BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

April 30, 2012

Ms. Jennifer Johnson
Secretary
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (RIN-AD-86)

Dear Ms. Johnson:

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System ("Board") in response to the request for public comment in connection with Notice of Proposed Rulemaking ("Proposed Rule") published on January 5, 2012, in connection with the enhanced Prudential standards required to be established under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

Better Markets strongly supports the efforts of the Board to implement Section 165 of the Dodd-Frank Act through regulation.[2] As so painfully and expensively demonstrated during the last financial crisis, reducing the risks that large bank holding companies and other nonbank financial companies pose to overall U.S. financial stability and to the real economy is extraordinarily important. The elements of the Proposed Rule contribute significantly to that goal.

We believe, however, that the Proposed Rule must be strengthened to be effective and accomplish the intent of the law. In particular we suggest that:

- The Board set far more stringent leverage limits for covered companies.
- The Board have greater information about and firmer control of covered company liquidity provisioning.

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1 Better Markets is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular in the rulemaking process associated with the implementation of the Dodd-Frank Act.

2 Federal Register, Volume 77, Number 3, January 5, 2012, 694-663.

- Single counterparty exposure limits be made more effective by limiting permissible netting for collateral, guarantees and hedges, and by looking through legal form to determine actual exposures to counterparties.
- The Board should develop stress-testing capacities that will allow it to evaluate the safety of the largest covered companies, without relying on testing done by the companies themselves.
- Debt-to-equity limitations for companies designated by the Financial Stability Oversight Council as threats to overall stability should be calculated using a narrow definition of equity.
- The leverage threshold for early remediation of covered companies should be set at a much lower level.

COMMENTS

Risk-based capital requirements and leverage limits

The Proposed Rule adopts Basel III capital requirements. Although the Basel III requirements will reduce bank leverage somewhat, they will allow large bank holding companies to remain highly leveraged.[3] Therefore these banks will continue to be highly risky individually, and collectively they will make the entire banking system highly unstable in times of financial stress. Therefore, significantly lower leverage ratios should be mandated for the largest bank holding companies if the regulations are to meet the intent of Section 165 of the Dodd-Frank Act, which is to "...prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, or ongoing activities, of large, interconnected financial institutions..."

Lower leverage ratios make individual banks safer. The ability of an individual bank to survive a significant decline in the value of its assets will depend on the market value of its equity at the moment of the loss. Other market participants will continue to deal with the bank only if, after the loss, it is perceived to have sufficient remaining equity to remain solvent in the event of another shock. So the bank's leverage – together with the market value and liquidity of its assets – is a key determinant of its ability to function and, indeed, to survive during times of financial stress.

[3] Basel III calls for a phased- in capital to risk-weighted-assets ratio of 10.5 percent, of which 7 percent is common equity. Large so-called G-SIBs are to have a maximum 3.5 percent additional capital surcharge. So if a G-SIB were assessed the full additional 3.5 percent surcharge, the common equity/risk-weighted asset ratio would be 10.5 percent. Since risk-weighted assets are on average significantly less actual assets – by one estimate approximately 40 percent less – the ratio could be less than 6.3 percent, giving a leverage ratio of nearly 16 relative to common equity.

Lower leverage ratios also make the financial system as a whole more stable. The ability of the banking system as a whole to absorb losses – through acquisition of the weak by the healthy – will be a function of the overall leverage of the banking system.[4]

Lower leverage ratios at the handful of large banks that hold the majority of banking assets are particularly important to preserving financial stability. Since the ten largest banks hold a majority of banking assets (see Table 1), and a large share of the assets of all financial intermediaries, equity declines at one or more such bank will have a large effect on the overall equity of the banking system.

Table 1

Rank	**Ten Largest U.S. Bank Holding Companies**	**Total Assets ($ Billions)**
1	JPMORGAN CHASE & CO.	2,266
2	BANK OF AMERICA CORPORATION	2,137
3	CITIGROUP INC.	1,874
4	WELLS FARGO & COMPANY	1,314
5	GOLDMAN SACHS GROUP, INC.	924
6	METLIFE, INC.	800
7	MORGAN STANLEY	750
8	TAUNUS CORPORATION	355
9	U.S. BANCORP	340
10	HSBC NORTH AMERICA HOLDINGS INC.	331
	Total	**11,090**

Source: http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx, data for 12/31/2011.

