June 3, 2016

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Single-Counterparty Credit Limits for Large Banking Organizations, Docket No. R-1534

Dear Mr. Frierson:

Better Markets[1] appreciates the opportunity to comment on the above-captioned rule proposed ("Proposed Rule") by the Board of Governors of the Federal Reserve System ("Board"). The Proposed Rule establishes single-counterparty credit limits for domestic and foreign bank holding companies with $50 billion or more in total consolidated assets, as mandated by Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

INTRODUCTION

Better Markets strongly supports the intent that underlies the Board's Proposed Rule. As so painfully and expensively demonstrated during the last financial crisis, reducing the risk that arises from the interconnectedness of large bank holding companies is crucial to ensuring that financial distress at one or two large banking organizations does not result in distress at other large banking institutions thereby jeopardizing the U.S. and the global financial system.

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

The Board's Proposed Rule is a reproposal of rules that were originally proposed in December 2011 and December 2012. Unfortunately, the Proposed Rule weakens the safeguards set out in the original proposals, to the detriment of financial stability. As Better Markets noted in its comment letter on the December 2011 proposal, while Better Markets supported the provisions in the proposed rule, those provisions "should be strengthened in the Proposed Rule."[2] As Dennis Kelleher, President and CEO of Better Markets, testified before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Financial Services Committee,

> While the proposed rule is a good start, it needs to be strengthened .... Better Markets advocated that 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. In no event should the proposed rule be weakened as some in the industry are advocating.[3]

Yet rather than strengthening the December 2011 and 2012 proposals, the Board's Proposed Rule weakens them.

COMMENTS ON THE PROPOSED RULE

The Board should maintain the 10% exposure limit.

The original proposals capped the net exposure of bank holding companies with $500 billion in assets to 10% of the bank holding company's capital and surplus. The 10% cap in the original proposal was a crucial element in limiting the interconnectedness between the world's largest, most systemically important banks. By limiting the levels of exposure to 10% to any one counterparty, the original proposals made it less likely that the failure of any large institution would imperil the entire financial system.

Unfortunately, the Board's current proposal increases the exposure limit between the largest institutions by 50%, from the previously proposed 10% to 15%. While the effect of increasing the cap is somewhat mitigated by using the Basel Committee on Banking Supervision's more stringent Tier 1 capital standard as the denominator for calculating single counterparty credit limits for bank holding companies with $250 billion or more in assets,[4] the Board's efforts to mitigate systemic risk would be better served by retaining the

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2 Better Markets Comment Letter re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (RIN-AD-86) (Apr. 30, 2012), *available at* http://www.federalreserve.gov/SECRS/2012/May/20120501/R-1438/R-1438_043012_107250_511116121698_1.pdf, incorporated hereby as if fully set forth herein.

3 Dennis M. Kelleher, President and CEO, Better Markets, Inc., Testimony on "The Impact of Dodd-Frank on Customers, Credit, and Job Creators," Committee on Financial Services, Subcommittee on Capital Markets and Government-Sponsored Enterprises (July 10, 2012), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-112-ba16-wstate-dkelleher-20120710.pdf, incorporated hereby as if fully set forth herein.

4 In its April 2012 Comment Letter (Id. n. 2 above), Better Markets called upon the Board to assess counterparty risk exposures based on a bank holding company's tangible common equity rather than

originally proposed 10% limit *and* adopting the Basel Committee's Tier 1 capital standard for calculating the ratio.

The Board should simplify and strengthen its treatment of exposures to affiliated counterparties.

The originally proposed rules required bank holding companies to aggregate their exposures to a single counterparty and its affiliates if the counterparty held more than 25% of the affiliate's voting securities or equities. By focusing on legal form, the originally proposed rules ignored the possibility that a counterparty could be liable for an affiliate's obligations, thus exposing a bank holding company not only to the credit risk of its counterparty but also the counterparty's affiliates as well. As the financial crisis made painfully apparent, in many cases, financial institutions assumed responsibility for the obligations of their affiliates, even when they were under no obligation to do so. Citigroup, for example, brought the liabilities of its structured investment vehicles onto its balance sheet in 2007. In doing so, Citigroup added $49 billion of liabilities to its books, thus exposing its counterparties to the liabilities of Citigroup's off-balance sheet vehicles.[5]

The simplest and most accurate way to incorporate the exposures of affiliated counterparties into the single counterparty credit limits would be to look past legal form to the potential exposure that a bank holding company could have to a counterparty and its affiliates in a stressed scenario. As the Board itself has acknowledged, "Under stress scenarios, [a financial company] may be contractually required, or compelled in the interest of mitigating reputational risk, to provide liquidity support" to an affiliate.[6] In such a scenario, the obligations of the affiliate effectively become the obligations of the counterparty, and the bank holding company is as exposed to those obligations as if they were undertaken directly by the counterparty itself.

