The Systemic Risk Council

The Honorable Jerome H. Powell
Chair, Board of Governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551

Comptroller Joseph M. Otting
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

SUBMITTED VIA FEDEX

August 8, 2018

Re: Comments regarding the eSLR and Volcker Rule

Dear Chair Powell and Comptroller Otting,

This letter offers the comments of the Systemic Risk Council (SRC) on the proposals of the Federal Reserve Board (Fed) and the Office of the Comptroller of the Currency (OCC) (together, "the Regulators") to relax (a) the leverage ratio applying to banks and banking groups, and (b) the so-called 'Volcker Rule' constraints on using insured deposits to fund speculative trading and investments.

The SRC has serious reservations about both proposals, as they would make the US banking system less resilient and so expose the American people to unnecessary risks. In this Comment Letter, we set out our concerns and offer some possible mitigating measures if the Fed and OCC continue on their charted course.

Relaxing the leverage constraint

The enhanced supplementary leverage ratio (eSLR) applies to (and only to) banking groups that have been designated as global systemically important banking organizations (GSIBs). It is currently 6% for insured depository institutions (i.e., operating banks) that are subsidiaries of such GSIBs; and 5% for the consolidated group holding company.

Summary of the proposals

The Regulators have proposed that the ratios be reduced to 3% (the standard leverage requirement for all banks) plus 50% of the surcharge that is applied to a particular GSIB's risk-based capital requirement. This would bring the US into line with the Basel international standard for GSIBs, which applies a 50% scalar to each large and complex bank's risk-weighted capital surcharge to generate the leverage

surcharge.[1]

That methodological alignment, which has merit, is independent from the policy question of how much equity US banks should be required to carry.[2] In fact, however, while the effect of the Regulators' proposal on bank holding companies might be modest, there would be a material reduction in equity requirements for operating bank subsidiaries.

The differential impact on opcos and holdcos arises for two reasons. First, the starting points are different (6% and 5% respectively). Second, the Regulators currently apply two sets of requirements --- the risk-based GSIB surcharges and the stress-testing requirements --- only at the holdco level (i.e., not to individual banking subsidiaries).[3]

While quantitative estimates of the effects of the proposal are subject to uncertainty, the broad shape is clear enough: under the Regulators' proposal, the equity in US banks is set to fall materially.[4] The SRC has serious reservations about this, and urges the Regulators at the very least to modify their proposal in order to reduce the effect on the system's resilience by tightening other regulatory requirements. Our reasons can be grouped under four headings:

- Why the minimum requirements introduced after the crisis are now too low even if they were right at the time they were set;
- Why it is a mistake to reduce leverage constraints;
- Why various arguments in favor of the Regulators' proposals are not robust; and
- Why it is a serious mistake to prioritize the capital adequacy of the holding company/consolidated group over that of key operating subsidiaries.

Changes in the macroeconomic environment require more, not less, equity in the banking system

We begin with a high-level point.

When the new capital regime was calibrated shortly after the crisis, there was an implicit assumption that the economy (national and global) would return to normal, meaning a relatively robust steady state rate of underlying growth (i.e., productivity growth) and, hence, nominal interest rates averaging around 5% or more. Since then, it has become clear that, to put it at its lowest, a return to past normality is by no means guaranteed. Many commentators now have a central expectation of (and/or risks stacked towards) lower

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[1] This is based on the average risk-weight being about 50%. Basel Committee on Banking Supervision, Basel III: Finalising post-crisis reforms 140-41 (Dec. 2017) (requiring a leverage ratio buffer of 50% of a GSIB's higher-loss absorbency risk-weighted capital requirements).

[2] It is not always understood that tangible common equity is a claim on the bank of equity holders (a liability) reflecting tangible net worth (i.e., the difference between assets and other liabilities).

[3] The Basel Committee also framed risk-capital surcharges in terms of consolidated group requirements. Some of the arguments in this letter against the Regulators' approach accordingly apply to Basel as well.