Moreover, revelation of insufficient equity at even one large bank can produce a Lehman moment when generalized panic sets in. Even if the failed bank is resolved in an efficient manner under the Orderly Liquidation Authority of the Dodd-Frank Act, contagion to other large banks is then likely. Concerns about equity positions of large banks led the entire federal government to provide extraordinary aid to banks during the financial crisis. The Troubled Asset Relief Program provided massive injections of equity capital. Banks were able to avoid equity losses because the government helped them borrow and avoid writedowns from asset sales in distressed markets – through the Term Auction Facility, the Temporary Liquidity Guarantee Program, the Term Securities Lending Facility, the Primary Dealer Credit Facility, and the Commercial Paper Funding Facility.

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4 For a discussion of the relationship between leverage, entity stability, and overall financial stability see V. Archaya et. al. (2010). Measuring Systemic Risk; C. Browlee and R. Engle (2012). Volatility, Correlation and Tails for Systemic Risk Measurement, *available at* http://vlab.stern.nyu.edu/.

It is important to recognize that risk-based capital requirements and market discipline did not restrain bank leverage during the run-up to the crisis. In fact, leverage at large bank holding companies was essentially the same as that of the 5 largest stand-alone investment banks by the end of 2007, and continued to rise for a substantial period thereafter (See Figure 1, below). There can be no doubt that the high leverage of the large bank holding companies made them vulnerable to the losses they experienced after the house price bubble burst.

