PUBLICCITIZEN Celebrating 40 Years of Progress

October 19, 2012

The Honorable Ben S. Bernanke
Chair
Board of Governors, Federal Reserve System

The Honorable Martin Gruenberg
Acting Chair
Federal Deposit Insurance Corp.

The Honorable Thomas J. Curry
Comptroller
Office of the Comptroller of the Currency

Re: Regulatory Capital Rules, RIN 3064-AD95, AD96, AD97

Dear Chairman Bernanke, Comptroller Curry and Acting Chairman Gruenberg,

On behalf of more than 300,000 Public Citizen members and supporters, we are pleased to comment on the Proposed Rules regarding the implementation of Basel III capital requirements and risk-weighting.

In summary, we ask the agencies to establish a sound leverage requirement of 20 percent. Further, we ask that the agencies dispense with risk-weighting. A substantial leverage ratio will marshall the discipline that at-risk owners bring to any business venture and absorb all losses, eliminating the possibility that taxpayers will again be asked to bail out the financial sector.

Lost in the Forest

We applaud the agencies for their prodigious rulemaking effort, reflected in more than 1,000 pages of discussion and explanation of the proposed new capital and risk-weighting guidelines. But we find the proposed capital requirement problematic in that it represents no change from the level that prevailed before the crash, which obviously proved inadequate.

This trio of agency proposed rules broadly aim to help ensure banks maintain strong capital positions, enabling them to continue lending to creditworthy households and businesses even after unforeseen losses and during severe economic downturns. The proposed rules implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision in addition to changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The first rule makes various adjustments in capital requirements and to the definition of capital. The second rule adjusts specific weights of assets. Banks and regulators use risk weighting to assign different levels of risk to different classes of assets—assets perceived as riskier require higher capital cushions and those assets seen as less risky require smaller capital cushions. The third rule applies to banks with significant international operations and addresses issues involving counterparty risk and interconnectedness.

Although it is widely acknowledged that sufficient capital serves as the foundation of safety in the financial sector, the reason this is true is subject to widespread confusion. Capital must not be confused with reserves. Reserves are funds banks must keep in cash in their vaults or with the central bank. Capital refers to the bank's investor funds at risk in the bank's activities.

"Capital is important to banking organizations and the financial system because it acts as a financial cushion to absorb a firm's losses," said Federal Reserve Chairman Ben Bernanke.[1] In resorting to metaphor, Chairman Bernanke and others who describe bank capital requirements similarly, may obscure a crucial point. Capital does not have any magic absorbent quality as do the sponges that make spills disappear. The "cushion" quality does not mean that capital dollars somehow soften a blow. Instead, the "cushion" and "absorption" qualities refer to the identification of first losers when bank deals go bad. The bank's owners must have substantial "skin in the game." These losers, sound public policy dictates, should be the bank's owners, not its creditors. A capital requirement says, for example, that if a bank wants to loan a small business $1 million, then the bank's owners should put in $100,000, with depositors putting in $900,000. If the small business finds

[1] Press Release, Federal Reserve, June 7, 2012, available at http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm

itself only able to repay $950,000, then the owners "absorb" the $50,000 shortfall, not the depositors.

This identification of initial losers naturally involves tensions. An owner (equity investor) may prefer not to "absorb" all losses. An owner might prefer to invest (and lose) only $10,000 in the small business loan of $1 million that's repaid at $950,000. Conversely, should the business instead succeed, the capital investor can make a greater claim on the interest the small business entrepreneur pays.

The policy choice to make owners first losers isn't arbitrary. At risk equity investors are owners. As such, they control the company. They elect board directors who oversee management. Through these directors, they set policy, including compensation. Shareholders vote on CEO pay. In 2012, Citicorp shareholders rejected the proposed pay for the CEO. While shareholder rights fall far from the ideal, oversight comes through continual pricing of the stock. That not only measures the success of the banking enterprise, but also determines the value of management's own stock. What this means for policy is that the agencies should look to equity investors as a constituency to ensure accountability and discipline. Such discipline should not be seen as retaliation for a banking sector that visited a Great Recession on the world economy. Equity investment provides the same discipline for all companies. Outside of taxpayer-backed, regulated banking, general corporations fund themselves with a greater portion of equity investment relative to borrowed capital than do banks. The average debt/equity ratio of most America corporations is far lower than large banks. [2] Apple Computer, arguably the most successful company currently, as measured by market capitalization, is 100 percent funded with equity capital. That is, the average investors in companies other than banks absorb losses to a greater extent than do investors of banks.

