October 21, 2013

Mr. Robert de V. Frierson, Secretary
Attention: Docket No. R-1460; RIN 7100-AD99
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman, Executive Secretary
Attention: RIN 3064-AE01
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Legislative and Regulatory Activities Division
Attention: Docket ID OCC-2013-0008; RIN 1557-AD69
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219

VIA ELECTRONIC MAIL: regs.comments@federalreserve.gov; comments@fdic.gov; regs.comments@occ.treas.gov

Re: Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 78 Fed. Reg. 51,101 (the "**Proposed Rule**")

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Proposed Rule, released jointly by the Board of Governors of the Federal Reserve System (the "**Board**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), and the Office of the Comptroller of the Currency (the "**OCC**," and together with the Board and the FDIC, the "**Agencies**").

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-two leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Proposed Rule increases the leverage ratios applicable to large U.S. bank holding companies and their insured depository institution subsidiaries pursuant to authorities established under the Federal Deposit Insurance Act,[1] the Bank Holding Company Act,[2] and Sections 165 and 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[3] While we commend the Agencies for their focus on systemic risk, this letter highlights our concerns with the Proposed Rule. First, the Proposed Rule is likely to cause financial institutions to abandon lower-margin business lines in favor of systemically riskier activities. Second, undue emphasis on strengthening leverage ratios conflicts with the liquidity standards set forth by the Basel Committee on Banking Supervision ("**Basel Committee**"). Finally, we believe that the Proposed Rule's enhanced supplementary leverage ratios will not materially contribute to reducing systemic risk and may indeed reduce the competitiveness of U.S. capital markets.

Among other things, we urge the Agencies to consider exempting effectively risk-free government assets from the Proposed Rule's leverage ratio calculations. In times of crisis, individuals and corporations flood banks with demand deposits, causing bank balance sheets to expand rapidly. In turn, banks generally place such funds in the safe keeping of the national central bank or alternatively invest them in government securities. A binding leverage ratio requirement, by not taking into account the risk-profiles of particular assets, discourages such socially valuable activity at precisely the time when it is most essential to restoring stability to financial markets. We recommend that the Proposed Rule's leverage ratio be amended to allow exemptions for such central bank deposits or other purchases of government securities.

We also encourage the Agencies to coordinate their approach to minimum leverage ratio requirements with foreign regulators, in order to promote consistency and comparability across borders and markets.

Rationale of the Proposed Rule

The U.S. government relies on two types of leverage ratio in regulating the capital of bank holding companies ("**BHCs**") and insured depository institutions ("**IDIs**"). The "generally applicable leverage ratio" is the ratio of a firm's Tier 1 capital to its total consolidated balance sheet assets.[4] The "supplementary leverage ratio" is the ratio of Tier 1 capital to total leverage exposure, which includes many off-balance sheet ("**OBS**") exposures in addition to total consolidated balance sheet assets. All BHCs and IDIs must maintain a minimum generally applicable leverage ratio of 4%. In addition, "advanced approaches" BHCs must maintain a minimum supplementary leverage ratio of 3%, consistent with the level set by the Basel Committee on Banking Supervision ("**Basel Committee**").[5] Finally, advanced approaches IDIs

[1] Federal Deposit Insurance Act of 1950, 12 U.S.C. §§ 1811-35 (2012).
[2] Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-52 (2012).
[3] 12 U.S.C. §§ 5365, 5371 (2012).
[4] 12 U.S.C. § 5371 (2012).
[5] The 2013 revised capital approaches, which were adopted as final by the Board on July 2, 2013 and the OCC on July 9, 2013, and adopted on an interim final basis by the FDIC on July 9, 2013, replace and revise the leverage capital standards at 12 C.F.R 3.6(b)-(c), 167.8 (OCC), 12 C.F.R part 208, appendix B, part 225, appendix D (Board), and 12 C.F.R 325.3, 390.467 (FDIC).
See Board, OCC, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 Fed. Reg. 62,018 (Oct. 11, 2013)(to be codified at 12 C.F.R. pts. 3, 5, 6, 165, 167, 208, 217 and 225) ; FDIC, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions,*

must maintain a minimum generally applicable leverage ratio of 5% to be considered "well-capitalized." The recently finalized rules contain no supplementary leverage ratio requirement to be considered "well-capitalized," but a 3% minimum is required to be "adequately-capitalized."[6]