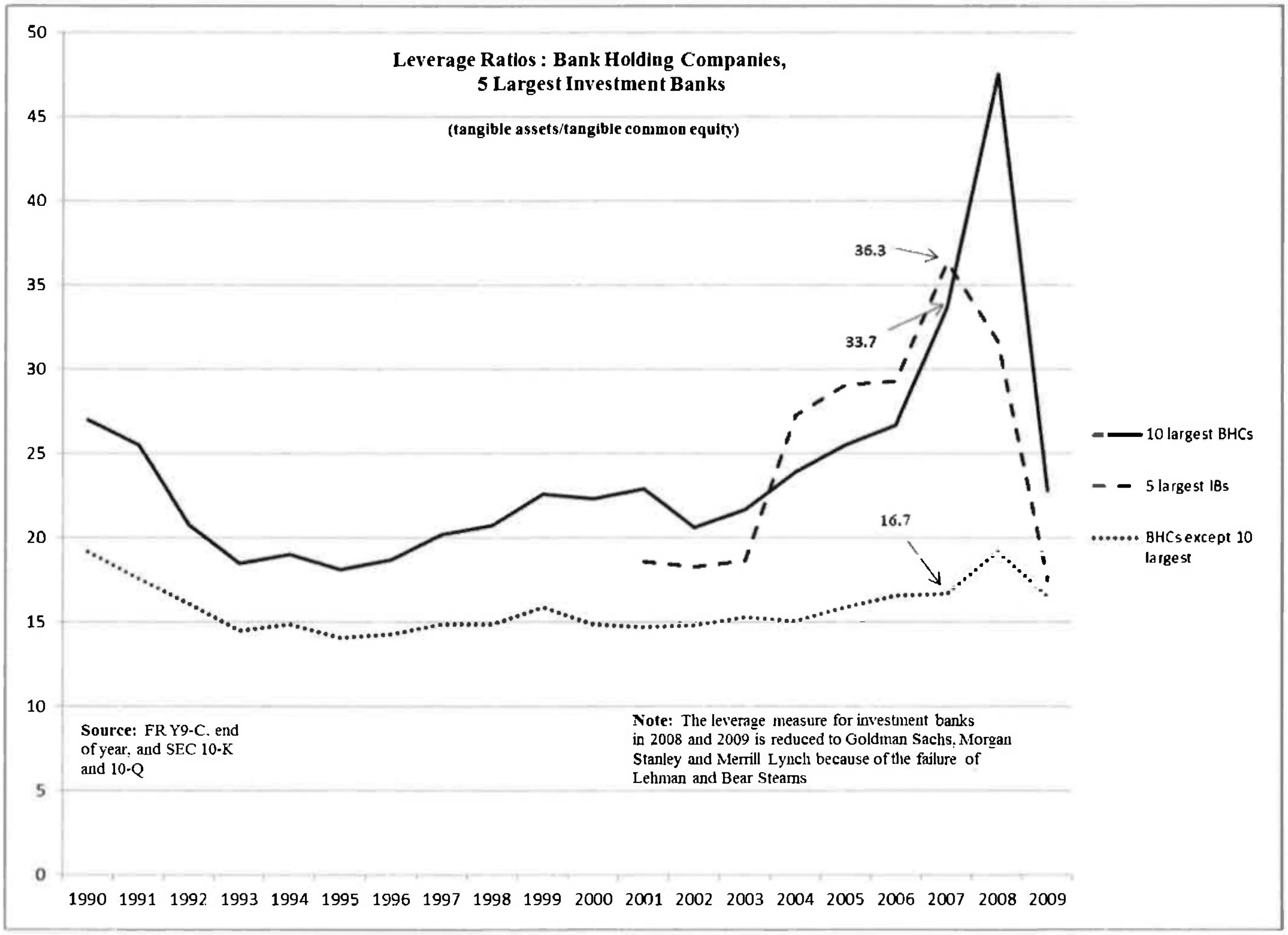

Figure 1

Therefore, the Board should use its authority under Section 165(b)(1)(A)(i) of the Dodd-Frank Act to impose significant leverage requirements on the largest banks. These leverage ratios should rise with bank asset size, since the combination of size and high leverage increases the risk to financial stability.

Required leverage ratio should be calculated using tangible common equity and tangible assets. During the financial crisis, market participants focused on the market value of the equity of financial firms under stress. Of the available accounting measures of firm equity, tangible common equity comes closest to the values that market participants take seriously.

As can be seen in Figure 1, the leverage ratios for smaller banks are consistently and significantly lower than those of the large bank holding companies. A natural hypothesis is that this reflects the differential treatment that lenders give to big banks that have an implicit guarantee from the federal government because they are "too big to fail." Some have suggested that leverage limits for the big banks should be set at the level that market forces have determined is appropriate for banks without implicit government guarantees. That would imply a leverage limit of 15.

However, there is good reason to believe that the leverage ratio of smaller banks would still be inadequate for large banks. While smaller banks may not have the same "too big to fail" guarantee, they are still inside the federal safety net. They have access to discount windows, and they have sticky sources of funds because their depositors are federally insured. This exempts them from substantial market discipline.

Moreover, to the extent that leverage ratios at smaller banks do reflect the effects of market discipline, that discipline will never take externalities into account. That is, large equity losses at several smaller banks can have an important impact on overall financial stability. The failures of Washington Mutual, Wachovia, and Indymac certainly contributed to overall financial distress during the financial crisis. But market forces do not take account of such externalities when funding the borrowing of individual banks, precisely because they are externalities.

In fact, recent work published by the Centre for Economic Policy Research indicates that an upper bound for the leverage ratio should be much lower – approximately 5 relative to risk-weighted assets.[5] This research indicates that this significantly reduced leverage ratio will deliver significant net economic benefits:

> We conclude that even proportionally large increases in bank capital are likely to result in a small long-run impact of the borrowing costs faced by bank customers.... In light of the estimates of costs and benefits we conclude that the amount of equity funding that is likely to be desirable for banks to use is very much larger than banks have had in recent years and higher than the minimum agreed Basel III framework." [6]

Thus, there are strong reasons to believe that the Basel III capital standards will not effectively constrain bank leverage. The Board should reconsider their decision to rely on those standards. They should instead conduct research similar to that done by the Centre for Economic Policy Research and provide it publicly as an explanation of the leverage ratio chosen.