[4] The Fed estimates that the amount of tier 1 capital required under the proposed eSLR standard across the lead insured depository institution subsidiaries of the subject GSIBs would fall by approximately $121 billion from the amount that is required under the current eSLR standard to be considered well-capitalized. Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions, 83 Fed. Reg. 17,317, 17,321 (Apr. 19, 2018) (proposed rule).

trend growth and a lower equilibrium nominal interest rate. Indeed, the Fed itself expects interest rates on average to be materially lower than in the past.[5]

It is very important that this be taken into account when contemplating any reforms to the post-crisis banking policy. It points in the opposite direction from the Regulators' current proposals.

That is because the closer nominal interest rates are to zero, the less scope there will be for monetary policy to stabilize the economy in the face of adverse macroeconomic shocks, meaning recessions (and therefore loan impairments and defaults) would be worse than otherwise. With lower 'trend' growth and deeper recessions than otherwise, there will be less scope than in the past for borrowers in general to grow out of debt-overhang problems.

Thus, loans originated prior to the realisation that growth is set to be lower than over recent decades will be riskier than originally believed. As a result, some loans and other exposures will be mispriced, provisions against expected losses too low, and their risk-weights (based on a misrepresentative historical period) also too low.

None of this was taken into account when Basel III was calibrated. The implication is that, given the downside risks to the medium-term macroeconomic outlook, banks will likely have to carry more equity capital to ensure the degree of system resilience that Basel III was aiming to achieve. The Regulators' proposal moves in the opposite direction of what is needed.

Why it is a mistake to reduce the leverage ratio now

Quite apart from those reasons for eschewing an easier capital policy, there are other reasons for being cautious at present. These concern the current economic conjuncture and, separately, the wider state of regulatory policy.

This would be a strange point of the credit cycle to decide that banks can hold less equity. Indeed, given the current pace of economic growth, some exuberance in asset markets, reflected in the softening of terms and conditions in some lending markets, a decent case could be made for the Fed to use its power to require banks temporarily to hold what is known as a counter cyclical capital buffer (CCB), a policy instrument designed to ensure that the authorities can make banks accumulate extra buffers during the good times in order to absorb losses when the tide turns.[6] The Fed's decision not to use that power currently would look even less warranted if it elects to reduce banks' base equity requirement, reducing the resources available to back continued lending when the economy slows.

More widely, it is an odd moment to relax equity requirements given that:

- the Crapo Bill has already relaxed equity requirements by raising the asset threshold at which

[5] See, e.g., Federal Reserve, Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy (Mar. 2018), https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20180321.pdf; Federal Reserve, *FOMC's target federal funds rate or ra*nge, change (basis points) and level, https://www.federalreserve.gov/monetarypolicy/openmarket.htm (last visited July 24, 2018).
[6] 12 C.F.R. § 217.11(b).

banking groups are subject to certain enhanced prudential standards, among other measures;
- the Regulators have not yet introduced the Net Stable Funding Ratio for banks; and
- the Regulators are proposing to relax the Volcker rule that bars banks from using insured deposits to fund proprietary trading and similar investment strategies (see below).

Given those three developments alone, the Regulators should be strengthening, not weakening, the equity base of banks, and should be doing so in the simplest way, i.e., via the leverage ratio. In the current conjuncture, the Regulators' proposals would be pro-cyclical.

The *SRC's response to two arguments in favor of the Regulators' proposals*

Before moving on to discuss the relative importance of loss-absorbing capacity in opcos and holdcos and to outline a possible mitigating measure, the SRC wishes to respond to the argument that the leverage ratio is, perversely, damaging market liquidity.

In particular, we urge caution in drawing policy conclusions from the argument that a binding opco leverage cap constrains market making by dealers and, therefore, has already impaired (or will in the future risk impairing) liquidity in various important capital markets. First, the absence of constraints on dealer balance sheets before the crisis helped market liquidity only as long as the party lasted. From the summer of 2007, and even more so in late 2008, liquidity in many markets evaporated quickly. Liquidity that exists only in the good times is illusory.

Second, so long as, thanks to the subsidy from a perceived government safety net, dealers could support their market-making activities by expanding their balance sheets at near zero cost, there were only very weak incentives for market participants of all kinds to invest in developing the underlying infrastructure of fixed-income capital markets. Since the introduction of leverage constraints on banks and dealers, those incentives to invest in improving the market microstructure have increased. It would be a mistake for the Regulators to dilute them.

