Fed. Rsrv. Bd., Statement by Governor Brainard (Jun. 25, 2020), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20200625c.htm.

[77] *See id.*

[78] Gaurav Vasisht, *It Is Time for the Fed to Stop Bank Shareholder Payouts*, REG. REV., https://www.theregreview.org/2020/06/04/vasisht-time-fed-stop-bank-shareholder-payouts/ (Jun. 4, 2020).

[79] *See, e.g.*, Dennis M. Kelleher, *Fed's Stress Test Actions Allowing Capital Payouts in the Middle of an Historic Economic Crisis Undermines Its Credibility and Makes Bank Failures and Bailouts More Likely*, BETTER MARKETS (Jun. 25, 2020), https://bettermarkets.com/newsroom/fed%E2%80%99s-stress-test-actions-allowing-capital-payouts-middle-historic-economic-crisis ("[The] stress tests for Wall Street's biggest banks released today were a credibility test for the Fed itself—would it force the banks to maintain adequate capital to ensure they are able to continue to be a 'source of strength' or would they bend to the unceasing Wall Street demands to eject capital regardless of the pandemic crisis?").

[80] Press Release, Fed. Rsrv. Bd., Federal Reserve Board Announces Individual Large Bank Capital Requirements, Which Will Be Effective on October 1 (Aug. 10, 2020), https://perma.cc/YKU8-LZNP.

above the required minimum."[81] The Fed decided that the capital requirements laid out after the June stress tests would remain the same, but in addition to paying dividends, banks could now engage in share buybacks; banks could, in the first quarter of 2021, buy back shares based on income earned in 2020.[82] Like how Brainard objected to the Fed allowing banks to pay dividends after the June 2020 stress test, Brainard found this new measure as unnecessarily depleting capital.[83] Indeed, ten minutes after the stress tests were announced, "JP Morgan announced a new $30 billion share buyback program starting in the first quarter," causing shares to rise by 5%.[84] Brainard and market commentators' fears of unnecessary payouts for profits, at the expense of capital, during a crisis where capital is needed, were well-founded.

E. Did the Fed's Capital and Liquidity Requirements Assist Large Banks Through the COVID Downturn?

Market commentators, including analysts at the very big banks regulated by the Fed, have attributed the banking industry's resilience during the COVID downturn to the Fed's capital and liquidity regulations. An analyst at Wells Fargo admitted that "banks were kicking and screaming while the government made them build capital and liquidity" but attributed "why they're in such good shape today" to

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[81] Press Release, Fed. Rsrv. Bd., Federal Reserve Board Releases Second Round of Bank Stress Test Results (Dec. 18, 2020), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201218b.htm. [hereinafter Second Round].

[82] *See id.* ("In light of the ongoing economic uncertainty and to preserve the strength of the banking sector, the Board is extending the current restrictions on distributions, with modifications. For the first quarter of 2021, both dividends and share repurchases will be limited to an amount based on income over the past year. If a firm does not earn income, it will not be able to pay a dividend or make repurchases.").

[83] *See* Hannah Lang, *Fed Extends Dividend Restrictions after Stress Test Results*, AM. BANKER (Dec. 18, 2020), https://www.americanbanker.com/news/fed-extends-dividend-restrictions-after-stress-test-results ("Today's action nearly doubles the amount of capital permitted to be paid out relative to last quarter. Prudence would call for more modest payouts to preserve lending to households and borrowers during an exceptionally challenging winter.").

[84] Brian Chappatta, *Jamie Dimon Gets His $30 Billion Buyback Wish*, BLOOMBERG (Dec. 18, 2020), https://www.bloomberg.com/opinion/articles/2020-12-18/bank-stress-tests-jamie-dimon-gets-his-30-billion-buyback-wish.

those very regulations.[85] Big banks not only remained profitable during the downturn, but they also entered the downturn "flush with capital and liquidity." [86] When the very goal of the Fed's capital and liquidity requirements was to ensure banks maintain capital and liquidity during booms so as to alleviate downturns, this can only be described as a success. *The Economist* projected that, *without* the Fed's post-2008 capital requirements, several large banks' capital-ratio would have dropped "to 1.5%, with several big banks' figures touching zero—ie, [sic] technical insolvency … The taxpayer bail-out in this parallel universe might have been even bigger than in the financial crisis."[87] Governor Brainard, in her rebuke to the October 2020 changes to NSFR requirements that most large banks were already compliant with, pointed to the NSFR and the post-2008 capital and liquidity framework as reasons for large banks' resilience.[88] This shows that the consensus is yes; the capital and liquidity requirements assisted large banks through the COVID downturn.