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[5] D. Miles et al. (2011). Optimal Bank Capital, Centre for Economic Policy Research Discussion Paper 8333, *available at* www.cepr.org/pubs/dps/DP8333.asp, 38-39.

[6] D. Miles et al., op. cit., 3.

Liquidity Requirements

Section 165(b)(1)(A)(ii) of the Dodd-Frank Act requires the Board to establish liquidity standards for covered companies. The discussion that accompanies the Proposed Rules is quite explicit about why standards are needed:

> "Many of the liquidity-related difficulties experienced by financial companies were due to lapses in basic principles of risk management... In particular, the [Senior Supervisors Group] noted that firms' inappropriate reliance on short-term sources of market funding and in some cases, the repo market, as well as inaccurate measurements of funding needs and lack of effective contingency funding were key factors in the liquidity crises many firms faced." [7]

The Board proposes a two-stage strategy to prevent covered companies from over-reliance on unstable short-term funding. In the short term, the Proposed Rules require the companies to handle the matter internally. Sections 252.51-252.61 of the proposed regulations require the companies to set up liquidity measurement, forecasting and stress testing, monitoring, and governance functions. They are also required to establish quantitative buffers of unencumbered highly liquid assets to handle impaired funding over a 30-day horizon, and to develop a contingency funding plan. In the longer term, the Board promises to establish external liquidity requirements for covered companies, in the form of the yet-to-be-determined Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR"), both of which are currently under development as part of Basel III.

The requirements for internal forecasts, self-insurance, and contingency planning are entirely reasonable. They are essentially a list of common sense self-protective steps that any well-managed, sophisticated financial firm with even minimally adequate compliance and controls should take. Moreover, they would appear to be consistent with the existing legal duties of a firm's executive, legal, and compliance officers to guard against significant threats, especially those that are potentially lethal.

The requirements in the Proposed Rule fail, however, to completely confront a behavioral fact revealed by the financial crisis. Firms did not have even these minimal protections in place because they were not required by regulators, and because the existing economic and legal incentives were not strong enough to establish them. The arbitrage profits from short-term finance of illiquid assets were just too massive to pass up or reduce by even modest, sensible self-control. When similar arbitrage opportunities come around in the future, these same firms will have strong incentive to ignore past problems and take potentially profitable risk, particularly when those profits are in the billions of dollars. Without strong and clear required regulations, these firms will be incentivized to understate the liquidity risk they face, and economize on the costs of self-insurance – again – which will risk a major financial crisis – again.

To the extent that the Board uncritically accepts the firm-controlled estimates of risk, its ability to control liquidity risk will be significantly and inexcusably limited, particularly in light of facts now known as a result of the recent financial collapse. The

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7 Federal Register, Volume 77, Number 3, January 5, 2012, 604.

effectiveness of externally established liquidity parameters, in the form of the LCR and NSFR, will also have limited impact if the Board allows itself to accept firm-controlled estimates of liquidity requirements.

However, the effectiveness of liquidity regulation in the Proposed Rule can be strengthened easily. First, it is possible to change the incentives of firms by making directors and CEOs personally responsible for their liquidity risk management. They can be required to attest to the soundness of their liquidity risk estimates. They also can be subject to significant financial penalties if their company's liquidity risk systems are found to be materially faulty. Second, by developing its own expertise in liquidity risk monitoring and forecasting, the Board can establish an independent standard by which the actions of supervised firms can be judged. In practice, the Board could gain substantial insight by monitoring the liquidity positions of the 10 largest bank holding companies.

Third, the Board can use the authority given by Section 165(g) of the Dodd-Frank Act to set default limits on the use of short term finance that can be applied if the Board determines that a covered company's liquidity risk management poses unacceptable risk.

Single-counterparty credit limits

We support the Board's efforts to implement Section 165(e). Section 165(e) of the Dodd-Frank Act gives the Board the authority to establish counterparty credit exposure limits among covered companies, which will include large, interconnected bank holding companies and other nonbank financial intermediaries. The regulations propose a 10 percent limit for credit exposure between a covered company and a counterparty that each have more than $500 billion in total consolidated assets or are a nonbank covered company. The limit is relative to the capital stock and surplus of the covered company. The exposure can be offset by credit risk mitigants such as collateral, guarantees, and credit derivative hedges.