Some may claim general economic harm will result from higher capital requirements, saying that they will retard a bank's ability to lend, to invest in the economy. In 2010, for example, the British Bankers Association argued against higher capital requirements because this is "capital that might otherwise have been deployed as loans to businesses or households."[3] Steve Bartlett, president of the Financial Services Roundtable, declared, "A dollar in capital is one less dollar working in the economy."[4]

But as Sanford Professor Anat Admati observes, "Capital is not a rainy day fund." As in the example above, investor equity capital is deployed alongside borrowed depositor funds in a

[2] Statistical survey, available at http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/Betas.html
[3] Taken from forthcoming book by Anat Admati, titled "The Bankers New Clothes," which cites The Guardian, July 10, 2010.
[4] Taken from forthcoming book by Anat Admati, titled "The Bankers New Clothes," which cites New York Times, Sept. 16, 2010, by Floyd Norris.

business loan. The capital figure that appears at the bottom of a balance sheet as shareholder equity and retained earnings does not measure some cookie jar of cash, but simply the accounting difference between assets and liabilities.

Higher at-risk equity requirements will be welcome by the creditor markets that currently provide the bulk of bank liabilities. JP Morgan Chase finances roughly $2 trillion of assets largely with borrowed capital from depositors and lenders. With greater at-risk investor capital, these creditors will enjoy greater protection in case the bank falters; creditor rates should correspondingly fall.

The cost of protecting taxpayers from another financial sector bailout will be minimal. The Financial Stability Board and Basel Committee on Banking Supervision commissioned a study on the economic impact of raising capital. The October 2011 report found that raising capital requirements at the largest 30 banks by 1 percentage point over eight years leads to "only a modest slowdown in growth" of 0.06 percent "followed by a recovery."[5] For context, the weather has a greater impact on the economy. [6]

Harvard Professor [and now Federal Reserve Board Governor] Jeremy Stein found that loan rates would rise 25 to 45 basis points for a ten percentage-point increase in the capital requirement."[7] The smallest change made by the Federal Reserve to interest rates is 25 basis points. For context, this means that the cost of near bullet proof capital will be the same as a Federal Reserve decision that may go unreported by the financial press owing to its insignificance.

Increasing capital requirements would not have significant adverse effects on the credit available to the nonfinancial sector or on economic growth and employment, according to scholars Samuel Hanson and colleagues.[8] Brookings Institution scholar Douglas Elliot, who was formerly an executive with J.P. Morgan, observed: "The industry has very significantly exaggerated the likely impact of the capital changes."[9]

---

[5]" "Assessment of the Macroeconomic Impact of higher loss absorbency," October, 2011, Basel Committee on Banking Supervision, available at: http://www.bis.org/publ/bcbs202.pdf

[6] "U.S. Economic Sensitivity to Weather Variablity, American Meteorological Society,December, 2010, available at: http://journals.ametsoc.org/doi/pdf/10.1175/2011BAMS2928.1

[7] "An Analysis of the Impact of "Substantially Heightened" Capital Requirements on Large Financial Institutions*" Stein, et al, May 2010, available at http://chifl.shufe.edu.cn/upload/htmleditor/File/120916100241.pdf

[8] "A Macroprudential Approach to Financial Regulation," Stein et al, July 2010, available at http://www.economics.harvard.edu/faculty/stein/files/JEP-macroprudential-July22-2010.pdf

[9] "Studies Question Bank Capital Fears," by David Enrich, Wall Street Journal, August 4, 2010

In sum, these studies and commentary show only a modest cost to the economy from greater equity capital requirements that would be dwarfed by the immeasurably greater benefit of preventing another financial crisis that requires a taxpayer-funded bailout. Public confidence, while difficult to measure quantitatively, would undoubtedly rise.

