Congress of the United States
Washington, DC 20515

November 5, 2013

The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, D.C. 20219

The Honorable Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

The Honorable Martin J. Gruenberg
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429-9990

Dear Comptroller Curry, Chairman Bernanke, and Chairman Gruenberg:

We write to commend you for tackling a core problem in our financial system: too much gambling with other people's money, by banks that are often regarded as too big to fail. As Andrew Haldane, the Executive Director for Financial Stability for the Bank of England, has noted, every financial crisis has one critical ingredient: excess leverage. This is because a financial institution with a lot of equity can absorb unexpected losses, whereas one with too much debt relative to its equity will fail in the face of financial stress.

We think that the standard you have proposed, a supplementary leverage ratio (SLR), is less prone to manipulation and more likely to succeed than many alternatives. At the same time, we also believe that the proposed ratio is simply too low. As Nobel Prize winner Eugene Fama recently argued, "The simple solution is to make sure these firms have a lot more equity capital -- not a little more, but a lot more -- so they are not playing with other people's money." We agree.

The problem the proposed rule addresses is as follows: A system in which banks or bank-like institutions are tightly coupled with one another, and in which those institutions have too much debt relative to equity, is prone to meltdowns that can spill into the real economy and cause massive damage. Whether these liabilities are in the form of derivatives and off-balance-sheet assets or overvalued tulips pledged as collateral, too much debt without loss-absorbing equity to match it is simply too dangerous to exist.

It is difficult to measure the exact cost to society of our undercapitalized large banks blowing up during the most recent financial crisis, but it was certainly enormous. The nonprofit advocacy and research group Better Markets pegged the cost at roughly $12 trillion, whereas the U.S. Government Accountability Office put it at $22 trillion. Regardless of which figure one uses, it is obvious that the United States is a much poorer society because there was too much leverage backed by over-valued collateral in our financial system. The proposed rule strikes at this problem.

Of course, all capital and accounting standards are not created equal, and many are prone to manipulation, especially during a crisis. For example, in 2009, the Financial Accounting Standards Board (FASB) Chairman Robert Herz complained of getting "calls and visits from some of those institutions that are now in government hands, about two weeks before they get taken over, trying to get the accounting [standards] changed." It is critical to set standards that are as simple and strong as possible, so as to reduce the pressure on regulatory bodies to allow bad actors into the market, as well as to create sufficient information in the market to ensure that investors are pricing risk accurately.

The proposed rule by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) would require large, systemically important financial institutions (SIFIs) to hold more equity relative to their amount of debt. This rule would require the application of the SLR to the institution's balance sheet, in addition to a risk-adjusted capital ratio. An SLR measures a financial institution's tier one capital against its total assets. A risk-adjusted capital ratio measures a financial institution's capital base against assets that are adjusted by regulators based on how risky they are perceived to be. According to the rule, SIFIs would be required to have a minimum capitalization of 3%; to be allowed capital distributions and executive bonuses, the capitalization would be higher, at 6% for the holding company.

An earlier rule proposed a minimum amount for the SLR. This rule would define the amount required for an institution to be deemed well-capitalized and able to pay out executive bonuses and dividends. It only applies to bank holding companies (BHCs) with more than $700 billion of consolidated assets or over $10 trillion in assets under custody. The institutions to which this rule would apply are Citigroup Inc.; JPMorgan Chase & Co.; Bank of America Corporation; The Bank of New York Mellon Corporation; Goldman Sachs Group Inc.; Morgan Stanley; State Street Corporation; and Wells Fargo & Company. These are the institutions that are often regarded as "too big to fail."

We believe that a SLR is a more accurate measurement of how much risk a financial institution is actually taking on, versus using risk-based capital.

In a crisis, as former FDIC Chairman Sheila Bair has observed, the market cares about the leverage ratio, not risk-adjusted capital. Risk weights are prone to manipulation by internal bank models. As the Vice-Chairman of the Federal Deposit Insurance Corporation (FDIC), Tom Hoenig, has noted, there was a "steady downward trend in risk weights and upward trend in leverage leading into the crisis." And less-capitalized banks manipulated risk weights after their internal models were approved by regulators. The use of a leverage ratio in the United States by regulators meant that American banks were, relatively speaking, better capitalized than their European counterparts.

