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Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
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The Honorable Thomas J. Curry
Comptroller
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

The Honorable Martin Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

RE: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (RIN 3064-AD95); Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (RIN 3064-AD96); Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (RIN 3064-AD97)

To Whom it May Concern:

Americans for Financial Reform (“AFR”) appreciates this opportunity to comment on the above-referenced notices of proposed rulemaking (the “Proposed Rules”) by the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of the Comptroller of the Currency (the “Agencies”). AFR is a coalition of over 250 national, state, local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups along with prominent independent experts.

Overview And Central Recommendation

These Proposed Rules build on a 20-year history of regulatory capital rules promulgated by the Basel Commission. That 20-year history has been a failure, culminating in the worst financial crisis since the Great Depression. This record demands a more fundamental reconsideration of the Basel regulatory capital model than is evident in these Proposed Rules. Regulators should dramatically lessen the reliance on complex, mechanistic risk adjustments and instead move toward significantly higher base levels of capital requirements.

This is particularly important in the case of leverage capital. The emphasis of capital regulation needs to shift from a primary emphasis on risk-adjusted capital with low leverage ratios as a backstop, to a more primary emphasis on adequate leverage ratios with risk-adjusted capital ratios used as a backstop to prevent arbitrage of leverage ratios through excessive investments in risky assets. No single capital metric can be a cure-all, but the lack of primary emphasis on leverage ratios has been a grave flaw in the Basel framework.

A primary emphasis on leverage ratios would reduce the opportunities for the arbitrage that made risk-weighted capital measures under previous Basel regimes essentially useless. It is well known that risk-weighted capital measures had no predictive power for the failure of large banks in the financial crisis, while much simpler leverage ratios did.¹ For an even more recent example of the failure of Basel risk weights, consider the example of the recent bailout of Dexia. This bank became insolvent despite registering core Tier 1 capital levels higher than those required in this proposal. A year prior to the bailout, the bank's core risk-based capital levels were measured in excess of 10 percent, even though leverage ratios were over 50 to 1.²

The historical failure of risk-based capital metrics calls for a fundamental shift in the structure of bank capital regulation. As many observers have commented, the byzantine complexity of risk adjustments and the excessive reliance on bank internal modeling have been deeply counterproductive.³ The reliance on complex internal models has undermined what should be the central regulatory goal – limiting excessive leverage. This implies that regulators should place significantly heightened leverage capital requirements at the center of their regulatory response to the financial crisis.

This proposal does not do that. We appreciate that these rules strengthen the definition of capital and marginally increase Tier 1 common equity requirements. However the required capital levels here still fall well short of what both common sense and bipartisan independent experts conclude

¹ Haldane, Andrew, "[The Dog And The Frisbee](#)"; International Monetary Fund (2009), "[Global Financial Stability Report, Chapter 3](#)".

² De Groen, Willem Pieter, "[A Closer Look At Dexia: The Case of the Misleading Capital Ratios](#)", CEPS Commentary, October 19, 2011; "[Deterioration of the Environment In the Second Half of 2011 Leads The Group to Announce Radical Restructuring Measures](#)", Dexia Press Release, February 23, 2012.

³ Haldane, *op cit.*, Hoenig, Thomas, "[Back to Basics: A Better Alternative to Basel Capital Rules](#)", Speech to American Banker Regulatory Symposium, September 14, 2012.

would be necessary to protect taxpayers from yet another financial system catastrophe. Furthermore, the maintenance of excessive reliance on risk weighting, complex exposure modeling, and various means of moving exposures off the balance sheet continues to invite banks to game the system and reduce their actual capital ratios even further.

The 3 to 4 percent leverage ratios required here are far too low. They are comparable to leverage ratios already existing under U.S. Prompt Corrective Action rules that were demonstrably inadequate to prevent the crisis. Adding to the impression that the leverage ratio is essentially a regulatory afterthought, increases in leverage capital requirements are not paired with the risk-adjusted capital buffers that are a central part of the new capital framework. This means that requirements to raise additional risk-adjusted capital are not paired with requirements to demonstrate lower absolute leverage.