We believe that these central observations should guide the agencies. Equity capital constitutes the at-risk funding for a bank and should be set at a level that can absorb all losses. Equity capital is not a rainy day fund sitting unproductively idle. Raising capital requirements will not sideline that capital; in fact, it will attract additional creditor capital. Arguments against such levels must be dismissed as serving only the profit opportunity for equity investors and such interests fall outside the mandate of prudential regulators.

Higher capital

The call for higher capital enjoys widespread support, from Republican and Democrat elected officials, scholars, current and former banking regulators, and even some banking industry executives.

Sen. Richard Shelby (R-Ala.), ranking Republican on the Senate Banking Committee, believes capital should be "higher." [10] Sens. Sherrod Brown (D-Ohio) and David Vitter (R-La.) wrote regulators together specifically to urge higher capital standards under this Basel exercise.[11] During recent House and Senate hearings about the JP Morgan "London Whale" losses, members of Congress pointed to the value of ample at-risk investor capital, including Republicans Sen. Bob Corker (R-Tenn.) as well as Reps. Spencer Bachus (R-Ala.) and Randy Neugebauer (R-Texas). [12]

Numerous scholars call for higher capital, including Stanford's Anat Admati and MIT's Simon Johnson.

FDIC Vice Chairman Thomas Hoenig[13] and Bank of England Executive Director Andrew Haldane[14] call for higher capital, as do the two dozen former regulators organized as the

[10] "Sen. Shelby favors tougher bank capital rules," Reuters, June 6, 2012, http://www.reuters.con /article/2012/06/06/us-financial-regulation-capital-shelby-idUSBRE8550ZV20120606

[11] Letter of August, 2012, available at http://www.businessinsider.com/senator-vitter-and-senator-brown-ask-fed-to-increase-capital-requirements-2012-8; see also Oct. 17, available at http://www.brown.senate.gov/newsroom/press/release/sens-sherrod-brown-david-vitter-ask-us-banking-agencies-to-simplify-and-strengthen-bank-capital-standards

[12] Remarks captured on video, available at http://www.youtube.com/watch?v=_x aMFtyzKM

[13] Speech by Thomas Hoenig, September 14, 2012, available at http://www.fdic.gov/news/news/speeches/chairman/spsep1412_2.html

Systemic Risk Council.[15] Former president of the Federal Reserve Bank of New York (and current Goldman Sachs managing director) Gerald Corrigan concurred. "In looking to the future, almost everyone who has seriously studied the causes of the crash agrees that certain basic reforms are a must ... Higher and more rigorous capital and liquidity standards that recognize the compelling reality that managing and supervising capital adequacy and liquidity adequacy must be viewed as a single discipline." [16]

Successful banks already boast substantially more capital than proposed by the agencies., which further underscores the deficiency of the agencies' proposed standard. M&T Bank, for example, reports a leverage ratio of 9.8 percent.[17] JP Morgan claims to maintain a "fortress" balance sheet and exceed regulatory minimums.[18] The Swiss government calls for higher capital standards.[19]

The capital figure used should be the cleanest measure, the leverage ratio, or the amount of tangible common equity as a ratio of total assets. Importantly, this ratio is blind to risk-weighting.

The proposed level of 3 percent is no higher than before the financial crisis. Clearly, that was insufficient. Former Citigroup CEO John Reed stated, "Capital should be significantly increased, maybe doubled." [20]

Hoenig notes that tangible equity ranged from 13 percent to16 percent before the advent of federal deposit insurance in 1933. Senator Brown observes that New York banks in the 1920s funded 15 percent to 20 percent of assets with investor capital.[21] That is, before banks could attract savers' deposits with the promise of full government protection, they needed to put greater owner capital at risk to reassure those depositors.

MIT Professor Johnson and Stanford Professor Admati assert capital should be 20 percent to25 percent, [22]

---

[14]Speech by Andrew Haldane, summer 2012, available at http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf

[15] October 4, 2012 letter from Sheila Bair, and Systemic Risk Council, available at http://www.federalreserve.gov/SECRS/2012/October/20121009/R-1442/R-1442_100412_108558_530565933983_1.pdf

[16] Testimony, Senate Banking Committee, Feburary 4, 2010, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=506fc179-ada7-456b-9b53-fc472b1763ff

[17] M&T Bank 10-k, available at http://ir.mandtbank.com/annuals.cfm

[18] These claims may not comport with reality, but it is instructive that the bank CEO elects to tell shareholders that their capital is beyond the minimum, as opposed to below.