The Proposed Rule increases the minimum supplementary leverage ratios applicable to U.S. bank holding companies with at least $700 billion in total consolidated assets or at least $10 trillion in assets under custody (each, a "**covered BHC**") and their insured depository institution subsidiaries (each, a "**subsidiary IDI**").[7] If implemented, covered BHCs and their subsidiary IDIs would be subject to an effective minimum supplementary leverage ratio of 5% and 6%, respectively.[8] The 5% requirement for covered BHCs represents (i) the 3% minimum already in place and (ii) a 2% buffer that must be maintained to avoid any limitations on capital distributions and discretionary bonus payments.[9] The 6% requirement for subsidiary IDIs represents (i) the current 3% minimum requirement and (ii) a 3% "add-on" to be considered "well-capitalized."[10] Since a 6% supplementary leverage ratio (including OBS exposures) is a more stringent requirement for "well-capitalized" banking institutions than the current 5% generally applicable leverage ratio requirement (excluding OBS exposures), the Agencies will consider eliminating the latter requirement.

By comparison, the Basel Committee has recently proposed a minimum leverage ratio of only 3% for bank holding companies and bank subsidiaries.[11] The leverage ratio approach adopted by the Basel Committee is consistent with the Agencies' supplementary leverage ratio insofar as it includes OBS exposures. However, while the Basel Committee has introduced higher capital requirements for global systemically important banks (**"G-SIBs"**), it has done so exclusively through risk-based capital adequacy standards.[12] The Basel Committee has not proposed an increased leverage ratio requirement for G-SIBs.[13]

Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 55,340 (Sept. 10, 2013) (to be codified at 12 C.F.R. pts. 303, 308, 324, 327, 333, 337, 347, 349, 360, 362, 363, 364, 365, 390 and 391) (Interim Final Rule).

[6] 12 C.F.R. § 325.103 (2012).

[7] Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 78 Fed. Reg. 51,101, 51,104 (Aug. 20, 2013) [hereinafter "Proposed Rule"].

[8] *Id.* at 51,104.

[9] *Id.* at 51,106.

[10] *Id.* at 51,106-7.

[11] *See* Basel Committee, *Consultative Document: Revised Basel III Leverage Ratio Framework and Disclosure Requirements* (June 2013), *available at* http://www.bis.org/publ/bcbs251.pdf.

[12] *See* Basel Committee, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (July 2013), *available at* http://www.bis.org/publ/bcbs255.pdf.

[13] *Compare* Proposed Rule, *supra* note 7, at 51,104, *with* Basel Committee, *Consultative Document: Revised Basel III Leverage Ratio Framework and Disclosure Requirements*, *supra* note 11, *and* Basel Committee, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement*, *supra* note 12. In a recent interview, the Chairman of the Basel Committee, Stefan Ingves, indicated that the Basel Committee does not intend to raise the leverage ratio requirement above 3%. Mr. Ingves stated that "'[t]he level that was talked about' in 2010 'of 3 percent still stands.'" Jim Brunsden, *Banks' Off-Balance-Sheet Risks Come Under Basel Scrutiny*, Bloomberg (Sept. 30, 2013),

The Proposed Rule states that the primary lesson to be drawn from the recent financial crisis is that "some financial companies had grown so large, leveraged, and interconnected that their failure could pose a threat to overall financial stability."[14] The Agencies further discuss the perception that some financial institutions continue to be "too big to fail," resulting in funding advantages for larger systemically important financial institutions ("**SIFIs**") and an overall decline in market discipline.[15] The Proposed Rule's enhanced supplementary leverage ratios are intended to mitigate the systemic risk of SIFI failure and to eliminate the market distortions associated with the "too big to fail" phenomenon. We share the Agencies' dual objectives; however, we do not believe that the approach set forth in the Proposed Rule is best calculated to achieve these policy aims.

Leverage Ratios and Risk

The Proposed Rule asserts that minimum leverage ratio requirements necessarily make financial institutions safer. We do not dispute the Agencies' claim that "the imprudent risk taking of major financial companies"[16] contributes to financial instability. Indeed, we are concerned that a policy premised on enhanced leverage ratios runs counter to the objective of reducing excessively risky behavior.

By definition, a leverage ratio requires precisely the same amount of capital for all asset classes, irrespective of their various risk profiles. Effectively, a leverage ratio is a risk-weighted assets approach under which all asset classes are assigned a risk weight of 100%. As a result, the regulatory cost of capital is the same for both high- and low-risk assets, giving bank management an incentive to increase return on equity by investing in high-risk assets with higher returns. Such incentives are inconsistent with prudent risk management and sound banking practice.