Put another way, the SRC believes that the regulatory authorities do not face a medium-term trade-off between operating-bank resilience and the liquidity of markets. We accept that such a trade-off might exist in the short term, but that does not warrant steps that could well compromise longer-term welfare.

Why it is a mistake to rely on the capital adequacy of holding companies rather than of operating banks

At the core of our concern about the Regulators' proposals is the reduction of equity in operating banks. Indeed, the Regulators' proposals raise a deep but neglected question about the structure of prudential policy for the banking system.

For nearly 40 years, following the failure of Banco Ambrosiano in 1982, international and domestic US doctrine has held that bank regulation and supervision should focus primarily on each consolidated group as a whole (hence the expression "consolidated supervision") and, in particular, on capital adequacy measured and assessed at the level of group holding companies. This doctrine is associated with two concrete policy positions on the distribution of capital across a banking group's various legal entities:

- that any equity buffer a group carries over and above minimum requirements should be held at the holdco level; and
- that a group that has diversified its risks across its various subsidiaries can carry less equity than would result from adding up the capital requirements for a series of otherwise similar but stand-alone operating companies.

The concrete upshot is that a holding company is seen to be a source of strength for the group as a whole while, at the same time, delivering capital efficiency.[7] In consequence, as described above, bank supervisors set any systemic surcharge and conduct stress testing at the holdco level.

The crisis should prompt some re-examination of this long-standing doctrine. Baldly, it is operating companies that incur losses; and it is opcos whose failure imposes social costs on the economy, because by definition it is they, not holdcos, that provide services to households and businesses in the real economy. Further, the obligation of holdcos to stand behind or redistribute resources to ailing subsidiaries is limited. Whether or not they do so is primarily a matter of private commercial interest, trading off possible future profits from a continuing business against the benefits of letting excess losses fall on the deposit-insurer and other third parties.[8]

Even when holdcos are able and ready to provide such support, delay in doing so can cause the operating bank to cut back its supply of credit to the real economy in order to de-lever. For large banking groups, that truly is perverse given the effects on and feedbacks from the real economy. Much better for the opco itself to carry equity enabling it to absorb losses without suspending business while the holdco board agonizes over when and if it should step in.

The Regulators' existing policy recognized those considerations. That is because the minimum requirements on operating banks have their roots in the policy of (and legal framework for) prompt corrective action (PCA) under the Federal Deposit Insurance Act, i.e., intervening in ailing banks before they topple over.[9]

The proposed plan does not recognize the general considerations set out above. Indeed, by materially reducing the amount of capital that a GSIB's operating bank subsidiaries must hold in order to be

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[7] In 1984, the Fed amended its Regulation Y to stress that "bank holding company[ies] shall serve as a source of financial and managerial strength to its subsidiary banks." 12 C.F.R. § 225.4.

[8] See, e.g., MCorp Financial, Inc. v. Bd. of Governors of the Fed. Reserve Sys., 900 F.2d 852, 861-62 (5th Cir. 1990), *rev'd on procedural* grounds, 502 U.S. 32 (1991) (holding that the Fed did not have the power to require a holding company to inject equity into an ailing subsidiary). Under the 1991 amendments to Section 38(e) of the Federal Deposit Insurance Act (FDIA), an undercapitalized IDI must submit a capital restoration plan to its primary federal prudential regulator, and the IDI's holding company must guarantee the IDI's compliance with the plan. The holding company's liability under this guarantee is limited to 5% of the IDI's total assets, however. Section 616 of the Dodd-Frank Act amended the FDIA to provide that the federal banking regulators must require bank holding companies to serve as a source of financial strength their insured depository institution subsidiaries, but the banking regulators have not promulgated a rule to this effect. It is hard to see how any rule-making could achieve this, other than the proposal for internal gone-concern loss-absorbing capacity advanced later in the main text.

