United States Senate
WASHINGTON, DC 20510

November 21, 2013

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

The Honorable Thomas J. Curry
Comptroller of the Currency
Administrator of National Banks
Washington, D.C. 20219

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Chairman Bernanke, Chairman Gruenberg, and Comptroller Curry:

Large, over-leveraged financial institutions were central to the 2008 financial crisis that nearly collapsed our nation's economy. When the assets of these largest banks declined in value, they did not have enough of their own capital to cover their losses, and instead relied upon unprecedented efforts by your agencies and taxpayer bailouts to stay afloat. Simpler, more robust capital rules will properly align incentives for large financial institutions by lessening government support for the financial sector and reassure financial markets that the U.S. financial system is healthy.

We write to your agencies today to urge you to help prevent the next financial crisis, and ensuing bailouts, by strengthening your proposed enhanced supplementary leverage ratio for the largest financial institutions. Your proposals make very positive steps in the right direction, but without further strengthening they will not provide adequate protection for taxpayers. We urge you, in the strongest terms possible, to consider a higher final leverage ratio.[1] We feel this proposal along with your proposal on a capital surcharge for the largest banks must move forward thoughtfully and aggressively.

Because of the central role that leverage played in the financial crisis, we have been disappointed that the recent international capital accords adopted inadequate leverage requirements for the largest banks.[2] In 2007, the investment banks Bear Stearns and Lehman Brothers would have been compliant with proposed international leverage rules, and yet each would have become insolvent, or nearly insolvent, if the value of their assets declined by as little as three percent. We are encouraged by your agencies' proposal because we believe that the Basel III framework should serve as a floor, not a ceiling. While we believe that the proposed levels are still inadequate and that you must require a more robust level in order to successfully address the "too big to fail" problem, as some have advocated, this move is a step in the right direction. We offer the following comments in response to your proposal.

First, using simple measures of assets and equity is the most effective form of capital regulation. The Bank of England's Andy Haldane has found the predictive value of simple measures of equity and leverage to be ten times greater than that of complex risk-weighted asset measurements.[3] As you implement your proposal, we urge you to focus on real, loss-absorbing equity. During the crisis, markets ignored certain instruments that qualified as Tier 1 capital but were not reliable buffers against loss and focused upon whether institutions had sufficient levels of common equity.[4]

We also believe that institutions' assets should be measured in the most comprehensive and straightforward manner possible. Risk weights should not be "managed" or "optimized" to gain more favorable capital treatment. The Basel Committee recently suggested that making risk-weighted assets calculations less complex would improve capital regulation by making capital ratios more comparable and easier to understand.[5] The Committee has also found that using internal models to calculate risk-weighted assets can incentivize financial institutions to underestimate their capital requirements.[6] Cash and excess reserves must also be included in asset calculations, and derivatives must be accounted for in a realistic manner. The "London Whale" episode provided a specific example of a bank altering its internal models to produce lower risk weights and capital; it also showed how many derivative exposures – especially so-called "portfolio hedges" – do not function as hedges and can amplify, rather than decrease, risk.[7]

Capital rules should be designed to take into account the fact that institutions' crisis planning will never be perfect and that banks are likely to downplay possible problems. The Board of Governors of Federal Reserve System's recent report on stress testing found that some of the largest institutions remain focused upon meeting regulatory minimum capital ratios; continue to overlook uncertain sources of financial losses; lack appropriate plans to raise capital when faced with financial distress; and design stress scenarios containing overly optimistic assumptions of their perceived strength during a financial crisis.[8] Given this reality, we agree with the view of experts that regulators should focus on financial institutions' levels of pure tangible common equity to total, non-risk-weighted assets.[9]

We agree with Federal Deposit Insurance Corporation Vice Chairman Thomas Hoenig that the argument that stronger leverage rules will hurt U.S. competitiveness is "nonsense."[10] Rather than put our financial sector at a disadvantage, strong leverage rules will serve as a source of strength during turbulent times. Most banks are meeting new, heightened capital requirements by retaining earnings and not cutting their lending, and institutions with higher starting capital ratios have seen their assets grow more quickly over the past four years.[11] Right now, U.S. institutions have a competitive advantage over their international counterparts, both because their competitors are undercapitalized and because the U.S. economy is growing faster than those of other countries.[12] The proposed rule will provide clear benefits to U.S. financial stability and competitiveness, while imposing minimal costs to society.

