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Americans for Financial Reform
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February 28, 2011

Hon. Ben Bernanke, Chairman
Federal Reserve Board
20th Street and Constitution Avenue NW
Washington, DC 20551

Hon. Sheila Bair, Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Mr. John Walsh, Acting Comptroller
Office of the Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

Re: Docket No. OCC-2010-0009 -- Risk-Based Capital Adequacy Framework-Basel II; Establishment of a Risk-Based Capital Floor

Dear Chairs Bernanke and Bair and Acting Comptroller Walsh,

American for Financial Reform ("AFR") appreciates this opportunity to comment on the Notice of Proposed Rulemaking regarding Risk Based Capital Standards: Advanced Capital Adequacy Framework-Basel II: Establishment of Risk Based Capital Floor ("Capital Adequacy NPR"). AFR is a coalition of over 250 national, state, local groups who have come together to advocate for reform of the financial industry. Members of the AFR include consumer, civil rights, investor, retiree, community, labor, religious and business groups along with economists and other experts.

The Capital Adequacy NPR under consideration proposes rules for capital adequacy standards to ensure financial firms have adequate equity to absorb losses and maintain a reasonable level of leverage measured against both average total and risk weighted assets, with the goal of increasing financial stability and helping to prevent financial institution collapse. In particular, the NPR implements the statutory requirement under Dodd-Frank Section 171 (the "Collins Amendment") that the capital requirements for bank holding companies and other large financial

institutions shall not fall below generally applicable leverage and capital standards established for insured depository institutions by the Federal banking agencies.[1]

In the area of capital adequacy, this requirement is one of the most important and clearest legislative directives in the entire Dodd-Frank Act. It is also particularly timely, as it addresses problems with the Advanced Approaches Rule ("AAR") under Basel II that have been made very apparent by the financial crisis. We therefore applaud this proposal as a vital means of extending and augmenting the nation's capital adequacy regime.

First, the proposal provides that the current capital adequacy requirements shall be a floor for capital adequacy purposes regardless of the outcome of the introduction of AAR. This is a prudent and critical measure, as the various Quantitative Impact Studies (QIS) have consistently found that certain Basel II approaches to determining capital risk weights could lead to substantial cuts in capital requirements at major banks. For example, the QIS 5 found that the largest banks using Advanced Internal Ratings-Based (AIRB) models would be permitted to cut required capital over 7 percent compared to current mandated levels, while some medium-sized bank holding companies could be permitted to cut over 20 percent.[2] Regulators should not sanction lower quantities of risk capital held against risk weighted assets than had obtained before the financial crisis of 2008, when the government was forced to bail out financial institutions deemed too big to fail at taxpayer expense.

The lower levels of capital required under the AAR are symptomatic of deeper problems with the Basel II approach that this regulation will help to address. One of these problems is the pro-cyclical nature of capital requirements under Basel II. Because the IRB approach permits banks to align their asset risk weights with recent observed performance of that asset, Basel II risk weights will tend to be lower in good economic times and higher during recessions.[3] This has the effect of lowering bank capital requirements in the upswing of an economic cycle and heightening them in downturns, thus encouraging over-lending in good times and economic contraction in bad. By instituting a flat limit on bank leverage that is not sensitive to the economic cycle, this rule should help to maintain a more consistent level of bank capital over the economic cycle.[4]

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[1] Certain other elements of Section 171 related to the quality of capital, such as the treatment of Trust Preferred Securities, are not addressed in this rulemaking.

[2] Basel Committee on Banking Supervision, "Results of the Fifth Quantitative Impact Study (QIS 5)", June, 2006, Bank of International Settlements, Basel, Switzerland. Available at http://www.bis.org/bcbs/qis/qis5results.pdf.

[3] See e.g. Repullo, Rafael and Javier Suarez, "The Pro-Cyclical Effects of Basel II", Centre for Economic Policy Research Discussion Paper 6862, June, 2008.

[4] This also implies that the economic benefits from the regulation should be measured over the entire economic cycle. For example, when compared to e.g. the Basel II rules this proposal might appear to lose economic benefits by constraining investments in an inflated asset during a financial bubble (e.g. subprime mortgages in 2003-2006 period), but viewed over the entire cycle it could result in significantly greater systemic stabilization.