While we agree with these provisions, they should be strengthened in the Proposed Rule.

First, when determining the credit exposure of a covered company, the Proposed Rule would exclude exposures of a fund or vehicle sponsored or advised by the covered company if the company does not hold more than 25 percent of the voting securities or equities of the fund or vehicle, and the fund or vehicle is not consolidated with the company for reporting purposes. This exclusion, which fails to look through legal form to measure actual credit exposure, will mean that the Board will be working with inaccurate measures.

The Board commentary in Question 23 of the Proposed Rule notes that "such arm's length treatment, however may be at odds with the support that some companies provided during the financial crisis to the funds they advised and supported." We would agree wholeheartedly with this. During the financial crisis, for example, Citigroup brought the SIV liabilities of $49 billion onto its balance sheet, even though they were not legally required to do so. Other bank holding companies may have acted similarly with respect to conduits they sponsored.[8]

Moreover, when it comes to issues of liquidity stress testing, the Board explicitly recognizes the need to look through legal form:

> "...stress testing should address potential liquidity issues arising from the covered company's use of sponsored vehicles that issue debt instruments periodically to the markets....**Under stress scenarios, the covered company may be contractually required, or compelled in the interest of mitigating reputational risk**, to provide liquidity support to such a vehicle..." [9] [emphasis added]

Thus, as recognized by the Board and as indisputably demonstrated during the last crisis, this exclusion must be eliminated and such credit exposure calculations should look through legal form.

Second, the Proposed Rule would use the company's total regulatory capital as calculated under risk-based capital adequacy guidelines, plus the balance of the allowance for loan and lease losses not included in Tier 2 capital, as the measure of the company's "capital stock and surplus". However, use of this measure is likely to underestimate the scale of a company's credit exposure to a counterparty. When market participants estimate the equity position of a company, they look at market values. This can easily diverge from capital estimates using risk weighting, especially in times of financial stress. Therefore, the exposures should be compared to tangible common equity, which is an accounting value that is more likely to reflect market estimates of equity.

Third, the Proposed Rule would allow covered companies to reduce their calculated credit exposure to the extent that they hold eligible loss mitigants such as collateral, credit guarantees, and credit derivatives. With some exceptions – such as collateral in the form of cash or government-backed assets, or guarantees from sovereigns or multinational institutions – allowing this kind of netting really reflects the triumph of hope over experience. For example, during the crisis monoline insurers were unable to cover losses on collateralized debt obligations ("CDOs") they insured; AIG failed to make good on the credit default swap it had written on bank-held CDOs; and Lehman-written hedges turned out to be much less useful than anticipated. The intent of the rule is to limit the degree of interconnected credit risk among the large banks and nonbanks. The Proposed Rule must be changed because it requires setting exposure limits that evaporate at the moment when they are needed most.

8 See the discussion of the run on conduits on pages 7-8 of the Better Markets December 19, 2011 Comment Letter to FSOC on the proposed regulation of nonbank financial companies, incorporated as if fully set forth herein, *available at* http://www.bettermarkets.com/sites/default/files/CL%20FSOC%20SIFIs%2012-19-11.pdf

9 Federal Register, Volume 77, Number 3, January 5, 2012, 607.

Stress Test Requirements

(a) We support the Board's efforts to implement Section 165(i)(1) of the Dodd-Frank Act, which requires the Board to conduct annual stress tests for covered companies. However, the Proposed Rule should be strengthened in the following ways:

First, the Board says that because supervisory stress tests will be "standardized across covered companies and not adjusted for each company, they are not expected to fully capture all potential risks that may affect a specific company's capital position." But if standardized stress tests are an inadequate tool, and individualized stress tests are in order, why not conduct stress tests using better models, at least for the largest bank holding companies that hold the majority of bank assets? The Board has the authority and resources to do whatever is required in this regard.

