United States Senate
WASHINGTON, DC 20510

October 17, 2012

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., N.W.
Washington, D.C. 20551

The Honorable Thomas J. Curry
Comptroller
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20551

Dear Chairman Bernanke, Chairman Gruenberg, and Comptroller Curry:

There is bipartisan consensus among members of the Senate Committee on Banking, Housing, and Urban Affairs that it is appropriate to require banks to fund themselves with equity sufficient to withstand significant economic shocks. With financial regulators considering a host of new domestic and international capital requirements, we write today to urge your agencies to simplify and enhance the capital rules that will apply to U.S. banks. Simpler, more robust capital rules will benefit smaller banks by lessening their regulatory burden; properly align incentives for megabanks by lessening government support for the financial sector; and reassure financial markets that the U.S. financial system is healthy.[1]

The Basel Committee has proposed requirements of a 4.5 percent Tier 1 Common Equity risk-based capital ratio (plus a 2.5 percent capital conservation buffer to avoid capital distribution restrictions), with an additional proposed surcharge between 1.0 percent and 2.5 percent for systemically important banks.[2] The proposal also contains a 3 percent Tier 1 capital leverage ratio.

This proposal is an improvement over the existing Basel II framework, but unfortunately, we are concerned that this proposal will still not be sufficient to prevent another financial crisis. These standards are considerably lower than the Basel Committee's conservative estimate of the

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[1] For more information on the importance of robust capital regulations, *see* Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig & Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive* 49, Stanford U. Working Paper No. 86 (Mar. 2011) *available at:* https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf.

[2] *See* Basel Committee on Banking Supervision, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" 64 (June 2011); *see also* Basel Committee on Banking Supervision, "Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement" 15 (July 2011).

optimal capital ratio of 13-14 percent.[3] Global banks hold assets with average risk-weighting of 40 percent, meaning that the 10 percent risk-weighted Basel III ratio would amount to leverage 25 times their equity.[4] Were a megabank's assets to decline by 4 percent under that scenario, it would become insolvent.[5]

We agree with FDIC Board Member Thomas Hoenig that Basel III's continued focus on risk-based capital ratios are "overly complex and opaque."[6] As you begin implementing these standards, we urge you to focus on simplifying these rules, with a focus on pure, loss-absorbing capital. This will strengthen mega banks' balance sheets, protect taxpayers, reassure investors, and reduce the regulatory burden on the community banks that are already better capitalized than Wall Street banks. In this case, simpler really is better.

Complexity

The largest U.S. financial institutions have become remarkably complex. This complexity inhibits corporate executives or regulators from properly executing their oversight responsibilities, making management, much less calculation of the proper capital standards, next to impossible. For example, the six largest banks currently have a combined 14,420 subsidiaries,[7] and the Federal Reserve Bank of Kansas City estimates that it would require 70,000 examiners to study a trillion-dollar bank with the same level of scrutiny as a community bank.[8] It is no wonder then that former executives have admitted that it is impossible to fully understand all of the positions that trillion-dollar megabanks are taking.[9] Sallie Krawcheck, the former head of wealth management at the nation's second-largest bank, recently said that this level of complexity, "makes you weep blood out of your eyes[.]"[10]

Institutional complexity has grown hand-in-hand with regulatory complexity. Morgan Stanley Chief Economist Vincent Reinhart told the Senate Banking Committee that "balance sheets of large firms have been splintered into a collection of special purpose vehicles, and securities have been issued with no other purpose than extracting as much value as possible from the Basel II Supervisory Accord."[11] The Bank of England's Andy Haldane has estimated that an average