However, the same may not be said for small banks. While in the boom before COVID, large banks had "increased dramatically their holdings of [HQLA]," because of the LCR, "smaller banks not subject to the LCR [had] decreased liquid asset holdings … even though they also have also been increasing their exposure to nonbank financial firms."[89] In other words, the LCR may have resulted in large banks being better poised to weather a financial crisis than smaller banks. Concern about small banks' health stems from how community banks often lend to local businesses, leading to higher risks during

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[85] Shawn Tully, *This Time, the Banks Were Ready: How the Big Four Prepared to Survive the Coronavirus*, FORTUNE (Apr. 20, 2020), https://fortune.com/longform/coronavirus-banks-big-four-stimulus-recession-covid-19/.

[86] *Id.*

[87] *How Resilient Are the Banks?*, THE ECONOMIST (July 2, 2020), https://www.economist.com/finance-and-economics/2020/07/02/how-resilient-are-the-banks.

[88] *See* Brainard, *supra* note 39 ("Given that the largest banks were generally in compliance with the NSFR by early this year in anticipation of its finalization, along with other post-crisis requirements, the resilience of the banking system during the COVID-19 crisis can be seen as a validation of the new capital and liquidity framework.").

[89] Vladimir Yankov, *The Liquidity Coverage Ratio and Corporate Liquidity Management*, FED. RSRV. (Feb. 26, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/the-liquidity-coverage-ratio-and-corporate-liquidity-management-20200226.htm.

downturns.[90] In October 2020, two small banks failed, and market commentators fear more could collapse if small businesses continue to be unable to pay loans back to small banks.[91] Community banks are essential to the national economy; through April 22, 2020, in the early, urgent stages of the COVID downturn, small banks provided the majority of the loans to small businesses under the PPP, and, in April, small banks provided 89% of commercial and industrial loans.[92] Fed Governor Bowman praised how community banks provided 73% of all PPP loans to minority-owned small businesses.[93] However, she recognized that small banks—those with less than $100 million in assets—faced compliance costs, nearly ten percent, versus larger banks—those between $1 billion and $10 billion in assets—whose compliance costs were 5.3%.[94] Without PPP, quarter-over-quarter loan growth would have been negative for community banks.[95]

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[90] *See* Paul H. Kupiec, *The Coronavirus Could Send Hundreds of Small Banks to the ICU*, AM. ENTER. INST. (June 26, 2020) https://www.aei.org/economics/the-coronavirus-could-send-hundreds-of-small-banks-to-the-icu/ ("Unfortunately, community banks' focus on local lending often creates concentrations that put these banks and their local economies at significant risk when business conditions deteriorate. Commercial real estate (CRE) lending is a key business line for many community banks …. Relative to their size, community banks are far more exposed to a deterioration in business conditions through their CRE loan portfolios than are the largest banks.").

[91] *See* Michael Braga, *Two Small Banks Failed in October. They Won't Be the Last If COVID Leaves Some Businesses Struggling to Pay Loans*, USA TODAY (Nov. 20, 2020) https://www.usatoday.com/story/money/2020/11/20/bank-failures-may-rise-covid-if-businesses-cant-recover-quickl/6283640002/ ("Two banks failed in October, the first to collapse since the start of the coronavirus pandemic …. Spiro acknowledged that the virus has put additional stress on community banks. That's because they're not as diversified as big banks, she said. They're more dependent on commercial real estate and small business loans that have been hit hard by the crisis.").

[92] Matthew C. Klein, *Smaller Banks Doled Out Bulk of PPP Loans, Fed Data Show*, BARRON'S, (May 5, 2020) https://www.barrons.com/articles/smaller-banks-doled-out-bulk-of-ppp-loans-fed-data-show-51588677303.

[93] *See* Michelle W. Bowman, Governor, Federal Reserve Board, Community Banks Rise to the Challenge, Speech at the Federal Reserve Bank of St. Louis Missouri's Community Banking in the 21st Century webcast (Sept. 30, 2020) www.federalreserve.gov/newsevents/speech/bowman20200930a.htm.

[94] *Id.*

[95] *Id.*

F. Future Developments in Ensuring the Banking System's Long-Term Stability

The Fed's capital and liquidity requirements helped large banks create capital buffers that assisted them through the COVID downturn, but the Fed weakened these very requirements or did not adequately use them (see the eSLR, CCyB, SCB, and NSFR) in the lead up to and during the crisis.[96] The Fed's greenlight to companies to pay dividends and implement share repurchase programs also undercut its goal of preserving capital during downturns.[97] While large banks still had enough capital reserves from their capital requirements to provide credit to smooth out the downturn, the Fed should not view this as a signal to keep toeing the line and cutting capital requirements.