[19] Official Policy statement, available at http://www.snb.ch/en/mmr/reference/stabrep_2012/source/stabrep_2012.en.pdf

[20] Testimony, Senate Banking Committee, February 4, 2010, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=753820b3-7c27-4ae7-8888-9e7a7ff38453

[21] "Two Senators are trying to make Jamie Dimon's worst nightmare a reality, Business Insider, August 8, 2012, available at http://www.businessinsider.com/senator-vitter-and-senator-brown-ask-fed-to-increase-capital-requirements-2012-8

[22] Testimony, Senate Banking Committee, February 4, 2010, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=98845464-f06e-4f20-b1bd-cbce9a87803c

In its 5-page letter on the Basel proposal, the Systemic Risk Council (SRC) notes that important institutions should maintain leverage ratio of "approximately 8 percent and indeed the ratio could be set more than double that."[23]

The SRC's concision should not hide its import: Namely, an esteemed group of former regulators, including some present at the crash, who now face no political pressure, who come from both major political parties, have marshaled their collective wisdom and declare that the leverage requirement should be five or six times higher than proposed in this draft rule. We urge the agencies to weigh this opinion heavily.

When home buyers make a down payment equal to 20 percent of the value of the home, financing the balance with a mortgage, private mortgage insurance is unnecessary. Elsewhere, Congress has tacitly declared that a 20 percent down payment constitutes a safe leve.[24] We believe this 20 percent level should apply to banks as well. We make no pretense that our proposal of a 20 percent leverage figure is grounded on any foundation other than judgment. Economic studies that imply precision should not be dismissed, but they must be considered in light of the many assumptions imbedded in the formulas, and the inevitable divergence between prediction and actual results. Bank safety, ultimately becomes an issue of judgment. We take most seriously the SRC's proposed leverage figure of 16 percent, and believe the agencies should consider this a minimum.

Risk Weighting

Risk weighting refers to the practice of discounting the value of a bank's investment based on risk. As provided under the first risk weighting rubric from Basel I in 1988, a commercial loan was risk weighted at 100 percent. Whatever the basic at-risk equity capital requirement, 100 percent of that at-risk capital would be required as part of the commercial loan. For mortgages, however, only 50 percent was required. For purchases of US Treasuries, 0 percent was required.

In theory, risk-weighting should address risk. On the surface, a bank with investments perceived as less-risky is less likely to fail and become a burden to taxpayers. As a result, such a bank should require less investor capital at risk. Conversely, a bank with seemingly riskier assets should use a relatively larger share of investor capital in those asset investments. As riskier assets are more likely to fail, the investor-contributed capital should absorb all the losses.

[23] October 4, 2012 letter from Sheila Bair, and Systemic Risk Council, available at http://www.federalreserve.gov/SECRS/2012/October/20121009/R-1442/R-1442_100412_108558_530565933983_1.pdf

[24] See Dodd-Frank, Title 14.

In practice, risk weighting has led to drastic undercapitalization. Deutsche Bank reported 2.24 trillion euros ($2.84 trillion) of assets in the second quarter of 2012, using the International Accounting Standard's Board rules. The company reported 372.6 billion euros of risk-weighted assets. This reduced figure allowed Deutsche Bank to claim 10.2 percent capital ratio for regulatory purposes.[25] In fact, Deutsche Bank holds only 2.8 percent capital. No prudent lender would accept a 2.8 percent down payment from any borrower, let alone on a $2.2 trillion loan.

