

The Systemic Risk Council

October 15, 2013

The Honorable Ben Bernanke
Chairman, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Martin Gruenberg
Chairman, Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Re: Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions

Federal Reserve Board: Docket No. R-1460
FDIC RIN: 3064-AE01
OCC Docket ID: 2013-0008

Dear Chairman Bernanke, Chairman Gruenberg and Comptroller Curry:

We write to support the agencies for proposing to establish a supplementary leverage ratio for the largest, most systemically significant, U.S. banking organizations. While we recommend the agencies raise the standard to at least 8 percent for both insured depository institutions and their holding companies, rather than the proposed 6 percent for insured depository institutions and 5 percent for holding companies, we commend the agencies for taking this important step in limiting destabilizing leverage at our nation's largest financial institutions. Strong leverage ratio requirements will substantially strengthen the loss absorbing capacity of U.S. financial institutions and reduce systemic risk.

A Leverage Requirement Is an Essential Tool for Improving System Stability

Leverage Is a Key Component of Institutional Risk & Financial Contagion. Not only is leverage a key component of an individual organization's riskiness and loss absorbing capacity, it is a key transmitter of risk to other institutions and throughout financial markets. Losses are an inevitable part of financial intermediation, but the impact of losses varies dramatically based on an institution's leverage. Not only will a highly leveraged firm fail *faster* than a less leveraged firm

facing equivalent losses, its failure or threat of failure will have a greater systemic impact transmitting potential losses to its counterparties (including those providing the leverage). If the counterparties are also highly levered, the impact spreads even farther and deeper.

The Leverage Ratio and System Stability. Measuring and limiting leverage is essential to understanding and reducing institutional and systemic risk. The proposed supplemental leverage ratio can reduce these risks in a number of ways, particularly by buttressing key weaknesses inherent in the current risk-based capital regime.

The existing risk-based capital requirements have a number of shortcomings that have been extensively highlighted.¹ Risk-weightings are static and imperfect. They are not impartial but instead set by regulators or by firm management (through internal models). In either instance they are tainted by various biases (including asset behavior in the recent past), incomplete information and the inherent impossibility of economic forecasting. The setting of particular weightings can also be tainted by political incentives (e.g., to favor local sovereign debt or particular institutions (i.e., “national champions”). Not surprisingly, this process often leads to complex rules filled with exceptions and carve-outs that can create perverse incentives to purchase certain favored assets and providing a false sense of security. These problems are further magnified in advanced approaches which allow the use of banks’ own internal models for setting regulatory capital.²

¹ See e.g., “*Basel III: A Well Intentioned Illusion*,” Thomas Hoenig, Vice Chairman, Federal Deposit Insurance Corporation, Apr. 9, 2013, <http://www.fdic.gov/news/news/speeches/spapr0913.html> (Noting “[a]n inherent problem with a risk-weighted capital standard is that the weights reflect past events, are static, and mostly ignore the market’s collective daily judgment about the relative risk of assets. It also introduces the element of political and special interests into the process, which affects the assignment of risk weights to the different asset classes. The result is often to artificially favor one group of assets over another, thereby redirecting investments and encouraging over-investment in the favored assets. The effect of this managed process is to increase leverage, raise the overall risk profile of these institutions, and increase the vulnerability of individual companies, the industry, and the economy. It is no coincidence, for example, that after a Basel standard assigned only a 7 percent risk weight on triple A, collateralized debt obligations and similar low risk weights on assets within a firm’s trading book, resources shifted to these activities. Over time, financial groups dramatically leveraged these assets onto their balance sheets even as the risks to that asset class increased exponentially. Similarly, assigning zero weights to sovereign debt encouraged banking firms to invest more heavily in these assets, simultaneously discounting the real risk they presented and playing an important role in increasing it. In placing a lower risk weight on select assets, less capital was allocated to fund them and to absorb unexpected loss for these banks, undermining their solvency.”) See also “*A More Prominent Role for the Leverage Ratio in the Capital Framework*,” Jeremiah Norton, Director, Federal Deposit Insurance Corporation, Feb. 6, 2013.

² See e.g., SRC Letter to Basel Committee on Bank Supervision Regarding Regulatory Simplification Discussion Paper, October 15, 2013, www.systemicriskcouncil.org (Noting the SRC’s “strong concerns about regulators’ continued willingness to allow these giant institutions to use their own internal risk models to lower their minimum required regulatory capital. Not only do models routinely fail in a crisis (precisely when we need loss absorbing shareholder equity most) – their use for regulatory capital purposes is a key contributor to complexity and market uncertainty... Accordingly, we believe regulators should stop using internal models to risk weight assets for regulatory capital purposes... Minimum risk-based capital requirements should be just that: a minimum. If internal models identify additional risks that require higher capital, firms should be required to raise more equity. Management, boards, examiners, investors and counterparties deserve an objective and clear minimum risk-based capital baseline.”)

Adding a strong simple leverage ratio can counter many of these shortcomings. A leverage ratio is easy to understand, comparable across firms, and difficult to “game.” This dramatically improves market transparency about a firm’s risk and allows investors and counterparties to perform apples-to-apples comparisons among large, complex institutions. These are enormous advantages compared to the current risk-based standards.

Strong Leverage Requirements Support Traditional Lending. While some opponents suggest strengthening leverage restrictions will decrease traditional lending, the opposite is more likely. As noted by Mervyn King, then Governor of the Bank of England:

Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending. That is why some of our weaker banks are shrinking their balance sheets. Capital supports lending and provides resilience. And, without a resilient banking system, it will be difficult to sustain a recovery.³

Stronger leverage requirements support traditional lending for several reasons:

A stronger leverage requirement will reduce the artificial (and perverse) incentives created by the risk-based capital framework to engage synthetic finance relative to traditional lending. Current risk-based capital rules already apply a significant “haircut” for traditional commercial and consumer lending activities while providing a smaller or no haircut for more exotic financial activities like derivatives, “repo” financing or sovereign debt purchases. In short, the current risk-based capital framework requires these institutions to hold more capital for traditional lending than they do for a host of exotic financing – this incentivizes this exotic finance at the expense of traditional lending. Because a robust leverage ratio would not distinguish between these asset types, it would help rebalance these incentives – and help *increase* traditional lending by reducing some of the perverse capital benefits that flow from holding these other types of assets under the current risk-based framework.

A stronger leverage requirement helps protect firms (and the system) from failures and positions firms to lend in a crisis. The strengths of leverage limits are even greater in a crisis. Whereas highly levered firms fail – or need to dramatically scale back on lending – *fueling* a crisis – well capitalized/lower levered firms can step in and make loans – *moderating* a crisis.

³ “A Governor looks back – and forward,” Sir Mervyn King, Governor of the Bank of England, June 13, 2013. <http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech670.pdf>. See also “Monetary Policy – many targets, many instruments. Where do we stand?” Mervyn King, Apr. 16, 2013 <http://www.bis.org/review/r130417c.pdf> (noting “...no matter how much liquidity is thrown at the banking system, lending and the economy will not recover if the banking system is inadequately capitalised and suffering from excessive leverage. That is why the Bank of England’s Financial Policy Committee has placed weight on the need for the weaker UK banks to raise capital. It is not surprising that the more strongly capitalised banks in the UK are expanding lending and the poorly capitalised banks are contracting lending.”); See also “Safe Banks Need Not Mean Slow Economic Growth,” Thomas Hoenig, Vice Chairman, Federal Deposit Insurance Corporation, Financial Times, Aug. 19, 2013.

A Strong Leverage Ratio Will Reduce Artificial Incentives for Interconnectedness and Short-Term, Repo Financing

Similarly, the risk-based capital rules assign low risk weightings to repo financing and lending among financial institutions generally. Primary reliance on risk-based capital ratios, therefore, has created perverse incentives for financial institutions to lend to each other, particularly in the repo market. However, financial institutions' over-reliance on the repo market proved to be highly destabilizing during the crisis. Regrettably, large, financial institutions continue to rely on repos and other forms of short-term, "wholesale" credit. Higher leverage requirements will help toughen capital requirements that have heretofore favored short-term repo financing, over safer, longer-term financing.

By reducing some of the capital advantages associated with repo funding and inter-bank lending generally, a leverage ratio can help encourage firms to better fund their activities with more stable, longer-term funding. In addition to reducing the risk that short-term shocks become much larger systemic problems, longer-term funding can give managers, investors and regulators significantly more time for planning their funding needs.

A Strong Leverage Ratio Will Improve Loss Absorbency and Crisis Risk

While a higher leverage ratio can help increase the total amount of capital – and loss absorbency in these large, complex institutions (a very good thing), it can also help reduce correlations and improve market/asset "diversity." Because existing risk-based capital requirements favor certain asset classes (and institutions naturally migrate to them to appear better capitalized) these requirements can result in "crowded-trades" and correlated holdings. Accordingly, if a favored asset class suffers a shock – the shock is likely to simultaneously affect many, if not all, these institutions. Similarly if one of these institutions is forced to liquidate these assets, the liquidation will affect the value of every other firm's holdings – spreading the shock and reducing the loss absorbing capacity of that capital.