As an example of the kind of leverage ratios that would be more effective, the Systemic Risk Council, a bipartisan group of former U.S. regulators and prominent members of the financial industry, has called for a minimum leverage requirement of at least 8 percent core Tier 1 capital.⁴ This obviously also implies a significantly higher level of risk-based capital than the 7 percent requirement proposed here (including the conservation buffer).

Such higher capital levels are economically justified. Numerous prominent economists have argued that the relatively high private costs of additional capital is driven by various public subsidies to leverage, and the true economic cost of higher equity levels are far lower.⁵ Unfortunately, this proposal appears to have instead been guided by the Basel Committee's own economic analysis of the impact of higher capital levels. As AFR has argued previously, this analysis is deeply flawed.⁶ For example, the Basel analysis assumes that all private costs of increased capital will be passed on to borrowers and none will be absorbed through reductions in executive compensation or other cost-cutting measures at banks, sets an inappropriately high return on equity, and does not count any costs of undercapitalization short of bank failure. Yet even this flawed analysis recommends minimum core Tier 1 capital levels that are in excess of those required here.⁷

In addition to strengthening this rule itself, it is important that the Agencies use additional upcoming rules and changes in bank regulation to address some of the fundamental problems with these rules. This proposed rule does not contain several of the most important Basel

⁴ Systemic Risk Council, "[Comment on Regulatory Capital Rules](#)", October 4, 2012.

⁵ Admati, Anat R., DeMarzo, Peter M., Hellwig, Martin F. and Pfleiderer, Paul C., [Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is not Expensive](#) (March 23, 2011). Rock Center for Corporate Governance at Stanford University Working Paper No. 86; Hanson, Samuel Gregory, Kashyap, Anil K. and Stein, Jeremy C., [A Macroprudential Approach to Financial Regulation](#) (November 12, 2010). Chicago Booth Research Paper No. 10-29.

⁶ Americans for Financial Reform, "[Comment to Basel Committee: Consultative Document on Global Systemically Important Banks](#)", August 26, 2011.

⁷ Basel Committee on Banking Supervision, "[An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements](#)", August, 2010.

proposals, including the new capital surcharge for Systemically Important Banks (G-SIBs), the various new liquidity reserve requirements, and the results of the current Fundamental Review of the Trading Book. Strengthening of the Basel G-SIB surcharges (including the addition of a leverage ratio surcharge) could significantly raise capital standards at the largest banks. Proper implementation of liquidity reserves, which should be supplemented with direct limitations on excessive reliance on short-term funding, would also improve financial stability. Finally, using the Fundamental Review to better address problems with modeling trading exposures would help address one of the key sources of undercapitalization.

As AFR has stated in a previous comment to the Federal Reserve Board, we feel that Basel proposals in some of these areas are inadequate and structurally flawed. However, since the Basel standards are a minimum and not a maximum, U.S. regulators are free to strengthen them. A more accurate economic analysis of the costs of capital requirements should make clear the need to do so.

Another opportunity to address issues in the capital framework lies in the emerging international movement to limit bank securities market activities. This movement is expressed in the Volcker Rule in the United States, the Vickers Commission proposal in the UK, and the Liikanen plan in Europe. The so-called ‘swaps push-out rule’ in the U.S. (Section 716 of the Dodd-Frank Act) also contemplates the separation of complex derivatives speculation from core banking. An important driver of the excessive complexity in bank capital regulation is the complexity of the securities market activities that systemically critical ‘too-big-to-fail’ banks are permitted to engage in. Reducing this complexity and restoring a distinction between securities market speculation and core banking will allow regulators to rely more on informed discretion and less on complex models. It will also reduce the possibilities for arbitrage of capital limits.

Summary of Additional AFR Recommendations

As implied by the overview discussion above, the most fundamental AFR recommendation is simply to increase the core leverage and capital requirements in this proposal. Regulators should rely much more on these clear high standards supplemented with regulatory oversight, and much less on complex risk adjustments. As we will detail in an upcoming letter, an economic analysis using reasonable assumptions would support significantly higher capital and leverage requirements. Higher core leverage requirements would also reduce reliance on the numerous complex model-based adjustments in this rule.

In addition to this broad recommendation, AFR has a number of detailed recommendations within the framework of the current proposal. Some of these recommendations, such as pairing capital with leverage buffers, move in the same direction as a higher base leverage requirement. Other recommendations address important issues that would remain vital even if baseline leverage limits were increased, such as the valuation of derivatives exposures.