In practice, risk weighting is difficult to determine. Risk weighting implies that risk can be weighed for classifications of investments. "Actually, no one can calculate proper risk weights," asserts former IMF chief economist Simon Johnson. "They are unknowable. Analysts at credit-rating companies, even if one sets aside all the conflicts of interest they face, are just as prone to group think, fads and misconceptions as the rest of us. Academics would do no better.."[26]

In practice, complexity equals opacity. For larger banks, the number of risk-weighting calculations will be numbered in the millions.[27] This frustrates market discipline, as outside investors cannot properly evaluate a company's risk. Models may be poorly understood within the bank, but certainly soar even harder for outside investors to comprehend. As Andrew Haldane, executive director of the Bank of England. concluded, "For investors today, banks are the blackest of boxes." [28] As the front guard of supervision, bank investors are sidelined with risk weighting.

The agencies' proposed rule invites an assessment of the specific risk-weights. The regulators have offered roughly a thousand separate risk weights, each of which deserves careful assessment. Each of these risk weights involve assumptions and predictions that will inevitably diverge from actual results. Nearly all include "cliff" problems—abrupt changes in weight from one asset to the next, or even between assets of different risk assessment. For example, sovereign debt is boxed in seven different risk weights. Such crude transitions certainly do not reflect reality. Investment in Greek versus Spanish debt involves different risk, but not a clean 50 percent difference, as provided in the proposal. Moreover, the seven different risk weights Credit default swaps (CDS), which are specific insurance-like contracts for debt, trade on the market and reflect current market perception of specific risk. These CDS spreads certainly reflect the market's more nuanced understanding of the risk differences.

[25] "How to lose weight fast the Deutsche Bank way," by Jonathan Weil, Bloomberg, Sept. 20, 2012, available at: http://www.bloomberg.com/news/2012-09-20/how-to-lose-weight-fast-the-deutsche-bank-way.html
[26] "A very strage way to assess the Safety of Banks," by Simon Johnson, Bloomberg, Sept. 30, 2012, available at: http://www.bloomberg.com/news/2012-09-30/a-very-strange-way-to-assess-the-safety-of-banks.html
[27] "The Dog and the Frisbee," speech by Andrew Haldane, August 31, 2012, available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf
[28] "The Dog and the Frisbee," speech by Andrew Haldane, August 31, 2012, available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf

That said, glaring problems are manifest. Permission for modeling techniques may allow large banks to hold even less capital than was required during the financial crisis. The current standard provides the identical preferential risk weight for all taxpayer-insured depository institutions, namely 20 percent. Not all large banks are equally safe. Many large banks are certainly more risky than many large non-financial corporations, yet this risk weight is 100 percent. Certainly, Apple Computer is safer than Bank of America, N.A.. Yet the current risk weights declare the opposite.

Risk-weighting leads to more consequences than simply risk management. Risk-weighting biases a bank's lending and investment. This is inappropriate.. As FDIC Vice Chairman Hoenig observed, risk weighting "relies on central planners' determination of risks, which creates its own adverse incentives for banks making asset choices. "[29]

Finally, risk weighting proves pro-cyclical. When the economy stumbles, risk weighting steers banks away from lending just when it is needed. When the economy thrives, risk weighting steers firms to higher lending, potentially overheating the economy and inflating an asset bubble.

The flaws in risk-weighting are legion, and with a sensible leverage ratio, they will be unnecessary.

Other Comments:

Regarding the time table, we note that many large banks already maintain capital standards that are only required at the end of a langorous implementation timetable. We urge the timetable be advanced.

As a member of the coalition, Americans for Financial Reform (AFR), we recommend you closely review the AFR comment as well. It address details of specific risk weights, acknowledging that the agencies are unlikely to abandon this rubric altogether. We also recommend, as noted, the comment from the SRC, which does generally endorse a new risk-weighting scheme.

We appreciate that Public Citizen essentially calls for replacing the 1,000 pages of obviously well considered, earnest agency proposals with a few simple pages. But we believe just as earnestly that our immodest proposal would be better for the safety of the banking system and for the economy. Simplicity can lead to clarity, a concept that is sorely needed in banking regulation.

[29] "Back to Basics," speech by Thomas M. Hoenig, September 14, 2012, available at: http://www.fdic.gov/news/news/speeches/chairman/spsep1412_2.html

Thank you for considering these comments. For further questions, please contact me at bnaylor@citizen.org, or 202.580.5626.

Sincerely,

Bartlett Naylor
Financial Policy Advocate
Public Citizen's Congress Watch