[9] Section 38 of the Federal Deposit Insurance Act, 12 U.S.C. § 1831o, and 12 C.F.R. § 6.4(c) together set out the minimum generally applicable leverage ratio for operating banks under the prompt corrective action regime, currently set at 5% of total assets. The current eSLR rule also requires operating bank subsidiaries of GSIBs to maintain a 6%supplementary leverage ratio, over and above the generally applicable leverage ratio, to be deemed "well capitalized'' under the prompt corrective action framework. It should be noted that the current leverage ratio for bank holding companies, set forth at 12 C.F.R. § 217(a)(4), does not come out of the prompt corrective action framework, but rather is a product of Section 5(b) of the Bank Holding Company Act of 1956, as amended by the Dodd-Frank Act.

considered "well capitalized" under the PCA regime, the proposal arguably would work at cross purposes with the PCA framework (as updated in the wake of the crisis).[10]

With an average GSIB risk-based capital surcharge of 1 percentage point, the operating-bank supplementary leverage ratio requirement would fall from 6% to 3.5%, leading the Regulators to estimate that the capital required in the eight largest FDIC-insured banks would fall by around $120bn. That is a lot. The SRC recommends that the Regulators ensure that, at the least, the supplementary leverage ratio for the affected banks does not fall below 5%, the constraint that currently applies and is expected to continue to apply at holding company level. Alternatively, the regulators could extend risk-based surcharges to systemically significant operating banks, rather than applying them only at the consolidated level (i.e., to the holdco).

A suggested mitigating measure if, despite those arguments, the Regulators proceed with their proposals

If, notwithstanding the above arguments, the Regulators go ahead and weaken the capital adequacy of US operating banks, the SRC urges the Regulators to mitigate this by requiring opcos to issue an offsetting larger amount of deeply subordinated bail-inable debt to their holding companies. The background to this proposal is as follows.

Since the crisis, Congress has introduced statutory powers for the resolution of large and complex financial groups. Big picture, the emphasis is on avoiding distress interrupting the supply of services by operating subsidiaries. That is to be achieved by hard wiring support from holdcos through gone-concern loss-absorbing capacity in the form of deeply subordinated bonds issued by opcos to holdcos that convert into equity, and so recapitalize opco, in the event of significant losses (or other sources of distress). The losses exceeding a distressed subsidiary's equity are, thereby, transferred up to holdco, which if rendered insolvent goes into a resolution or bankruptcy procedure via which holdco bonds held by external investors are converted into equity. This approach would move ownership and control of the group from the pre-resolution equity holders to the bondholders. (In the jargon, that resolution strategy is known as single point of entry (SPE) bailin; the externally issued holdco bonds contribute, with equity, to total loss-absorbing capacity (TLAC); and the subordinated bonds issued by the subsidiary to its holdco are, together with its equity, known as internal-TLAC (iTLAC).[11])

Thus, under the SRC's proposal for the Regulators to mitigate any reduction in opco leverage requirements, each operating bank's internal Total Loss Absorbing Capacity would remain unchanged relative to total assets, but its composition would shift from common equity to bonds convertible into equity.

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[10] See, e.g., 78 Fed. Reg. 62,040 (Oct. 11, 2013) (explaining that under the PCA regime, "insured depository institutions that fail to meet [the PCA's] capital measures are subject to increasingly strict limits on their activities, including their ability to make capital distributions, pay management fees, grow their balance sheet, and take other actions").

[11] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (Dec. 18, 2013). The feasibility of this resolution strategy was endorsed in 2013 by (then) Governor Powell. Jerome Powell, Governor, Board of the Federal Reserve System, Remarks at the Institute of International Bankers Washington, DC Conference: "Ending 'Too Big to Fail'" (Mar. 4, 2013).

This would require the banking regulators to introduce rules governing iTLAC requirements for US banks. So far, in contrast to some European jurisdictions, that has not been done.[12] That has been a mistake, as the SRC has noted in earlier Comment letters, since the capacity to shift opco losses exceeding equity up to holdcos is completely central to SPE bail-in resolution.[13] The gravity of this gap in the regime for implementing the Dodd-Frank Act will increase if and when opco equity requirements are reduced. While the Fed and the Federal Deposit Insurance Corporation (FDIC) can, in principle, do something to police internal loss-transferability via their examination and authorization of Title I "Living Wills", that is an opaque, case-by-case process, whereas a general policy on iTLAC would be more transparent and easier to understand. It would also bring the US into line with the international norm.[14]

By introducing an offsetting iTLAC requirement, the Fed would maintain the loss-absorbing capacity of opcos while, in effect, granting a tax break to banking subsidiaries (given that interest on the internal debt would be tax deductible). For stability policy, the overall effect would be to increase reliance on the credibility of resolution plans.