First, there are a number of reforms in the proposed rule targeted at some of the worst flaws of the previous capital regime. If this proposed new capital regime is to make any progress at all in containing the excesses that led to the disastrous 2008 financial crisis, it is vital that these proposed improvements to the strength and adequacy of capital regulation be maintained and built upon in the final rule. These reforms include:

- A greatly improved definition of core tier one (common equity) capital that is more genuinely loss-absorbing than the core capital permitted under previous regimes.
- The addition of a capital conservation buffer and a potential countercyclical buffer for larger banks as well.
- The supplementation of risk-adjusted capital metrics with a leverage ratio based on total assets. This is an important conceptual step, even though the leverage ratio is far too low. This step is particularly important for the supplementary leverage ratio targeted at large bank holding companies.
- The identification of risk-adjusted capital calculated under the Standardized Approach as the generally applicable capital floor required for all banks. This somewhat reduces the emphasis on bank internal modeling.
- New restrictions on eligible credit guarantors and new requirements for credit guarantee instruments. If properly managed, these could help to prevent inappropriate migration of risk outside of regulatory oversight or capital requirements.
- More sensitive capital risk weights for residential housing and commercial real estate, two areas that were at the epicenter of the crisis.
- New capital rules for instruments held on the trading book that per Basel Committee studies should result in tripling trading book capital. The trading book was an area of extreme undercapitalization leading into the crisis.
- New disclosure requirements for large banks that, while imperfect, should improve balance sheet transparency.

The new reforms are most relevant for the nation's largest banks. This is entirely appropriate as these banks were major drivers of the systemic crisis of 2008-2010 and remain the greatest threat to financial stability. Large banks will be most impacted by new trading book capital rules, the standardized approaches floor, new disclosure rules, and variety of other changes.

However, it should not be forgotten that the crisis led to the failures of almost 400 community banks and drained the FDIC Deposit Insurance Fund to a low point of a negative \$21 billion deficit in 2009. The Deposit Insurance Fund still remains far below required reserve levels, and the increase in the size of the deposit guarantee to \$250,000 raises taxpayer exposure going

forward. Thus, while it is reasonable for regulators to reduce the complexity and burden of compliance with these Proposed Rules for smaller banks, it is important to maintain key reforms for community banks as well. Central reforms such as the changes in the definition of capital, the capital conservation buffer (although not the countercyclical buffer), and important changes in the Standardized Approach to risk weighting should be maintained for all banks regardless of size.

Despite the presence of some improvements, and in addition to the broad issue raised above, there are specific weaknesses in the details of the capital and risk adjustment framework in the proposed rule. Some AFR recommendations for improvements and clarifications to the rule are listed below and are then discussed in more detail in the main body of this comment.

Recommendations Most Relevant To Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (RIN 3064-AD95)

- New capital buffers should also be reflected in steps up in the leverage floor as well.
- The supplementary leverage ratio should be phased in more rapidly, and total assets for the leverage calculation should be assessed based on International Financial Reporting Standard (IFRS) accounting.
- The countercyclical buffer is a positive aspect of the rule but should not be reserved solely for periods of ‘excessive credit growth’. Instead it should be linked to periods of general economic growth and high financial sector profits.
- Restrictions on compensation and dividend payouts for banks that fall below capital thresholds should be strengthened, particularly in the area of executive pay.

Recommendations Most Relevant To Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (RIN 3064-AD96)

- These rules still excessively privilege lending within the financial system over lending to real economy businesses and consumers. Increases in risk weights for exposures to other banks can help address this issue.
- Weighting for sovereign exposures needs to be made more risk sensitive.
- The definition of Category 2 residential mortgages should be based on product features and not on underwriting characteristics. In addition, Category 2 mortgages should be defined so as not to discourage responsible loan modifications for troubled borrowers.

Recommendations Most Relevant to Modeling Choices Under the Standardized Approaches (RIN 3064-AD96) And/Or Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (RIN 3064-AD97)

- The Standardized Approaches still permit excessive bank reliance on internal models.
- Exposure calculations for derivatives are not sufficiently conservative. Exposure calculations should be strengthened in a number of ways. This can also help improve incentives for derivatives transfer to central counterparties.
- The rules place an excessive reliance on credit default swaps (CDS) as a credit risk mitigant. As is these rules will lead to a significant increase in reliance on CDS markets that have been shown to be problematic.