Leverage ratios should operate as a capital backstop with risk-based capital guidelines serving as the primary means of capital regulation. The Basel Committee supports this view, stating explicitly that the leverage ratio requirement of Basel III is "intended as a backstop to prevent any excessive leverage that might be possible under a risk-based framework."[17] Increasing the leverage ratio minimum threatens to reverse this relationship by shifting the binding capital requirement from a *risk-based* measure to a *risk-neutral* measure. According to research conducted by a leading consulting firm on behalf of the Global Financial Markets Association and The Clearing House in connection with the Basel Committee's consultative document on the revised Basel III leverage ratio framework, a 3% Basel III leverage ratio would be binding on 44% of G-SIBs, with 4% and 5% levels binding 81% and 93% of G-SIBs, respectively.[18] A binding leverage ratio thus runs counter to the Basel Committee's position that "a risk-based capital regime should remain at the core of the regulatory framework for banks . . .

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http://www.bloomberg.com/news/print/2013-09-29/banks-face-basel-debt-limit-capturing-off-balance-sheet-risks.html.

[14] Proposed Rule, *supra* note 7, at 51,102

[15] *Id.* at 51,102-3.

[16] *Id.* at 51,102.

[17] Basel Committee, *Discussion Paper: The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability* (July 2013), *available at* http://www.bis.org/publ/bcbs258.pdf, at 7.

[18] Letter from GFMA et al. to Basel Committee Secretariat app. 4 (Results of the Supplementary Outside-in Analysis) at 5 (Sept. 20, 2013), *available at* http://www.gfma.org/correspondence/item.aspx?id=536.

."[19] When a risk-neutral leverage ratio becomes the binding capital requirement, financial institutions will effectively be required to respond by shedding their lowest risk assets (cash, Treasuries, repurchase agreements, *etc*.) and increasing their exposure to riskier assets.

Such shedding of low-risk assets will cause banks to become riskier and more susceptible to large losses. While the Proposed Rule would result in a larger capital base relative to total assets, the increase may not be appropriately matched to the increased riskiness of the bank's operations. A firm's return on equity is the product of its return on assets and its assets-to-equity ratio. An increase in a firm's supplementary leverage ratio will *decrease* its assets-to-equity ratio, thus *decreasing* its return on equity. To prevent such a decline, the firm must *increase* its return on assets by investing in assets with a higher risk and potential return. Banks will thus respond to the Proposed Rule's increased capital requirements by becoming riskier, the net result being a bank that will have more capital yet perversely face a much higher risk of failure. In the most adverse case, the capital offset (*i.e*., the marginal increase in capital relative to the increased risk) will be grossly deficient across all banks in aggregate, and the financial system as a whole will be less stable as a result.

A reduction in low-risk and low-margin products could adversely affect bank clients and other market participants who rely on such products. In particular, the repurchase agreement market will contract significantly, thus reducing the supply of safe, short-term investments demanded by corporate treasuries and municipalities.[20] Banks may also reduce corporate revolving lines of credit, which are crucial funding backstops for corporations. In addition, the demand for U.S. and foreign sovereign debt could weaken, decreasing liquidity in the markets for such debt and increasing the volatility and cost of funding for government debt. As increasing numbers of firms exit such business lines, market concentration could increase, exacerbating "too big to fail" issues and promoting the migration of critical financial services to the shadow banking sector.

We believe that the Agencies should shift their focus to improving the efficacy of risk-based capital adequacy measures. Simple leverage ratios have historically been a reliable leading indicator of neither failure nor risk. The rationale for the risk-weighting approach established by the Basel Committee over twenty years ago remains valid and should not be discounted simply because implementation has to date been flawed. Quite simply, capital adequacy should not be judged without taking into account the riskiness of assets.[21]

The Basel III regime has made progress toward addressing the deficiencies in the risk-based system. For example, the definition of bank capital has been narrowed to rely more heavily on the strongest forms of capital, and the calibration of risk-weights has been vastly improved, including the treatment of securitized assets and off-balance sheet exposures. Complementary tools, such as liquidity requirements and stress testing, will make the financial system much more resilient to sudden negative shocks.

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[19] *Id.* at 1.

[20] While we understand the Agencies' concerns about over-reliance by an institution on short-term wholesale funding, we do not believe that the Agencies should address such questions through the blunt instrument of a constraining leverage ratio but rather through a more tailored approach that does not harm markets.