Reforms to the Volcker Rule

Alongside other agencies, the Regulators propose to relax the regulations implementing the Dodd-Frank Act's Volcker Rule on proprietary trading and investment, essentially in the interests of reducing complexity.

The principle underlying the Volcker Rule is that banks benefiting from access to Fed liquidity insurance and FDIC deposit insurance, backed ultimately by taxpayers, should not be in the business of speculative trading and investment; or, more generally, that such commercial activities should not have access to a government safety net. The complexity and length of the existing regulations implementing the statutory rule are, however, a recipe for its intent being undermined by interpretive creativity as the years pass. Indeed, overall the current regulations are so complicated that even the proposed simplifications are hard to understand. Revisiting the regulations is, therefore, sensible in the SRC's view.

While SRC members hold a range of views about the Volcker Rule and its current application, members as a whole have considerable reservations about the substance of the agencies' proposed streamlining. At their core, the proposals amount to giving more discretion to the management of banking groups to determine what are "market making" or "hedging" services provided to clients. In a world in which firms travel as a herd --- captured in the famous remark that "[a]s long as the music is playing, you've got to get up and dance"[15] --- it is hardly prudent to let the integrity of the policy rest on the reliability of management's discretionary judgment. There are echoes here of the big mistake made by the Basel

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[12] Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate
Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 8,266, 8,304 (Jan. 24, 2017). Although the Fed has not proposed domestic internal TLAC requirements, it has stated that "[s]uch requirements would complement [its existing TLAC rule] and enhance the prospects for a successful SPOE resolution of a covered BHC or of the
parent foreign GSIB of a covered IHC." Id.

[13] Systemic Risk Council, Comments Regarding the TLAC Proposal (Apr. 14, 2016), http://systemicrisk.wpengine.com/wp-content/uploads/2016/04/SRC-TLAC-comment-on-FRB-proposed-rule.pdf.

[14] See, e.g., Financial Stability Board, Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-*SIBs ("Internal TLAC")* (July 6, 2017), http://www.fsb.org/2017/07/guiding-principles-on-the-internal-total-loss-absorbing-capacity-of-g-sibs-internal-tlac-2/ .

[15] Citi Chief on Buyouts*: 'We're Still Dancing'*, N.Y. Times (July 10, 2007), https://dealbook.nytimes.com/2007/07/10/citi-chief-on-buyout-loans-were-still-dancing/.

Committee when it allowed banks' internal models to determine their capital requirements. It is not obvious to the SRC why reliance on banks' and dealers' self-applying carve-outs for hedging and market making should work any better. If that is correct, and it is obviously a risk, over time the Volcker Rule will not in practice apply a meaningful constraint on speculating with FDIC-backed deposits.

The SRC accordingly encourages the Regulators to solicit alternatives to its current proposed reforms.

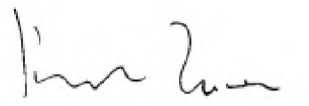
Summary and Conclusions

In this comment letter, the Systemic Risk Council has set out why it has material reservations about the Regulators' proposal to permit banks to lever up again, and about the regulatory agencies' proposal to simplify the Volcker Rule by handing discretion to banks and dealers.

The SRC shares the widely held view that, ten years after the worst phase of crisis, it makes sense to assess where the current regulatory regime could be simplified without sacrificing systemic resilience. The current proposals, however, are not good candidates for achieving this objective. The economy is weaker than before the crisis, which makes a case for increasing not reducing banks' equity. The most obvious lesson of 2008 is that it is the resilience of operating banks and dealers, not holding companies, that matters most to the welfare of the American people. And the second lesson, perhaps, is that clear lines are needed both in the interests of simplicity and because it is unreasonable to expect private bankers to police their own risk-taking in the public interest.

We accordingly urge the Regulators to think again, and at least to modify and mitigate their current proposals to allow banks to become less resilient.

Yours sincerely,



Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
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Cc: Jelena McWilliams, Chair, Federal Deposit Insurance Corporation

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