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[3] *See* Andrew Haldane, Executive Director, Financial Stability, Bank of England, "Control Rights (and Wrongs)" 11, Wincott Annual Memorial Lecture, Westminster, London, Oct. 24, 2011 *available at* http://www.bis.org/review/r111026a.pdf?frames=0.
[4] *See id.*
[5] *See id.*
[6] 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.
[7] *See* Dafna Avraham, Patricia Selvaggi & James Vickery, A Structural View of U.S. Bank Holding Companies, FRBNY Econ. Policy Rev. (July 2012) at 7, Table 1.
[8] *See* Yalman Onaran, ZOMBIE BANKS: HOW BROKEN BANKS AND DEBTOR NATIONS ARE CRIPPLING THE GLOBAL ECONOMY 3 (Bloomberg Press, 2012).
[9] *See* Cheyenne Hopkins, *No One Was Sleeping as Citi Slipped*, AM. BANKER, Apr. 8, 2010 ("'There isn't a way for an institution with hundreds of thousands of transactions a day involving something over a trillion dollars that you are going to know what's in those position books,' Rubin said. 'I didn't know it when I was at Goldman Sachs and you wouldn't know it on the board of Citi either. You rely on the people there to bring you problems when they exist.'") *available at:* http://www.americanbanker.com/issues/175_67/citi-1017353-1.html.
[10] William Alden, *A Warning on Bank Complexity, From Someone Who Would Know*, N.Y. TIMES DEALBOOK, Sept. 13, 2012 *available at* http://dealbook.nytimes.com/2012/09/13/a-warning-on-bank-complexity-from-someone-who-would-know.
[11] Vincent Reinhart, "For Best Results: Simplify," Statement before the Senate Committee on Banking, Housing, and Urban Affairs on Establishing a Framework for Systemic Risk Regulation (July 23, 2009) at 2.

large bank would have to conduct more than 200 million calculations in order to determine their regulatory capital under the Basel II framework.[12]

Basel II also relied upon banks' internal modeling. According to Reinhart, "the reliance of self-regulation inherent in the Basel II supervisory agreement can be seen as an official admission of defeat: a large complex financial institution cannot be understood from outside."[13] The reliance on internal modeling then gives large institutions an opportunity to use models to game capital standards. Adjusting between the standardized and internal-ratings-based approaches to risk weighting can alter a bank's capital ratio between 0.5 and 1.0 percentage points.[14]

Opacity

Haldane argues that this complexity and opacity provides limitless arbitrage opportunities.[15] Risk-weighting can obscure banks' true capital situations, distorting the views of markets and regulators, and undermining confidence.[16] In 2007, the 10 largest banks had average risk-based capital ratios of 11 percent, but tangible equity ratios of about 2.8 percent.[17]

A bank may have to calculate several thousand factors to determine its value at risk (VaR), and then several thousand default and loss scenarios, meaning that there could be a range of several million scenarios arising from a large bank's trading book.[18] Haldane describes the remarkable variation between results when the UK's Financial Services Authority (FSA) asked banks to determine their regulatory capital based upon a hypothetical portfolio:

> The range of reported capital requirements held against this common portfolio was striking. For wholesale exposures to banks, capital requirements differed by a factor of over 100%. For corporate exposures, they differed by a factor of around 150%. And for sovereign exposures, they differed by a factor of up to 280%. Those differences could equate to a confidence interval around reported capital ratios of 2 percentage points or more.[19]

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[12] *See* Andrew Haldane, "Capital Discipline" 3, Remarks based on a speech given at the American Economic Association, Denver, Colorado, Jan. 9, 2011.
[13] Reinhart, *supra*, at 3.
[14] *See* George Hay, *Measuring Risks at Europe's Banks*, REUTERS BREAKINGVIEWS, Nov. 24, 2011, *available at:* http://www.nytimes.com/2011/11/25/business/global/measuring-risks-at-europes-banks.html.
[15] *See* Andrew Haldane, "The Dog and the Frisbee" 10, 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.
[16] *See* Barclays Capital, "The Shrinking European Bank Sector: The RWA Debate Rumbles On", May 23, 2011 *at* 8 ("The very wide dispersion of risk weights between otherwise fairly similar banks has increased investor unease towards the risk weight calculation itself. When banks, as they did in Q1 2011, offer only vague or unverifiable explanations for reductions in risk weight intensity, we believe that investor unease is only likely to grow. The logical worst case scenario here is that eventually investors interpret lower risk weightings not as evidence of genuinely lower risk – but as evidence of banks 'gaming' the regulators to flatter their capital ratios. This would be an outright negative for the sector: who wants to invest in companies if you can't tell how levered they are?").
[17] *See* Thomas M. Hoenig, Director, Federal Deposit Insurance Corporation, "Back to Basics: A Better Alternative to Basel Capital Rules", delivered to the American Banker Regulatory Symposium, Washington, D.C., Sept. 14, 2012 *available at* http://www.fdic.gov/news/news/speeches/chairman/spsep1412_2.html. Prior to the crisis, Lehman Brothers ostensibly had a capital ratio of 11 percent, yet its assets were sold in bankruptcy for nine cents on the dollar. *See* Simon Johnson & James Kwak, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 206 (Pantheon, 2010).
[18] *See* Haldane, *supra*, note 15 at 9.
[19] Haldane, *supra*, note 12 at 3-4.