We saw this clearly with mortgage-backed securities leading up to and during the financial crisis. Prior to the crisis, risk-based capital frameworks required that financial institutions have significantly more capital when holding traditional mortgages than when holding mortgage-backed securities. This was based on mistaken – but historically reasonable – views that mortgage-backed securities were "safe." These capital incentives helped fuel the growth of the securitization market, and resulted in many mega-institutions and others holding these assets. When the market turned, or when a troubled institution was forced to sell the assets, many other firms were adversely affected, spreading the risk.⁴

The leverage ratio, however, helps counter this phenomenon. Because it treats all assets the same – it reduces some of the artificial advantages that flow from the acquisition of favored asset-classes in the risk-based framework. Accordingly, institutions can make better (and more unique) risk-reward decisions. This helps increase the asset diversity among firms, improving

⁴ To make matters worse, because these traditional assets were now tied up in complicated trusts and off-balance sheet vehicles, they became even more difficult to workout when they ran into trouble.

loss absorbency and reducing the correlations when shocks occur, particularly when shocks affect “favored” asset classes.

Leverage Requirements and Strong Risk-Based Requirements are the Best Approach

While critics of a leverage ratio argue that it could create perverse incentives for banks to seek higher risk/higher yield assets, any such incentives can be addressed by complementing the leverage ratio with a standardized system of risk weights.

Instead of internal models, the risk weights should be determined by regulators, not the banks, and based on sound judgment as well as strong analytics. The establishment of these weights should be insulated from political interference or desires of governments to drive capital to particular asset classes, e.g., housing or sovereign debt. The process of setting minimum risk-based capital should also remain fluid, with a basic international framework recognizing the ability of domestic regulators to supplement risk weights (i.e., raise capital requirements) as judgment and empirical experience warrants.

Because each approach addresses the potential shortcomings of the other, using these two approaches in tandem is best. Moreover, the fact that the proposed tougher leverage ratios will be the binding capital constraint for most of the institutions to which it applies is not an argument for weakening the leverage ratio, as some have suggested. Rather, it is an argument for fundamentally revising and strengthening the risk-based capital requirements which currently permit excessive levels of leverage because of the way they can be manipulated-- or “optimized” to use industry parlance --by adjusting internal models or shifting more resources into favored asset classes.

Crafting an Effective Leverage Ratio

Eight Percent Is a More Appropriate Level. We understand the challenges in drawing lines in regulation, and defending one number relative to another, similar but different number. That being said, lines need to be drawn, and ultimately, any number must be based to some degree on prudent judgment. Extensive research conducted on banks that became troubled during the crisis demonstrated that an institution’s leverage ratio is a much better predictor of financial health than its risk-based ratio.⁵ To be true to Dodd-Frank’s mandate for higher capital levels for SIFIs, we believe the agencies should consider a leverage ratio substantially higher than the Basel III standard of 3 percent, for the largest, complex institutions. While the agencies’ proposal is a significant step in the right direction, we believe that leverage for such institutions should be no greater than 12 to 1 reflecting a minimum ratio of approximately 8 percent, and indeed the ratio could be set more than double that, based on available research.

Moreover, to protect depositors and taxpayers, holding companies are required to serve as a “source of strength” for their bank subsidiaries. Under the proposal Banks would have a leverage

⁵ See “Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and Across System,” GAO-09-739, Washington, DC July 2009; Calibrating regulator minimum capital requirements and capital buffers: a top-down approach, Basel Committee on Banking Supervision, Basel, Switzerland, October 2010; and “Is Basel II enough? The benefits of a leverage ratio,” speech by Philip M. Hildebrand, London, 15 December 2008.

