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June 3, 2016

Board of Governors Federal Reserve Board
c/o Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Re: Regulation YY; Docket No. R–1534; RIN 7100-AE 48
Single-Counterparty Credit Limits for Large Banking Organizations

Dear Governors,

On behalf of more than 400,000 members and supporters of Public Citizen, we write to express our views on the Federal Reserve Board's (Board) proposal regarding Single-Counterparty Credit Limits for Large Banking Organizations. In brief, we find the proposed credit limit too high.

The financial crisis of 2007–2008 demonstrated the peril that can ensue when the nation's largest financial institutions found some of their larger borrowers unable to meet their obligations. As the old saying instructs, "if a small borrower can't pay a bank, that's a problem for the small borrower. If a large borrower can't pay, that's a problem for the bank."

Precipitating the crash, insurance firm AIG was unable to satisfy the credit default swap (CDS) insurance policy claims by major firms such as Goldman Sachs and Citigroup. Since these insurance policies backed some of Goldman's and Citi's other endeavors, Washington banking officials decided to deploy taxpayer funds to make good on AIG contracts.

Regulators had also overlooked the credit exposure of derivative contracts (especially regrettable given that the legal basis for permitting these speculative contracts in the first place was that they were closely related to lending).[1] For example, certain commercial banks were subject to single-borrower lending and investment limits. However, these limits often excluded credit exposures generated by derivatives and some securities financing transactions, and did not apply at the consolidated holding company level.

[1] Saule Omarova, *The Quiet Metamorphosis*, CORNELL LAW SCHOOL (July 2009), http://scholarship.law.cornell.edu/facpub/1021/.

Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) authorizes the Board to establish single-counterparty credit limits for bank holding companies with total consolidated assets of $50 billion or more and any U.S. intermediate holding company in order to limit the risks that the failure of any individual firm could pose to a covered company.

Credit exposure to a company is defined in section 165(e) of the Dodd-Frank Act as all extensions of credit to the company, including loans, deposits, and lines of credit; all repurchase agreements, reverse repurchase agreements, and securities borrowing and lending transactions with the company (to the extent that such transactions create credit exposure for the covered company); all guarantees, acceptances, and letters of credit (including endorsement or standby letters of credit) issued on behalf of the company; all purchases of, or investments in, securities issued by the company; counterparty credit exposure to the company in connection with derivative transactions between the covered company and the company; and any other similar transaction that the Board, by regulation, determines to be a credit exposure for purposes of section 165.4

The statute provides a baseline prohibition for these firms to a credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus of the covered company. Critically, the statute provides that the Board may determine by regulation a lower limit if considered necessary to mitigate risks to the financial stability of the United States.

For the largest banks, the Board proposes a credit limit of 15 percent exposure to another large bank. We support the Board's exercise of congressionally-authorized latitude in reducing the level from the maximum set by Congress. We believe, however, that the limit remains too high. The Board explains only that this level stems from a study that compares the risk sensitivity of financial firms to other financial firms, relative to the sensitivity of financial firms to real economy firms. The Board's study answers an important question. But other critical questions remain. Most notably, would either the 25 percent and 15 percent levels provide for prudence?

The statutorily-proposed 25 percent limit could mean that a bank could expose 100 percent of its entire capital to 4 borrowers. If an industry where four corporations faltered, this would lead to abrupt insolvency at the bank. Such a circumstance now exists in the energy sector. A Deloitte Touche study predicted that a third of the world's energy companies could declare bankruptcy this year, leaving $150 billion in unpaid debt.[2] In the troubled oil and gas extraction sector, the mega-banks are especially exposed. A Goldman Sachs report itemized the vulnerabilities: Bank of America leads the list with $21.3 billion. Citigroup is next at $20.5 billion. Wells Fargo is third at $17 billion. JPMorgan Chase is at $13.8 billion. Morgan Stanley is at $4.8 billion, PNC Bank has $2.6 billion and US Bancorp is at $3.1 billion.[3]

On the other side of the coin, why and when does a bank need or choose to expose so much capital to a single firm? At JPMorgan, with roughly $200 billion in capital, this rule would allow it to loan $30 billion to a single borrower. The largest loan in American history totaled $60 billion. Not one bank but a syndicate of more than a dozen participated in this loan, including JPMorgan, Morgan Stanley, Barclays, and Bank of America. [4]

[2] Claire Zillman, *A Third of Oil Companies could go Bankruptcy this year*, FORTUNE (February 16, 2016), http://fortune.com/2016/02/16/oil-companies-bankrupt/.

[3] Jake Novak, *Just how much oil pain is coming for the banks?* CNBC (Jan. 20, 2016) http://www.cnbc.com/2016/01/20/which-banks-have-the-most-oil-exposure.html.

[4] See Michel Sierra, Verizon Markets $61 billion bridge loan," REUTERS (Sept. 2, 2013), http://www.reuters.com/article/us-vodafone-verizon-financing-idUSBRE98202C20130903; and Kayla Tausche, "JPMorgan, Morgan Stanley lead largest-ever loan," CNBC (Sept. 1, 2013) http://www.cnbc.com/id/100997104

Public Citizen proposes a much lower capital limit. We suggest 5 percent of Tier I capital. For JPMorgan, this would permit a $10 billion loan to a real economy firm, which is certainly sufficient for today's largest companies, especially when this $10 billion joins a syndicate with other large lenders. This 5% limit would mean that 20 JPMorgan client firms with loans of this size would need to declare bankruptcy for the bank to reach insolvency.

Further, the Board allows for the use of credit default swaps to reduce the calculation of the exposure. Surely the AIG experience where the credit default swap itself proved worthless should inform the Board about the dangers of this attempted hedge. Public Citizen asks that any borrower's obligations to a bank be recognized directly, whether or not the bank has taken an off-setting position. Generally, we view credit default swaps as undermining the basic relationship between creditor and borrower. In addition, we oppose the Board's acceptance of netting derivatives positions. Reducing to zero the bank's exposure when it makes opposite bets with two counterparties ignores the possibility that some counterparties might not make good if they're on the losing side. Here to, AIG provides a concrete example of these risks.

We urge the Board to reduce the proposed credit limit to 5 percent, which would be a far better prudential protection against the risk of systemic failure, better insulating our economy from additional financial crises.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org, or 202.580.5626

Sincerely,

Public Citizen