Risk-weighted capital ratios also have the added downside of increasing, rather than reducing, systemic risk. Regulators deemed certain asset classes as less risky than others. Mortgage backed securities, sovereign debt of Zone A states, agency debt, and interbank debt all effectively received subsidies because regulators determined that banks had to hold limited capital against them. Thus, a crisis beginning in mortgage debt spread through agency debt, interbank debt and into sovereign debt. Risk-adjusted capital allowed banks to treat Greek sovereign debt as bearing the same risk as German sovereign debt. Regulators cannot predict the future, but risk-adjusted capital models require them to. Leverage ratios do not.

As you continue crafting and applying this rule, we believe several principles should apply:

1) **When in Doubt, Require More Capital**: Insufficient capital requirements for banking institutions might increase the return on equity of specific institutions and help bank executives garner bonuses, but it also caused a multi-trillion-dollar financial crisis. Erring on the side of requiring too little capital is not a risk worth taking. It makes no sense that smaller, simpler, less complex banks that have no implicit backstop are better capitalized than large, opaque, and systemically significant institutions that have sprawling international operations and an undeserved taxpayer-enabled funding advantage.

   Stanford University professor Anat Admati recommends that large banks hold capital levels of 20 percent. Tom Hoenig has pointed out that the average Tier 1 leverage ratio for banks that have between $250 million and $10 billion in assets is a little under 10 percent. A 6% ratio, with a 3% minimum threshold, is insufficient. We urge you to increase the SLR substantially for large institutions, in accordance with bipartisan legislation backed by Senators Sherrod Brown and David Vitter.

2) **Set the Highest Possible Standards**: Setting high capital standards is critical; in a crisis, simplicity matters. An SLR is simpler and easier to understand than a risk-based capital ratio. Therefore, we think an SLR should be the primary measure for regulators, and that risk-based capital standards should be the backstop. During a crisis, investors believed the leverage ratio, whereas they did not trust risk-based capital.

   Ensuring that the SLR is a high-quality ratio is also critical. The numerator in the ratio should be Common Equity Tier 1 capital. In addition, the SLR should conform to the proposed Basel revision of leverage ratio (from consultative document issued June 2013). The Basil revision updates capital standards for derivatives and off-balance sheet assets, although we'd prefer the use of the more cautious International Financial Reporting Standards (IFRS) when accounting for derivatives exposure as opposed to Generally Accepted Accounting Principles (GAAP). Regulators should also ensure that loan loss reserves and deferred tax credits are not being included as a part of an institution's regulatory capital.

3) **Cast a Wide Net**: The application of the Supplementary Leverage Ratio should be extended beyond the largest financial institutions. The Savings and Loan crisis involved thrifts that were not particularly large, but it still was costly to certain regional economies. The fall of Long Term Capital Management, a highly leveraged hedge fund, created enormous problems for the large banks and nearly required a massive bailout. In a deeply interconnected system without the firewalls of Glass-Steagall, the risks of inadequate capitalization are not confined solely to the largest institutions or solely to banks. Regulators should consider using their authority to extend it beyond the largest financial institutions, and into institutions that are smaller institutions that are nonetheless an integral part of the financial system.

4) **No Self-Regulation**: There should be no self-regulation when it comes to setting capital standards. Large banks are asking that requirements to hold capital against derivatives exposure be calculated based on internal bank models, which include the use of Value-At-Risk (VAR) calculations. Internal bank models are prone to manipulation, and VAR fails precisely when a financial crisis hits.

   This is also why banks should not be allowed to net between trading and banking books. We believe that the more reasonable firewalls there are within and between institutions, the less interconnected the system is, and the less risk it poses to the real economy.

   In addition, we think that it is problematic to treat insured depository institutions (IDIs) that are subsidiaries of bank holding companies differently from the holding companies themselves. There is no reason for a 5% ratio for the IDIs and a 6% ratio for the holding company. This is an invitation to regulatory arbitrage.

Once again, we thank you for your attention to this matter. Inadequate capitalization of large financial institutions was at the heart of the financial crisis. Thank you for your work to address this critical problem.

Sincerely,

Alan Grayson
Member of Congress

John Conyers
Member of Congress

Keith Ellison
Member of Congress