Proposal:	1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations
Description:	

Comment ID:	156739
From:	Neal Moran
Proposal:	1813 (AG64) Reg H, Q, LL & YY-Regulatory Capital Rule: Amendments to LBOs and Banking Organizations
Subject:	R-1813 Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking

Comments:

I am a former federal bank examiner who spent more than 36 years in bank supervision including more than a decade in Large Bank Supervision at the OCC. I covered some of the largest and most complex banking organizations and have dealt with risk-based capital regulations since the 1980s. I currently write a blog (www.uponfurtheranalysis.com) primarily devoted to banking and its regulation. I welcome the opportunity to comment on the Notice of Proposed Rulemaking (NPR) and believe I bring to the discussion both extensive technical knowledge of the issues and a lack of self-interest. Many of the comment letters submitted to date repeat some dubious narratives. One is that the pandemic offered a real-life stress test for the financial sector. This view ignores early and massive federal intervention to bolster the markets. It also ignores the extent that PPP and other programs strengthened borrowers' balance sheets and significantly reduced default risk, at least in the short term. The other is the supposed impact the proposal would have on mortgage availability, especially for lower income or first-time home buyers. The proposal does not differ substantially from what already applies to most financial institutions under the Standardized Approach. My comments on specific aspects of the proposal are as follows: Scope of Application The proposed rules would apply to banking organizations with $100 billion or more in total assets. The failures of Silicon Valley and Signature Banks and the use of the Systemic Risk Exception to justify payouts to uninsured depositors show that banks in this asset range are systematically important or are at least viewed as such by bank supervisors. Although regulators did not invoke the Systemic Risk Exception for First Republic Bank, the extraordinary steps taken by bank supervisors and other U.S. government officials suggest the systemic importance of that institution as well. It stands to reason that systemically important institutions should be subject to rigorous and stringent capital requirements. AOCI Inclusion. Extending the treatment of accumulated other comprehensive income (AOCI) to Category 3 and Category 4 institutions recognizes economic reality. Underwater investment portfolios limit a bank's ability to absorb losses and increase the FDIC's loss exposure. One potential concern is that the change may encourage banks to designate more securities as held-to-maturity (HTM) rather than available-for-sale (AFS) to avoid capital volatility. There's some history here. HTM at the eight Advanced Approaches banks went from 24% of total securities in Q1 2018 to 64% by Q1 2023. Designating securities as HTM does nothing to mitigate a bank's interest rate risk profile but limits a bank's practical liquidity and the ability to rebalance portfolios. Regulators can take actions to discourage migration to HTM. First, regulators should make a clear policy statement that supervisors will consider unrealized losses when assessing capital adequacy, regardless of accounting classification. This approach would continue to provide supervisors with flexibility in dealing with individual circumstances. Second, HTM securities should be excluded from the definition of High-Quality Liquid Assets when calculating the Liquidity Coverage Ratio. The potential to taint a portfolio, especially an underwater one, severely reduces the value of HTM securities as a source of liquidity. Residential Mortgages The proposed capital treatment of residential mortgages has received by far the most attention and the most criticism. However, the NPR merely recognizes economic reality. Model-based approaches to estimate credit losses for residential mortgages failed miserably during the Global Financial Crisis and it's remarkable that the approach has survived as long as it has. Moreover, FFIEC 101 data indicate that current risk weights for residential mortgages under the Advanced Approach (AA) are roughly 15% for most AA BHCs. In contrast, a "prudently underwritten" residential mortgage is risk weighted at 50% under the Standardized Approach. FNMA and Freddie Mac MBS, which are de facto full faith and credit obligations, are risk weighted at 20%. The proposed rule would replace the model-based calculation under the Advanced Approach with one based on loan-to-value (LTV) ratios. Decades of experience show that borrower equity provides a strong disincentive against defaults and gives the lending banks a cushion against losses in the event of default. Risk-based capital standards should be based on … risk. However, the proposed rule's expanded use of LTV ratios has allowed opponents of the rule to emphasize its potential adverse impact on first-time home buyers and lower income borrowers. This is an unnecessary distraction. Merely requiring all institutions to use the current Standardized Approach for residential mortgage exposures is both simpler and would deprive the rule's opponents of their current talking point. They would instead be forced to argue that the largest and most systemically important should somehow receive more favorable mortgage risk weighting than community and midsize banks. I do, however, recommend that regulators offer further clarification on which residential mortgages qualify for the 50% risk weight. For national banks, 12 C.F.R. 3.32(g)(1)(ii) requires the loan be: "made in accordance with prudent