When such variation between banks' self-reporting results for their risk-based capital is combined with a system that relies upon banks' internal modeling, markets will lack confidence in these institutions' capital measures.

Another key failing of Basel II was its reliance on a risk-weighting system that inaccurately assigned safe ratings to instruments such as pools of mortgages. Banks were able to use so-called "riskless" mortgage securitizations to arbitrage regulatory capital standards.[20] The Swiss bank UBS illustrates the shortcomings of previous capital regimes. UBS Investment Bank retained the super-senior tranches of mortgage-backed security collateralized debt obligations (CDOs) and avoided capital charges by engaging in credit default swaps against the credit risks of these securities.[21] UBS's risk-weighted assets were nearly one-sixth of their gross assets; in reality, they had less than 2 percent capital.[22] These transactions were not actually riskless – in fact, some amplified risk within the system, creating a "daisy chain" of potential defaults. In October 2008, the Swiss National Bank committed $60 billion to save UBS.[23]

There are indications that things may not change significantly under Basel III. There are reports that European banks plan to engage in a practice called "risk-weighted asset optimization," altering their risk calculations for regulatory capital.[24] In the U.S., banks have said that they will "manage the hell out of R[isk] W[eighted] A[ssets]."[25]

Simplified Equity and Leverage Requirements Are Required

The answer is not more and more complex capital regulations. Haldane has found that simple measures of equity and leverage actually have predictive value that is ten times greater than that of complex risk-weighted asset measurements.[26] The case of UBS shows that complexity may in fact make the financial system more fragile and sensitive to shocks.

Simpler, more robust capital rules will benefit smaller banks and properly align incentives for megabanks. First, simplifying capital and leverage calculations will benefit small banks that lack large legal and compliance divisions, but are nonetheless facing a deluge of new rules pursuant to Dodd-Frank and Basel III.[27]

Second, community banks evaluate their capital positions within the constraints of a free market economy. If they fail, they will be put through the FDIC resolution process. But the largest banks enjoy protection from a "safety net" – a variety of implicit guarantees that their profits will

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[20] *See* The Financial Crisis Inquiry Commission, THE FINANCIAL CRISIS INQUIRY REPORT 100 (Jan. 2011).
[21] *See* Martin Hellwig, *Capital Regulation After the Crisis: Business as Usual?*, Max Planck Institute for Research on Collective Goods, July, 2010 at 3.
[22] *See* Jack Ewing, *A Fight to Make Banks More Prudent*, N.Y. Times, Dec. 20, 2011 ("On paper the risk-weighted assets of UBS — the total of all the money it had at risk — were 374 billion Swiss francs (about $400 billion in today's dollars) at the end of 2007. But that was an adjusted figure based on the bank's overly optimistic estimate of the amount at risk. Gross assets, counting everything without adjusting for perceived risk, were much larger: 3.3 trillion Swiss francs. Measured against these total assets, UBS capital was well below 2 percent.").
[23] *See id.*
[24] *See* Liam Vaughan, *Financial Alchemy Foils Capital Rules as Banks Redefine Risk*, BLOOMBERG, Nov. 9, 2011; *see also* Hay, *supra*.
[25] *See* Tom Braithwaite, *Banks Turn to Financial Alchemy in Search for Capital*, FINANCIAL TIMES, Oct. 24, 2011.
[26] *See* Haldane, *supra*, note 15 at 14.
[27] *See id.*, at 11-12.

be enjoyed by private parties and the costs will be paid by society.[28] Dr. Hoenig has noted that the government safety net allows large banks to be undercapitalized relative to their community bank competition. In 2009, the 20 largest financial institutions on average funded themselves with a mix of 3.5 percent equity capital, as compared to an equity to capital ratio of 6 percent held by the second tier of institutions.[29] Were the largest banks to meet the 6 percent benchmark, they would be forced to raise $300 billion in capital, shrink their balance sheets by $5 trillion, or some combination thereof.[30] Equity funding is an essential tool for lessening government support for the financial sector at levels that would be adequate in the absence of the safety net.[31]