requirement of 6 percent, while the holding company would be 5 percent. Setting a holding company leverage ratio below that of the bank's compromises the holding company's ability to serve as a source of strength for the bank. Where a financial conglomerates' insured banking subsidiaries represent a large portion of holding company assets, a weaker minimum ratio for the consolidated entity will mean that the bank subsidizes excessive leverage in nonbank affiliates. For instance, if 80% of the consolidated entity's assets are in the insured bank, and the insured bank's minimum ratio is 6%, non-bank affiliates can maintain a capital ratio as low as 2% and while still meeting a consolidated standard of 5%. Even where the insured bank represents a smaller percentage of consolidated assets, the consolidated entity's minimum capital ratio should be at least as high as that of its bank. As we saw during the crisis, the large financial institutions with the smaller insured deposit base were the ones most likely to get into trouble. This is because they had large securities and derivatives trading portfolios that were heavily exposed to sudden, market losses, and were overly reliant on wholesale, short-term funding. To help stabilize the system, the FDIC was forced to take huge risks in temporarily guaranteeing their debt so that they could continue to fund themselves. In addition, the Federal Reserve approved a number of 23A applications to allow these institutions to transfer tens of billions of assets into their insured banks.

The logic of lower holding company capital requirements is also inconsistent with the need for an effective orderly liquidation authority (OLA) under Title II of the Dodd-Frank Act. OLA is a critical tool for ending too-big-to fail. However, for the FDIC's "single point of entry" OLA strategy to work without exposing taxpayers to risk or creating gaming and moral hazard opportunities at the operating company level, LCFIs must have enough capital and loss absorbing capital at the holding company level. Raising leverage protections buttresses that regime and helps reduce the risk of too big to fail, while allowing lower holding company capital undermines OLA's credibility, encourages gaming and leaves markets uncertain about the government's willingness and ability to handle an LCFI failure without taxpayer exposure.

Given the experience of the 2008 financial crisis, as well as the spirit of the Dodd-Frank Act which clearly mandates that holding companies be a source of strength for insured banks,⁶ we strongly encourage the regulators to set both ratios at 8 percent, or even higher for the holding company than for the insured depository institution.

Strong Definition of Capital. The agencies' have requested specific comment on the appropriate definition of capital to use in the "numerator" of the leverage ratio. As proposed, Tier 1 capital would be used, which is a weaker standard than the Tier 1 common standard agreed to by the Basel Committee for risk-based ratios and included in the so-called Basel III rules recently approved by the agencies. Tier 1 capital includes perpetual preferred securities, minority interests, and other elements which make it less capable of absorbing losses than the more stringent Tier 1 common standard. Common equity was the only measure of capital strength trusted by the markets during the financial crisis. In defining capital, we encourage regulators to use the standard most likely to keep an institution solvent and lending during periods of market distress. In addition, in the interests of simplicity and clarity, we would encourage the agencies to use the same standard in defining capital for both the leverage and risk-based ratios. This

⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, Sec. 616.

would better enable markets analysts and others to compare the impact of risk weighting on large banks' reported capital strength.

Independent/Complementary Standard. To be effective, it is essential that the leverage ratio and the risk-based ratio remain independent tests. Introducing "risk-based" criteria into the leverage ratio will undermine its effectiveness as a counter support to the risk-based standards. For example, some have advocated for removing Treasury securities or other assets from the denominator of the leverage ratio on the grounds these securities are credit-risk free and therefore should not be included. This would be a mistake for a number of reasons:

- (1) While Treasury securities are generally considered free from credit-risk they do carry other risks that are important to investors, counterparties and regulators. By including all assets in the leverage ratio, markets will have a much better idea of the firm's true size and risk. Leaving them out will create another gap in transparency.
- (2) Removing Treasuries will make firms appear less levered than they actually are – effectively *lowering* the amount of capital they would otherwise be required to hold.⁷ This will provide a false sense of security to those relying on the flawed ratio and a reason to discount the ratio for those seeking a more accurate sense of the firm's financial condition.
- (3) Any gaps in the leverage ratio will magnify the arbitrage incentives that already exist in the risk-based approach. The point of leverage ratio is to counter the weaknesses inherent in the risk-based framework, not to further them. The risk-based approaches already incent a number of asset classes "favored" by regulators (especially sovereign debt like Treasuries). The leverage ratio should help counter those incentives with a separate, simple, *all assets* test.

Conclusion

We appreciate the opportunity to provide these comments and commend the agencies for taking this important step. A strong leverage ratio requirement can significantly improve system stability and we urge the agencies to finalize rules that achieve these goals.

Respectfully submitted,



The Systemic Risk Council
www.systemicriskcouncil.org

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⁷ See e.g., "Leverage Ratio Take 2: who is exposed, as proposed," Goldman Sachs Equity Research, July 10, 2013. (Estimating a 70bp rise in the leverage ratio with the exclusion of all government assets from the calculation (i.e., Fed Funds, Treasuries, Agencies), and an additional 50bp if all cash assets were excluded.)

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