Instead, the Fed should prioritize maintaining strong capital buffers during boom periods and preserving capital during downturns, as well as protect strong stress measures instead of undercutting them, like in the recent SCB rule change.[98] The Fed should use the tools it has available, especially the CCyB that has remained unused, to establish capital buffers that will require banks to strengthen their reserves during times of economic boom, preventing them from investing all of their capital in risky and profit-making assets. Then, not only will banks have enough capital and liquidity to tide over during periods of economic stress, but they can also be used as a resource and source of credit during a credit squeeze. Capital requirements prevent banks from hurting the general public during periods of economic stress by preventing their default, and capital requirements can also cement banks as *helpers* to the general public and economy as a source of credit when credit is in short supply.[99] The COVID downturn showed how banks can serve this role, and the Fed should see these recent developments as supporting the general proposition that strong capital requirements strengthen financial stability and access to credit when credit is in short supply.

All capital requirements should be protected, but capital requirements based solely on a bank's size, not the risk of its assets, should especially be protected because banks' risk estimations tend to

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[96] *See supra* Capital and Liquidity Requirements and the Fed's Adjustments Leading to and During the COVID Downturn.
[97] *See supra* June 2020 and December 2020 Stress Tests.
[98] *See* Press Release, *supra* note 29.
[99] *See supra* text accompany note 1.

underestimate true market risk of assets during a recession.[100] Indeed, one of the very problems of the 2008 crisis was how banks' capital requirements were based on risk estimations that underestimated the riskiness of assets.[101] This is not to say that risk-weighted capital requirement measures should be substituted. Instead, stringent capital requirements based on bank size should *supplement* what the Fed believes are adequate capital requirements based on asset risk. What banks give up in the form of under-utilized capital reserves, society gains in terms of financial stability. And, given the inaccurate measures of risk-weighted assets, especially during times of economic boom, this is likely a more accurate measure of what capital requirements a bank should hold.[102] Furthermore, supporting the complicated risk-weighted capital requirement measures with simple-to-apply rules of static capital requirements based on size eliminates the problem of capital arbitrage, where companies seek to game the risk-weighted measurement system to employ risky assets without adequate capital reserves.[103] Indeed, a simple rule is often a better regulatory response to complicated systemic issues than a complicated rule.[104]

However, protecting large banks is insufficient in terms of protecting the financial system; just as the Fed's stringent capital and

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[100] *See* Caludio Borio & Haibin Zhu, *Capital Regulation, Risk-Taking and Monetary Policy: A Missing Link in the Transmission Mechanism?*, 8 J. FIN. STABILITY 236, 239 (2012) (discussing how risk models deriving minimum capital requirements based on market inputs are procyclical, meaning risk is measured low during economic expansions and high during economic contractions).

[101] *See* Francesco Vallascas & Jens Hagendorff, *The Risk Sensitivity of Capital Requirements: Evidence from an International Sample of Large Banks*, 17 REV. FIN. 1947, 1948 (2013) (discussing how "[s]ome commentators argue that one reason why banks held insufficient capital as they entered the crisis was because regulatory capital requirements were insufficiently attuned to the riskiness of bank activities.")

[102] *See id.* at 1949 (demonstrating how "the risk sensitivity of capital requirements is very weak").

[103] *See id.* (demonstrating how "the capital buffers that banks typically hold above regulatory requirements partly result from capital arbitrage").

[104] *See* Andrew G. Haldane, Executive Director, Financial Stability and Member of the Financial Policy Committee & Vasileios Madouros, Economist, The Dog and the Frisbee, Speech at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium (Aug. 31, 2012) at 5 https://www.bis.org/review/r120905a.pdf ("In complex environments, decision rules based on one, or a few, good reasons can trump sophisticated alternatives. Less may be more.").

liquidity helped large banks through the downturn, the lax requirements for small banks may have hindered them. While regulatory compliance is a larger percent cost for small banks, compliance with those capital and liquidity requirements could prevent small bank failures. Again, in the trade-off between profits and systemic risk and bank failures, financial stability wins.