Finally, clear capital standards will reassure financial markets. Accounting gimmicks may help institutions appear to have higher regulatory capital levels and avoid raising more equity, but when risk weights are gamed, the markets lose faith in banks' balance sheets. During the crisis, the markets were not reassured by the allegedly healthy Tier 1 capital ratios at the largest Wall Street institutions.[32] Markets ignored certain instruments that qualified as Tier 1 capital but were not reliable buffers against loss.[33] Instead, market participants were primarily concerned with whether institutions had sufficient levels of common equity.[34]

We support Dr. Hoenig's view that regulators should focus on the level of pure tangible common equity at financial institutions.[35] Governor Mervyn King and the Bank of England have also advocated a pure leverage ratio to backstop capital requirements and ever-changing risk weights.[36] Former FDIC Chairman Bair has noted that European banks are less well capitalized than U.S. banks because they have no required leverage ratios and rely on Basel II's internal

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[28] *See* Remarks By Paul A. Volcker Before The Statutory Congress Of The European People's Parties, Bonn, Germany, Dec. 9, 2009 ("One consistent response has been to protect and support national commercial banking systems with a combination of regulation and a so-called 'safety net', including deposit insurance and a central bank able and willing to serve as a 'lender of last resort'. The central idea is to provide liquidity to troubled but solvent institutions while protecting individual depositors.").

[29] *See* Thomas M. Hoenig, "Leverage and Debt: The Impact of Today's Choices on Tomorrow" 2, speech delivered to the Kansas Bankers Association 2009 Annual Meeting (Aug. 6, 2009). Some have argued that the ability of community banks to operate with added equity buffers is due to the relational nature of community banking, and that larger banks must compete with other entities that enjoy competitive advantages. *See* Anil K Kashyap, Jeremy C. Stein & Samuel Hanson, *An Analysis of the Impact of "Substantially Heightened" Capital Requirements on Large Financial Institutions* (May 2010) at 22. Such arguments ignore the role of the public safety net, the associated moral hazard, the implicit subsidies that large banks receive, and managements' fixation upon return on equity as a metric for success.

[30] *See* Hoenig, *supra*, note 29 at 3.

[31] *See* Hoenig, *supra*, note 17 ("[T]he equity ratio for the banking industry before the safety net was implemented ran between 13 and 16 percent. Therefore, the starting point for any discussion of an acceptable level of tangible equity for all banking firms should be well above the 3 1/4 percent level now implied by the Basel III proposal.").

[32] *See* Fred Furlong, Stress Testing and Bank Capital Supervision, Economic Letter 2011-20, Federal Reserve Bank of San Francisco, June 27, 2011 at 2 ("As a result, as the financial crisis was reaching a crescendo in the third quarter of 2008, Group 1 tier 1 ratios ranged from 7.5% to 16%, comfortably above the well-capitalized benchmark. However, financial markets were not reassured by supervisory capital ratios even at these levels.").

[33] *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.

[34] *See* Special Inspector General for the Troubled Asset Relied Program, Exiting TARP: Repayments by the Largest Financial Institutions 18, Sept. 29, 2011 ("FRB Governor Tarullo told SIGTARP that during the financial crisis, it became clear that the markets cared about common equity, not Tier 1 [Capital.]").

[35] *See* Hoenig, *supra*, note 6 ("[E]xperience suggests that the tangible common equity leverage ratio is what investors focus on and is what ultimately determines whether capital is adequate.").

[36] *See* Mervyn King, Governor of the Bank of England, "Banking: From Bagehot to Basel, and Back Again", The Second Bagehot Lecture, Buttonwood Gathering, New York City, Oct. 25, 2010, at 11.

models that, among other flaws, treat sovereign debt as riskless.[37] But the levels contained in the Basel proposal are too low. Three percent allows institutions to take on 33 dollars in debt for each dollar in equity. Haldane estimates that the largest banks would have needed a minimum of seven percent leverage to have survived the financial crisis.[38]

We agree with Dr. Hoenig that capital rules should be "simple, understandable and enforceable."[39] And they should be sufficient to withstand the next financial crisis.

Thank you for considering our views on this important matter.

Sincerely,

Sherrod Brown
United States Senator

David Vitter
United States Senator

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[37] *See* Sheila Bair, *The Eurozone Crisis Will Not Go Away Until Banks Face Reality*, FORTUNE MAGAZINE, Nov. 21, 2011.
[38] *See* Haldane, *supra*, note 15 at 20.
[39] Hoenig, *supra*, note 17.