A second issue addressed by this rule is the inappropriate delegation of regulatory flexibility to private actors such as large banks' internal risk management divisions, and also credit rating agencies. The Basel II IRB approach allows banks to model asset-specific risks using their own assumptions and modeling. These modeled risks are then used to calculate the risk weights that determine required levels of capital. Private ratings agency forecasts of default probabilities and loss given default are often key inputs into these models. During the financial crisis it became clear that bank internal risk models incorporated highly problematic assumptions, and in any case may not be well suited to forecasting the effects of systemic crises.[5] It also became clear that ratings agencies faced deep conflicts of interest that contributed to profoundly flawed estimates of credit risk.[6] Given this experience, regulators should avoid delegation of vital and complex regulatory responsibilities to private actors who face strong conflicts of interest due to profit motives. Given the opacity of financial institution internal risk modeling and the difficulty of providing proper oversight of such models, it may be necessary to seriously reexamine the dependence on internal modeling in regulating capital standards.[7]

While it is not a comprehensive solution to these issues, this rule should assist regulators in addressing both of them. The rule implements the intention of the Dodd-Frank act to set a clear, consistent, ongoing floor for minimum capital and leverage limits. This floor will not vary over the business cycle and therefore is not inherently pro-cyclical in ways that contribute to economic instability. It also does not depend on internal modeling decisions by profit-driven regulated entities which face significant conflicts between the interests of their shareholders and the public interest in systemic stability. Going forward, it is vital to maintain these principles and to effectively implement the floor called for in the Dodd-Frank act.

Some have criticized this approach as unduly constraining the regulatory flexibility necessary to implement Basel III and to address new challenges in financial regulation. This criticism is misguided. This rule leaves regulators substantial flexibility to amend capital rules over time, so long as such amendments do not result in any reduction in capital or leverage requirements compared to either the generally applicable rules for depository institutions, or the leverage or capital requirements in effect at the time of passage of the Dodd-Frank Act.

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[5] See e.g. Jon Danielsson, "Blame The Models", Journal of Financial Stability, Elsevier Press, Volume 4(4), December 2008.

[6] See Carl Levin and Tom Coburn, "Wall Street And The Financial Crisis: The Role of the Credit Rating Agencies", Memorandum, U.S. Senate Permanent Subcommittee on Investigations, April 23, 2010. Available at http://levin.senate.gov/newsroom/supporting/2010/PSI.LevinCoburnmemo.042310.pdf

[7] Tarullo, Daniel, Banking on Basel: The Future of International Financial Regulation, Peterson Institute for International Economics, October, 2008. ISBN 978-0-88132-423-5.

Beyond the general issue of the economic impact and justification for the permanent leverage and capital floor created by this rule, which AFR strongly favors, several other relevant questions are asked by the authors of the Proposed Rule.

Question 1: How should the proposed rule be applied to foreign banks in evaluating capital equivalency in the context of applications to establish branches or make bank or nonbank acquisitions in the United States, and in evaluating capital comparability in the context of foreign bank FHC declarations?

Foreign banks operating in the United States should be treated consistently with U.S. banks. This rule should therefore be applied to the U.S. operations of foreign banks in a manner that is as consistent as possible with the treatment of U.S. banks.

Question 4: The agencies request comment on the most appropriate method of conducting the aforementioned analysis. What are potential quantitative methods for comparing future capital requirements to ensure that any new capital framework is not quantitatively lower than the requirements in effect as of the date of the enactment of the Act?

While AFR does not seek to comment in detail on this question at this time, we would call for an approach that ensures that future requirements hold all banks to the capital and leverage standards in effect for insured depository institutions at the time of passage of Dodd-Frank Act. Importantly, this requirement should be effective across all possible sets of exposures. An "on average" metric that permits capital or leverage standards to decline for some types of exposures while increasing them for others should be avoided and would clearly not be in accord with the intention of the Dodd-Frank Act.

The various Quantitative Impact Studies performed for Basel II offered a variety of methods of determining the impact on regulatory capital of implementing new capital rules across a wide variety of types of assets. These approaches may have to be expanded to incorporate the full range of possible types of exposures.

Assets not explicitly included in a lower risk weight category are assigned to the 100 percent risk weight category. Going forward, there may be situations where exposures of a depository institution holding company or a nonbank financial company supervised by the Board not only do not wholly fit within the terms of a risk weight category, but also impose risks that are not commensurate with the risk weight.

The proposed rule also points out that assets which have not been explicitly classified are currently given a 100 percent risk weight. AFR believes that in cases where asset characteristics have not yet been analyzed by regulators, the asset should be fully risk weighting (at 100 percent). If regulators feel such a weight is inappropriate then the characteristics should be analyzed and the asset class assigned an appropriate risk weight through the regulatory process.

Finally, as a general comment, we believe that capital adequacy rules are just one of many tools that need to be at the disposal of regulators to ensure a sound and solvent banking system. We would like to emphasize that ongoing capital regulation, liquidity requirements and consolidated supervision are all jointly of critical importance in preventing systemic threats from bank and nonbank companies.

Thank you again for this opportunity to comment on this NPR. If you have the further questions, please contact David Arkush, Director of Public Citizen's Congress Watch at (202) 454-5130 or Heather McGhee, Director of the Washington Office of Demos at (202) 559-1543 ext. 105, Co-chairs of the AFR Systemic Risk and Resolution Authority Taskforce.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- ACORN
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans for Fairness in Lending
- Americans United for Change
- Calvert Asset Management Company, Inc.
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action

- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People's Action
- National Training and Information Center/National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS

- U.S. Public Interest Research Group
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)

- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA

- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG