Systemic Risk Council

October 4, 2012

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

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

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

RE: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (RIN 3064-AD95); Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (RIN 3064-AD96); Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (RIN 3064-AD97)

Dear Chairman Bernanke, Comptroller Curry, and Acting Chairman Gruenberg:

The Systemic Risk Council, an independent and non-partisan council formed by the CFA Institute and The Pew Charitable Trusts, appreciates the opportunity to comment on the three notices of proposed rulemaking cited above. We have been concerned about the slow progress of regulatory reform of U.S. capital markets, especially those focused on systemic risk, and are therefore pleased to see these proposals. Your rulemaking actions this June begin to address one of our key priorities: immediate action to propose and finalize rules that will substantially strengthen both the quality and amount of capital at the nation's largest financial institutions.

We strongly support your proposals overall to implement the new Basel III regulatory capital framework, the Standardized Approach for risk-weighted assets contained in Basel II, and the capital-related provisions in the Dodd-Frank Act that will raise both the quality and quantity of capital at banking organizations in the United States. These are good minimum standards that can and should be exceeded, based on the risk profile of an individual banking organization, as determined by that organization's primary federal regulator. Your actions are in stark contrast to your European counterparts who reportedly want the Basel III capital requirements to be the maximum rather than the minimum. The recent European-British finance ministers' debate on requiring more than the Basel III minimum capital is just one example. Continental Europeans felt that stronger capital requirements would confer a competitive advantage on UK banking

organizations. We believe that a stronger U.S. regulatory capital regime will continue to benefit U.S. banking organizations vis-a-vis their more thinly capitalized European competitors.

While we generally applaud these proposals, we believe equity funding (capital) should be strengthened by simplifying the new rules, addressing interconnectedness, and further constraining leverage. We offer several suggestions that would strengthen capital adequacy, particularly at the largest banking organizations.

- Timetable – The Basel III proposed rule is a good and much needed improvement with its emphasis on common equity capital, the most loss absorbing component of capital. However, the implementation timetable is extraordinarily long. The largest U.S. banking organizations have consistently said they already meet the Basel III requirements so why wait? The final rule should significantly shorten the time line for implementation.

- Complexity and the Standardized Proposed Rule – The Standardized rule proposes that the Standardized Approach be designated as the new "generally applicable" risk-based capital requirement, or the new floor for the largest banking organizations that use complex modeling methods to lower their risk-based capital requirements. However, the Standardized Approach also would allow use of complex modeling methods to determine capital requirements for transactions that were some of the most troublesome during the crisis – repo-style transactions, eligible margin loans, and OTC derivatives - and the proposal poses questions about using even more complex modeling methods. These modeling techniques would allow big banking organizations with sophisticated analytical capabilities to have even less capital than was required during the crisis. This simply defies logic if the Standardized Approach is to serve as a capital floor for the Advanced Approaches capital framework. Furthermore, complex models are prone to failure as evidenced by the recent and mounting losses from the "whale" trading at one of the largest and well-managed U.S. banking organizations.

- Concentration of Risk among Banking Organizations – The regulatory capital proposals should do more to reduce interconnectedness among banking organizations. Interconnectedness was an often cited reason for bailing out financial institutions during the crisis. To ensure the resilience of the financial system in times of stress, banking organizations need to reduce their exposures to each other. However, the Standardized proposal retains the same preferential risk weight for all U.S. insured depository institutions (20 percent) and the same, much higher risk weight for corporations (100 percent). This means a banking organization would have to fund a claim on IBM with five times more equity (capital) than a claim on Citibank. Provisions in Title I of the Dodd-Frank Act require the Federal Reserve to set credit limits for large banking organizations' exposures to each other and require credit exposures reports. Thus, regulators need to consider whether their new capital proposals are consistent with the Dodd-Frank Act's overarching goal of reducing interconnectedness, especially for the largest banking organizations.

- Prioritization – We encourage you to put greater priority on addressing leverage at the very largest banking organizations and the shadow sector (systemically important

financial institutions or SIFIs). The Basel III proposed rule applies tougher capital requirements to all banking organizations, which is appropriate. However, in general, traditional banking organizations, which confine their activities to commercial banking, already have capital far in excess of the new minimums. For the most part their capital levels remained high during the crisis, and excessive leverage among traditional banks was not a driver of the crisis. By contrast, the greater risks relative to capital at the large, complex banking organizations and "shadow" banks contributed significantly to the crisis. Nonetheless, federal bank regulators have failed to propose a SIFI capital surcharge for these organizations.

- Leverage Ratio[1] - The Basel Committee has developed a SIFI capital surcharge for large, internationally-active banking organizations based on risk-based capital levels but not on leverage. However, the Dodd-Frank Act requires that *both* risk-based capital *and* leverage standards should be higher for SIFIs than for non-SIFIs. The new international leverage ratio under Basel III and the proposed rule is only 3 percent (though the 3 percent does apply to certain off-balance sheet assets). The current U.S. leverage well capitalized standard applicable to FDIC insured banks is 5 percent. Extensive research conducted on banks that became troubled during the crisis demonstrated an institution's leverage ratio is a much better predictor of financial health than its risk-based ratio.[2] To be true to Dodd-Frank's mandate for higher capital levels for SIFIs, we believe the Federal Reserve should consider a leverage ratio substantially higher than the Basel III standard of 3 percent, for the largest, complex institutions. 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.

- Shadow Banks - The Financial Stability Oversight Council (FSOC) should move ahead with the designation of nonbank financial companies as systemic. Currently these capital rules only apply to banking organizations and savings associations and their holding companies but leverage was a much greater problem among shadow banks during the crisis. Indeed, FDIC insured commercial banks maintained leverage at around 12 to 1, while leverage at major securities firms, for instance, exceeded 30 to 1. One lesson of the crisis is that it is not sufficient to simply regulate FDIC insured banks; risk seeps out into other, less transparent parts of the system. The FSOC needs to move forward with SIFI designations and the Federal Reserve Board needs to promulgate a capital regime which will constrain excessive leverage in that sector.

Thank you for the opportunity to comment on these important rules. There is broad agreement that stronger capital requirements will give us a much more resilient financial system and tame

[1] The underlying concept of the U.S. leverage ratio is capital relative to on-balance sheet assets. The Basel III leverage ratio is based on capital to on-and off-balance sheet assets. By contrast, the other Basel ratios are capital to risk-weighted assets.

[2] See *Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and across System,* GAO-09-739, Washington, DC, July 2009; *Calibrating regulatory 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 Mr. Philipp M. Hildebrand, London, 15 December 2008.

risk taking by forcing financial institutions to put more of their own "skin in the game". This will help reduce volatility, sustain growth, and keep employment high. While we applaud these stronger capital rules, we encourage you to reinforce and simplify them, and place greater priority on constraining leverage among both bank and non-bank SIFIs.

Respectfully submitted,

The Systemic Risk Council

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