underwriting standards, including standards relating to the loan amount as a percent of the appraised value of the property." The capital regulation itself does not define "prudent underwriting standards." Instead, it relies on the Interagency Guidelines on Real Estate Lending, which allows institutions to establish their own internal limits. The guidelines do indicate, however, that "for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement." Reliance on guidelines, and vague and indirect guidelines at that, may make the provision hard to enforce. It is likely to favor the imprudent and litigious over the merely prudent. It is also remarkable that these guidelines date from the early 1990s, as though the mortgage meltdown during the Global Financial Crisis never happened. Instead, the capital regulations should establish a bright line that requires an LTV of no more than 90% at origination to qualify for the 50% risk weight. Mortgages with LTVs higher than 90% would be risk weighted at 100%. Operational Risk Calibrating capital requirements for operational risk presents considerable methodological challenges. The proposed tying of the business indicator and internal loss multiplier to the operational risk capital requirement makes intuitive sense. One practical effect of the very low credit risk weights under the current Advanced Approach is that the capital charge for operational risk is effectively zero for most firms since the Standardized Approach is the more binding constraint. The lack of an effective capital charge is hard to square with the centrality of operational risk to a financial institution's risk management. Large financial institutions have experienced not only large operational risk losses but some notable near misses. As recently as 2020, a large financial institution mistakenly wired $900 million, and it took two years of litigation to get all the money back. While the Supplementary Information section of the NPR discusses some of the differences between the current Advanced Measurement Approaches (AMA) and the proposed calculation under the Standardized Approach, it would also be helpful to compare output (estimated capital charges) under the two approaches. Repo-Style Transactions and Eligible Margin Loans The proposal calls for some modest changes in the capital treatment of repo-style transactions and eligible margin loans. While these proposed changes are a step in the right direction, they do not address some more significant limitations to the current framework. The Collateral Haircut Approach allows banks to offset the credit risk of these transactions with financial collateral. The "financial collateral" definition covers a range of securities but does not consider their liquidity other than that debt securities be investment grade and equity securities be publicly traded. Illiquid securities provide much less loss mitigation. Requiring that financial collateral be high quality liquid assets or at least liquid and readily marketable (as defined in the liquidity regulations) would better ensure protection against loss. The Collateral Haircut Approach not only recognizes the risk mitigation benefits of financial collateral but can also result in a risk-based capital requirement of zero, even if neither the counterparty nor the collateral is risk free. For example, most equity margin lenders require an LTV of roughly 50%. The supervisory haircut is 30% for eligible margin loans where the collateral is publicly traded but not on a Main Index. As a result, a margin loan to, say, a hedge fund, with a 70% LTV would have an exposure at default (EAD) of zero and a risk-based capital requirement of zero. This does not appear to be anything like a risk-free transaction. I therefore recommend establishing an EAD floor of 20%. Capital charges could still be zero if, for example, the transaction is collateralized by cash or Treasuries. However, loans to risky counterparties backed by risky collateral would not escape a capital charge. Market Risk The market risk elements of the proposal incorporate the Fundamental Review of the Trading Book, which has been in the works for roughly a decade. Replacing a VAR-based approach with one that focuses on Expected Shortfall provides a better indicator of tail risk and is more appropriate for measuring risk-based capital. The proposed market risk capital rules are highly complex with many moving parts, which can lead to critiques of specific elements of the proposal that could either understate or overstate risk. The perfect should not be the enemy of the good, however, and regulators should weigh the potential benefits of further refining the market risk proposal against adding complexity to the rule or causing further delay in its implementation. Potential Economic Impacts Regulations can have unintended effects on the economy and do more harm than good. However, claims that the proposed rule would dampen lending activity should be viewed with skepticism. Banks reacted to favorable results from the 2023 CCAR exercise, not with announcements of new lending initiatives but with announcements of increased dividends. A 2017 debate between the CEO of the country's largest BHC and Minneapolis Fed President Neel Kashkari is instructive in this regard. As Mr. Kashkari pointed out, while the CEO argued that capital standards were restraining lending and impairing economic growth, the firm also bought back $26 billion in stock over the prior five years. If there really was demand for additional loans from creditworthy borrowers, why did it turn those customers away and instead buy back its stock? Thank you for the opportunity to comment on this important proposal.

Sincerely,

Neal Moran