Second, the Board plans to publish the results of its stress tests. This information will be much more useful to the public if there is also information about the forecasting ability of these models. The Board should develop and publish metrics to evaluate the forecasting accuracy of its stress tests models.[10] It should also produce historical simulations to demonstrate the ability of these models to forecast bank weaknesses before the recent crisis.

(b) We support the Board's efforts to implement Section 165(i)(2) of the Dodd-Frank Act, which requires the Board to issue regulations for company-run stress tests that must be conducted semi-annually by covered companies, and annually by financial companies with more than $10 billion in assets. However, the Proposed Rule should be strengthened in the following ways:

First, the Board anticipates being informed by the stress tests conducted by the banks, using their individual models. But the Board cannot know whether these models produce meaningful information without understanding their statistical properties and running them independently. The Board must set standards for the internal validation of these models, and test them to see that they are indeed useful and informative. Otherwise, it will base its regulatory judgments in part on information which may or may not be meaningful. The Board has the authority and resources to do whatever is required in this regard.

Second, under the Proposed Rule the banks required to conduct stress tests must post the results on the company's web site or in any other forum that is reasonably accessible to the public. Given the potential usefulness of these data, they should also be published in a standardized format on an easily accessible government website, such as the one already maintained by FFIEC.

Third, under the Proposed Rule the banks will be required to publish a general list of results of their internal stress tests. For these results to be comparable and meaningful, the banks should also be required to post a set of standard metrics, developed by the Board in the process of validating these models, that measure the forecasting accuracy of the models.

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10 *See* C. Brownlee and R. Engle (2011), op. cit.

Increased stress test transparency, as proposed, is critical because that is the only hope for increased market discipline, which is an essential goal of the Dodd-Frank Act. If the Board provides the public with easily accessible, detailed information about the ability of covered companies to respond to financial stress, its supervisory efforts will be augmented by market forces. Badly positioned companies will see equity price reactions and changes in the costs and terms of borrowing. If they experience these changed incentives before they are under actual financial stress, our financial system will be far more stable.

Debt to Equity Limitation for Certain Covered Companies

Section 165(j) of the Dodd-Frank Act provides the Board may require a covered company to have a debt-to-equity ratio of no more than 15 if the Financial Stability Oversight Council determines that a covered company poses a grave threat to the financial stability of the U.S., and that restriction would mitigate that threat. A reduction in the covered company's leverage ratio would, *ceteris paribus*, reduce any threat it might pose to financial stability.

We would note, however, that the Proposed Rule defines equity to include items – such as unrealized gains on available for sale securities and accumulated net gains on cash flow hedges – that are unlikely to be available to absorb losses in times of financial stress. Thus, the Proposed Rule will not achieve its stated purpose in this regard. Equity must be defined as tangible common equity, which will – and will be understood to – absorb losses in times of financial stress.

Early Remediation

Leverage is widely and correctly understood to be a key measure of the riskiness of a covered company. Therefore, it is appropriate and encouraging to observe that leverage is included among the early remediation triggers in Sections 252.161-252.164 of the Proposed Rule. However, as currently proposed, this metric does not help trigger remediation unless leverage rises above 20. Moreover, leverage is defined as the ratio of Tier 1 capital to total assets, and Tier 1 capital includes components beyond tangible common equity.

For the reasons set forth in our discussion of risk-based capital requirements and leverage limits above, leverage thresholds (properly calculated) must be far lower than those in the Proposed Rule. Double digit leverage ratios reflect both the effects of explicit and implicit government guarantees, and the fact that market discipline does not require even the largest covered company to internalize the spillover effects that its distress or failure can produce in the financial system and the real economy.

CONCLUSION

In closing, the Board's proposals to increase the scope, expertise, and authority of the risk management function in covered companies are well considered and should be adopted as set forth in the Proposed Rule. Those provisions should not be weakened or diluted in any way.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

Dennis M. Kelleher
President & CEO

Marc Jarsulic
Chief Economist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
mjarsulic@bettermarkets.com

www.bettermarkets.com