It is also important to remember that community banks did not threaten the economy with their collapse or cause the financial crisis: the big banks did. And it is with that lesson in mind that we appreciate your agencies' decision to ensure that efforts to protect our economy and taxpayers from being threatened again by the collapse of a too-big-to-fail firm will not unnecessarily impact the smaller banks who don't engage in non-traditional, riskier capital markets activities.

Just a few years ago, your agencies, two Presidents, Congress, and the American people were all pressed into the terrible choice of bailing out the largest financial firms or risking the collapse of the economy. We urge you to use your authorities to enhance capital and reduce leverage at the largest financial firms, so that none of us is again faced with such a choice. We commend you on your approach and urge you to strengthen your proposal and begin implementing it as soon as is practicable.

Thank you for considering our views.

Sincerely,

Sherrod Brown

Carl Levin

[1] *See* Letter from the Systemic Risk Council on Regulatory Capital Rules 3, Oct. 4, 2012 available at http://www.systemicriskcouncil.org/wp-content/uploads/2013/06/SRC-capital-comment-letter-10-3-12.pdf; *see also* Remarks by Thomas M. Hoenig, Director, Federal Deposit Insurance Corporation, "Financial Oversight: It's Time to Improve Outcomes", AICPA/SIFMA FSA National Conference, New York, N.Y., Nov. 30, 2012 available at http://www.fdic.gov/news/news/speeches/archives/2012/spnov3012.html.
[2] *See* Basel Committee on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems 61 (June 2011) available at http://www.bis.org/publ/bcbs189.pdf.
[3] *See* Andrew Haldane, "The Dog and the Frisbee" 14, Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium, Jackson Hole, Wyoming, Aug. 31, 2012 available at http://www.kansascityfed.org/publicat/sympos/2012/ah.pdf.
[4] *See* Remarks by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, "The Evolution of Capital Regulation" 3, to the Clearing House Business Meeting and Conference, Nov. 9, 2011 available at http://www.federalreserve.gov/newsevents/speech/tarullo20111109a.pdf.
[5] *See* Basel Committee on Banking Supervision, The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability 11 (July 2013) available at http://www.bis.org/publ/bcbs258.pdf.
[6] *See id.*
[7] *See* "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," staff report released by U.S. Permanent Subcommittee on Investigations (Mar. 15, 2013), at 96-98, 168-171, 191-196.
[8] *See* Board of Governors of the Federal Reserve System, Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice 14-15, 17 (Aug. 2013) available at http://www.federalreserve.gov/bankinforeg/bcreg20130819a1.pdf.
[9] *See* Remarks by Jeremiah O. Norton, Director, Federal Deposit Insurance Corporation, "A More Prominent Role for the Leverage Ratio in the Capital Framework", to the Florida Bankers Association, Orlando, Fla., Feb. 6, 2013 available at http://www.fdic.gov/news/news/speeches/spfeb0613.html; *see also* Statement by FDIC Director Thomas Hoenig, Basel Capital Notices of Proposed Rulemaking, June 12, 2012 available at http://www.fdic.gov/news/news/speeches/chairman/spjun1412.html.
[10] Thomas M. Hoenig, President and Chief Executive Officer, Federal Reserve Bank of Kansas City, "Do SIFIs Have a Future?" 4, Pew Financial Reform Project and New York University Stern School of Business, "Dodd-Frank One Year On", Washington, D.C., June 27, 2011 available at http://www.kansascityfed.org/publicat/speeches/Hoenig-NYUPewConference-06-27-11.pdf.
[11] *See* Benjamin Cohen, *How Have Banks Adjusted To Higher Capital Requirements?*, BIS Quarterly Rev. 32, 37, Sept. 2013 available at http://www.bis.org/publ/qtrpdf/r_qt1309.pdf.
[12] *See* Ambereen Choudhury & Elisa Martinuzzi, *Wall Street Banks Win Market Share as Europeans Struggle*, BLOOMBERG, Aug. 8, 2013 available at http://www.bloomberg.com/news/2013-08-08/wall-street-banks-win-market-share-as-europeans-struggle.html.