[21] *See Testimony Before the S. Comm. on Banking, Housing & Urban Affairs*, 112th Cong. 18 (July 21, 2011) (statement of Hal S. Scott, Director, Comm. on Capital Mkts. Reg.), *available at* http://www.capmktsreg.org/pdfs/2011.07.21_Senate_Statement.pdf.

Leverage Ratios and Liquidity Requirements

The Proposed Rule's emphasis on leverage ratios is in direct conflict with the objectives of liquidity regulation, such as the Basel Committee's liquidity coverage ratio, which aims to ensure an adequate amount of liquid assets to cover a sudden withdrawal of short-term liabilities.[22]

Minimum liquidity requirements, much like minimum capital requirements, are designed to establish an absolute floor—not a target. Ideally, bank management and market forces will establish liquidity levels well above the regulatory minimum. However, increasing the minimum leverage ratio requirement threatens this objective. Low-risk assets, such as cash and Treasuries, are the most liquid asset classes as well as the most effective in satisfying liquidity requirements. The Proposed Rule's effective regulatory tax on low-risk securities will, contrary to policy, provide incentives to reduce inventories of liquid securities. The Proposed Rule may also reduce banks' willingness to accommodate large increases in client cash balances or accept segregated deposits. This downward pressure may cause liquidity levels to drop to the regulatory minimum, contrary to the Basel Committee's goal of "ensuring that banks have an adequate stock of unencumbered high-quality liquid assets . . . ."[23] Indeed, the Basel Committee has recognized that risk-based capital measures are preferable to leverage ratios for purposes of liquidity regulation, since risk-based measures do not "deter banks from holding liquid or other assets which carry low risk."[24]

Leverage Ratios and Contagion Risk

In 2008, the Lehman Brothers failure sparked a contagious run on other financial institutions that spread rapidly throughout our financial system. Absent government intervention, contagion forces banks and financial institutions to liquidate assets at fire-sale prices, thus exacerbating the stress on such institutions. To the extent that the failure of a large SIFI increases the risk of contagion, the "too-big-to-fail" problem persists with all its attendant consequences.

The Proposed Rule's requirement to increase the minimum leverage ratio for the largest financial institutions does not adequately address the risk of contagion. Capital requirements may reduce the chance that a SIFI will fail—the more capital an institution has, the better its ability to withstand a run. Nevertheless, a run of the magnitude experienced in the 2008 financial crisis is likely to overwhelm any capital requirements within the plausible range of policy options—short of restoring 19th century levels of capital—due to the losses that ensue from fire sales. Moreover, the Proposed Rule may even accelerate such fire sales, as banks scramble to sell assets in times of market stress when the leverage ratio becomes a binding constraint for an increasing number of banks. Indeed, a binding leverage ratio makes a bank indifferent, at the time of sale, between selling risky versus less risky assets, as each will equally lower its total asset level. Thus, in times of stress, a bank is likely to offload those assets that are more liquid and easier to sell, with the perverse result that the bank will hold a greater proportion of risky assets during an economic downturn or run.

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[22] *See* Basel Committee, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (January 2013), *available at* http://www.bis.org/publ/bcbs238.pdf.
[23] *Id.* at 1.
[24] *See* Basel Committee, *Discussion Paper: The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability*, *supra* note 17, at 5.

Capital requirements cannot definitively prevent contagion, both because the amount of capital required will be insufficient and also because short-term debt holders may not base their decision-making on the solvency of affected institutions. The most effective means of combatting contagion is therefore through use of "lender-of-last-resort" liquidity provision authorities by central banks. With the risk of contagion largely eliminated through solid lender-of-last-resort policies, the Agencies can credibly commit to a policy allowing any bank to fail regardless of its size.

Leverage Ratio and Competition

The Proposed Rule would also put covered BHCs and their subsidiary IDIs at a significant competitive disadvantage. The Proposed Rule's requirement to increase the minimum leverage ratio for these institutions will lead covered BHCs and their subsidiary IDIs to retain significantly more capital than their counterparties in countries that follow the Basel Committee's consistent 3% recommendation. Such a discrepancy in regulatory capital would harm U.S. institutions, the provision of credit to U.S. consumers and businesses, and U.S. market liquidity. Indeed, application of the Proposed Rule to only the most internationally connected institutions is likely to pose the greatest detriment to these institutions and our internationally dependent markets.

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Thank you very much for your consideration of the Committee's opinion. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu), or its Executive Director of Research, C. Wallace DeWitt (cwdewitt@capmktsreg.org), at your convenience.

Respectfully submitted,

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