Under the Board's Proposed Rule, a bank holding company is required to aggregate its exposures to a counterparty with those from entities that are "economically

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using the bank holding company's total regulatory capital plus an allowance for the bank holding company's loan and lease losses as a measure of the bank holding company's "capital stock and surplus." While this change is welcome, and Better Markets commends the Board for using a more transparent and reliable measure of an institution's capital, increasing the permissible exposure level from 10% to 15% is a step in the wrong direction.

5 *See* Robin Sidel, David Reilly, and David Enrich, "Citigroup Alters Course, Bails Out Affiliated Fund," *Wall Street Journal* (Dec. 14, 2007), *available at* http://www.wsj.com/articles/SB119759010104328237. As Stanford Business School professor Darrell Duffie has written, large banks have a strong incentive to rescue their off-balance sheet affiliates, even if they have no obligation to do so, in order to protect their reputations. *See* Darrell Duffie, *How Big Banks Fail: And What to Do About It* 20 (2011). The Bank for International Settlements has undertaken an initiative to identify and measure this sort of risk, which it refers to as "step-in risk"—the risk that a financial institution will provide support to its unconsolidated affiliates, even if it not obligated to do so—to mitigate risk to its reputation. *See* Bank for International Settlements, "Identification and Measurement of Step-in Risk: Consultative Document" (Dec. 2015), *available at* http://www.bis.org/bcbs/publ/d349.pdf.

6 Board of Governors of the Federal Reserve System, "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies," 77 *Federal Register* 594 (Jan. 5, 2012), *available at* https://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf.

interdependent" with the counterparty. While this formulation looks past legal form, it unfortunately defines "economically interdependent" using a multitude of factors that will be difficult to objectively evaluate. Given that in a time of crisis, a counterparty will seek to protect its affiliates, a more effective way of mitigating counterparty credit risk would be to simply require a holding company to calculate its exposure to a counterparty by aggregating all of its exposures to the counterparty and its affiliates.

Such an approach would ensure that if a counterparty brings its off-balance sheet liabilities back onto its balance sheet in the midst of a stress scenario, a bank holding company will not suddenly find itself exposed to a risk it did not anticipate. Such an approach would also be considerably easier to implement and administer than one that relies on a multitude of factors. Moreover, given actual market events just eight years ago in the midst of the financial crash of 2008, this approach would also capture the reality of what will most likely happen, which is precisely what the law and rule are intended to avoid.

The Board should set counterparty credit limits on a bank holding company's gross credit exposure to a counterparty rather than its net credit exposure.

As with earlier proposals, the Board's Proposed Rule allows bank holding companies to increase their credit exposure to a counterparty by deducting "credit risk mitigants" such as "eligible guarantees" and "eligible credit and equity credit derivative hedges" from their gross credit exposure to arrive at an "aggregate net credit exposure." This "aggregate net credit exposure" is then used to calculate the holding company's single counterparty credit limit.

Unfortunately, allowing bank holding companies to increase their exposure to counterparties through the use of guarantees and derivatives reflects the triumph of hope over experience. As the financial crisis demonstrated in so many different ways, in times of system-wide stress, these kinds of guarantees and derivatives propagated systemic risk rather than contained it. Monoline insurers proved unable to cover losses on collateralized debt obligations. AIG failed to make good on the credit default swaps it had written against mortgage-backed securities held by the largest banks. And protection issued by Lehman Brothers proved to be useless when Lehman went bankrupt. Lehman also proved that exposures do not net in a crisis.

The point of the single counterparty credit limit rule is to limit the systemic risk that arises from the interconnectedness that arises when a firm has excessive exposure to any single counterparty. But by allowing bank holding companies to calculate their single counterparty credit limits using aggregate rather than gross exposure, the Proposed Rule increases systemic risk by encouraging bank holding companies to rely on the kind of financial engineering that has proven to be dangerously fragile just when it was needed the most.

CONCLUSION

Better Markets supports the goals that underlie the Proposed Rule: the financial system should be made stronger and more resilient by reducing the dangerous interconnections that can arise when large bank holding companies take on too much exposure to individual counterparties. Unfortunately, the Proposed Rule represents a step back from earlier proposals. Protecting the financial system from the dangerous interconnections that grew up between the world's largest financial firms in the years before 2008 requires the Board to do more to ensure that the bank holding companies that it supervises do not become dangerously over-exposed to any single counterparty.

Sincerely,

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