KAY R. HAGAN
NORTH CAROLINA

SUITE SD-521
DIRKSEN BUILDING
WASHINGTON, DC 20510
(202) 224-6342

United States Senate

WASHINGTON, DC 20510

April 30, 2012

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

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

Dear Chairman Bernanke:

I am writing with respect to proposed rules issued by the Board of Governors of the Federal Reserve System ("Board") that would implement Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The financial crisis that began in 2007 highlighted the economic costs associated with the disorderly failure of a major financial company and the Dodd-Frank Act put in place a path to prudent reforms that would enhance financial stability.

In determining enhanced prudential standards, policymakers must balance the benefits of financial stability and market integrity against the costs to economic growth and credit availability caused by risk-based capital requirements, counterparty credit limits, and liquidity requirements. In enacting Section 165, Congress struck a balance between these competing considerations. I commend the Board for attempting to craft standards that adhere to Congressional intent and for providing the public with additional time to comment on the proposal.

Implementation Timeframe

I appreciate the Board's phased implementation approach and its decision not to act prematurely in certain areas. The rule recognizes the critical interplay between Section 165 and efforts by the Basel Committee on Banking Supervision ("BCBS") to strengthen the regulatory capital regime for internationally active banks and by the Financial Stability Oversight Council ("Council") to designate nonbank financial companies for enhanced oversight by the Board. I would encourage the Board to move expeditiously in proposing rules with respect to foreign banking organizations ("FBO") and nonbank financial companies in consultation with the BCBS and the Council and to continue to develop a framework that is sensitive to the differences between mid-sized regional banks that may be subject to the proposed rules and more complex institutions.

Liquidity Requirements

During the financial crisis, solvent financial firms experienced liquidity shortages and had difficulty meeting obligations on a timely basis. In response, banking regulators pursued requirements that would require global systemically important banks ("G-SIBs") to hold assets that could be used to meet cash outflows during times of stress. The BCBS proposed a liquidity coverage ratio ("LCR") as part of Basel III reforms in December 2010 and the Board proposed liquidity requirements as a part of its proposed rule. These steps will be of the utmost importance in improving financial stability.

In its rule, the Board proposes a multi-stage process for implementing liquidity requirements that would cause bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies the Council has designated, pursuant to section 113 of the Dodd-Frank Act, for supervision by the Board, (together, "covered companies" and each a "covered company") to maintain a liquidity buffer of unencumbered "highly liquid assets." The Board's liquidity requirements under the prosed rule improve upon the definition of highly-quality liquid assets used in the LCR by taking into account the diverse pool of highly liquid assets and liquidity facilities available to covered companies in the United States. In particular, the Board's definition of highly liquid assets includes securities issued or guaranteed by U.S. government agencies and enterprises.

Question 14 of the proposed rule asks what additional assets could be included in the definition of highly liquid assets. In the rule, the Board spelled out a three part test that would require a covered company to demonstrate to the satisfaction of the Federal Reserve that an asset:

(i) Has low credit risk (low risk of default) and low market risk (little or no price volatility);
(ii) Is traded in an active secondary two-way market that has observable market prices, committed market makers, a large number of market participants, and a high trading volume; and
(iii) Is a type of asset that investors historically have purchased in periods of financial market distress during which liquidity is impaired (flight to quality)."

The rule also suggests that highly liquid assets should be diversified by instrument type, counterparty, and geographic market.

Covered Bonds (CBs) are one asset that I encourage the Board to include in its definition of highly liquid assets. The BCBS included CBs in its definition of highly-quality liquid assets for the purposes of the LCR. The $3.2 trillion of outstanding CBs represent a deep and liquid market. In addition to their low credit risk, low market risk, and active secondary market, CBs offer geographic and counterparty diversity to the pool of highly liquid assets available to covered companies.

Single Counterparty Credit Limits

Excessive credit exposures between counterparties can pose risks to the financial system. I strongly support the policy goal of limiting extremely large exposures of covered companies to counterparties by imposing single counterparty credit limits ("SCCL"). Unfortunately, the blunt approach used by the Board to apply Section 165(e) overreaches in several respects.

First, in exercising authorities under Section 165(e)(2), the proposed rule fails to take into account the broader economic impact of the SCCL. Despite significant empirical and historical data on capital requirements, it is widely acknowledged that estimates of the impact of capital requirements on real economic activity are subject to significant variation. SCCLs, on the other hand, are novel features of prudential regulation at the holding company level with little empirical data that can be used quantify their impact on real economic activity, credit availability and market liquidity. Section 165(e) prohibits a covered company from having "credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus" of the covered company and provides the Board with authority to lower that amount "to mitigate risks to the financial stability of the United States." The Board exercised its authority to lower statutory credit exposure limits before providing a complete assessment of the impacts to credit availability, economic growth, or liquidity that its proposed levels would have. In proposing capital requirements the BCBS conducted repeated rounds of Quantitative Impact Studies (QIS) prior to adopting rules. The board did not conduct a comprehensive and iterative QIS before proposing to expand SCCLs. I would urge the Board to conduct an economic impact assessment, which is informed by data gathered after the statutory limit goes into effect, before exercising its authority under 165(e)(2).

Should the Board choose to exercise its authority under Section 165(e)(2), after completing an economic impact assessment, the Board should modify its approach to adequately take into account the different risk characteristics of counterparties to "major covered companies" with total consolidated assets of $500 billion or more. Counterparties to major covered companies vary greatly in their risk characteristics. The proposed rule does not, however, acknowledge these variations among counterparties. For example, a covered company, subject to enhanced prudential regulation by the Board, should pose lower risk than a similarly sized nonbank financial company that was not covered by enhanced prudential standards and Board oversight under the rule. Exposure to central banks, high quality sovereigns, or state and local governments would be viewed as posing risk commensurate to a lightly regulated foreign fund. Additionally, without appropriately calibrated risk characteristics, the proposed rule could run counter to the central clearing mandate in the Dodd-Frank Act, by forcing major covered companies to curtail their use of clearinghouses. If the Board were to exercise its authority after completing a risk assessment, it should fully consider the risk characteristics of counterparties when lowering the statutory threshold and should consider prudent use of its exemptive authority under 165(e)(6) in cases that serve the public interest.

I applaud the Board for its work to improve financial stability through enhanced prudential regulations in the U.S. and internationally and I look forward to the Board's rules that covering nonbank financial companies and foreign banking organizations. Thank you for your consideration of these comments. Please feel free to contact me or my staff if you would like to discuss these issues further.

Sincerely,

Kay R. Hagan

Kay R. Hagan
United States Senator

cc: The Honorable Janet L. Yellen
Board of Governors of the Federal Reserve System

The Honorable Elizabeth A. Duke, Member
Board of Directors of the Federal Reserve System

The Honorable Sarah Bloom Raskin
Board of Governors of the Federal Reserve System

The Honorable Daniel K. Tarullo
Board of Governors of the Federal Reserve System

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System