Lastly, calling for stronger capital requirements makes economic sense; one study has found that "US capital requirements have been suboptimally [sic] low" and that "the marginal benefit of a higher capital requirement … significantly exceeds the marginal cost."[105] Furthermore, larger capital buffers ensure banks are more resilient, and resilient banks can lend more.[106] Stronger liquidity requirements also result in increased resilience during crises, and, while at the expense of liquidity creation, "lower systemic risk may enable greater bank lending in the long-run."[107] Of course, small banks do not individually pose the systemic risk that large banks do, and so stress testing on individual banks does not make sense. But the capital and liquidity requirements that have helped large banks can also help small banks through a crisis, and given community banks' importance in distributing loans to small businesses, the Fed should not relax these requirements just based on a bank's size.

G. Conclusion

More recently, the Fed has trodden a middle ground between aggressive capital requirements and pro-bank allowances. On the one hand, the 2021 stress test scenarios track closely to the aggressive scenarios of the December stress test, "testing whether banks could keep lending if unemployment rose more than four percentage points

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[105] Juliane Begenau, *Capital Requirements, Risk Choice, and Liquidity Provision in a Business-Cycle Model*, 136 J. FIN. ECON. 355, 355 (2020).

[106] *See* William F. Bassett & Jose M. Berrospide, *The Impact of Post Stress Tests Capital on Bank Lending* 25 (Wash.: Bd. Governors Fed. Res. Sys., Working Paper No. 2018-087, 2018). Finance and Economics Discussion Series Federal Reserve Board 25 (2018) ("Our findings suggest that the increased level of capital and the higher capital buffers brought by the post-crisis regulatory reform, which make banks safer and more resilient, altogether put banks in a better position to lend more, at least across some loan categories.").

[107] Daniel Roberts, Asani Sarkar & Or Shachar, *Bank Liquidity Creation, Systemic Risk and Basel Liquidity Regulations* 3 (Sept. 6, 2019) ("While banks reduce lending following LCR, they may also become more resilient.").

to nearly 11%, stocks lost more than half of their value and commercial real estate valuations declined by 40%."[108] On the other hand, this year's stress test only applies to "the 19 largest and most complex institutions. Smaller regional banks will be exempt because of a recent switch to a two-year cycle."[109] The exemption of smaller regional banks from more frequent tests does not align with the test's emphasis on a drop in commercial real estate valuations; it is these very banks, and especially community banks, that are often the most exposed, and are currently the most concerned, with commercial real estate valuations.[110] An analyst at the Federal Reserve Bank of San Francisco applied the December 2020 stress test to community banks and found that "[a]bout one-fifth of community banks, holding 34% of community bank assets, are projected to fall below adequate capitalization under a severely adverse scenario" yet still found this a "reassuring view" because "only a handful of community banks are projected to be insolvent."[111] This is quite a positive outlook in comparison to the actual December 2020 stress test results, where all large banks under these stress scenarios would have risk-based capital ratios well above the required minimum.[112] Because smaller community banks tend to have portfolios concentrated in commercial real estate, they are more exposed to downturns, like the COVID downturn.[113] Small, community banks are not subject to stress tests, and

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[108] Jesse Hamilton, *Fed to Crank Up Stress-Test Pain, Assuming Jobs and Market Doom*, BLOOMBERG (Feb. 12, 2021), https://www.bloomberg.com/news/articles/2021-02-12/fed-s-next-round-of-stress-tests-assume-severe-global-downturn.

[109] *Id.*

[110] *See* Justin Ho, *Community Banks Are Thriving. Bankers Worry It Won't Last.*, MARKETPLACE (Dec. 11, 2020), https://www.marketplace.org/2020/12/11/community-banks-are-thriving-bankers-worry-it-wont-last/ (interviewing multiple bank presidents worrying about the financial health of their borrowers, namely commercial real estate clients).

[111] Simon Kwan, *Resilience of Community Banks in the Time of COVID-19*, FED. RSRV. BANK OF SAN FRANCISCO (Mar. 1, 2021), https://www.frbsf.org/economic-research/publications/economic-letter/2021/march/resilience-of-community-banks-in-time-of-covid-19/.

[112] *See* Second Round, *supra* note 79, at 1 ("All firms' risk-based capital ratios would remain above the required minimum.").

[113] *See* Kwan, *supra* note 109, at 1 ("Because community banks have a high concentration in commercial real estate (CRE) lending, the disproportionate effect of the COVID-19 shock on the CRE sector has raised particular concerns about the resilience of community banks.").

with small, regional banks facing less frequent stress testing than large banks, the Fed should ensure that its capital requirements for these institutions adequately reflect the risk these smaller banks hold to their communities and to the system as a whole.

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