Discussion of Recommendations

Recommendations Most Relevant To Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (RIN 3064-AD95)

New Capital Buffers Should Also Be Reflected In Leverage Ratios

This rule requires that banks maintain a 2.5 percent ‘capital conservation buffer’ in addition to the 4.5 percent minimum level of core Tier 1 Common Equity. Large banks may also be required to hold an additional 2.5 percent buffer for counter cyclical purposes. Both of these additional buffers are based entirely on risk-weighted capital levels and contain no counterpart in leverage requirements.

Yet risk-weighted assets can clearly be a highly deceptive guide to overall leverage. Since 2008, the two specialist U.S. investment banks have managed to double total assets without any change in risk-weighted assets. When derivatives exposures are measured according to International Financial Reporting System (IFRS) standards, the overall ratio of risk-weighted to total assets in the U.S. banking system is roughly 46 percent, indicating significant scope for manipulating the relationship between these metrics.⁸ As discussed in the Overview above, numerous studies have found that prior to the crisis risk-weighted assets did not predict bank failure while leverage did.

All these considerations indicate that if regulators wish to ensure that additional capital buffers genuinely reflect higher loss absorbency, they should include additional leverage standards in these buffers.

Phase In the Supplementary Leverage Ratio More Rapidly, and Measure Total Bank Assets For This Ratio Using International Financial Reporting Standards (IFRS) Standards

⁸Blundell-Wignall, Adrian, and Paul E. Atkinson, “[Deleveraging. Traditional vs. Capital Markets](#)”, OECD Journal, Volume 2012, Issue 1.

The Agencies have proposed to set the supplementary leverage ratio for larger banks at a low 3 percent (33 to 1) leverage ratio and to forego supplementing capital buffers with an additional leverage requirement. These choices indicate that the supplementary leverage ratio is intended simply as an emergency regulatory backstop to risk weighted assets.

As discussed in the Overview, AFR disagrees with this approach. However, if the Agencies proceed in this way then it seems inconsistent to set a six-year phase in period (until 2018) and to exclude a wide range of assets from its measurement. If the leverage ratio is conceived as an emergency backstop intended to trigger regulatory action when risk-based capital standards do not, it seems more important that it take effect more quickly and also that it be calculated against the full range of assets that might appear on the bank balance sheet.

In addition to the slow phase in period, the Agencies effectively exclude a wide range of derivatives and off-balance sheet exposures from the purview of this already low leverage ratio. Under the current proposal, which permits extensive netting of derivatives exposures and does not include off balance sheet securities lending exposures, the supplementary leverage ratio proposal depends too heavily on what are effectively risk adjustments to the bank asset base. This defeats the purpose of a leverage ratio.

A straightforward way to address this issue is to set the leverage ratio asset measurement using IFRS accounting, which makes it more difficult to net derivatives exposures and also forces recognition of more off balance sheet securities lending exposures. The difference made by this adjustment would be considerable, as derivatives exposures measured under IFRS are five to ten times those recognized under Generally Accepted Accounting Practices (GAAP).⁹ Yet in many ways it would give a more accurate perspective on the bank's total potential liabilities. GAAP accounting focuses on whether netting can be achieved in case of default. But derivatives exposures may trigger a run prior to default, as counterparties novate away from the bank if they perceive weakness.¹⁰ This kind of liquidity exposure is an important vulnerability that leverage standards are also designed to protect against. A similar phenomenon can occur with off balance sheet securities lending exposures which can trigger collateral calls, as occurred in the MF Global situation. IFRS also forces recognition of this type of exposure.¹¹

In the case of risk adjusted capital, there is certainly a case for adjusting some of these exposures downward to recognize the risk reduction that can occur with proper netting. However, leverage ratios are specifically intended not to be risk adjusted metrics, and to give a picture of total bank exposures. Instead, the treatment of derivatives exposure under the supplementary leverage ratio

⁹ Corbi, Antonio, "[Netting and Offsetting: Reporting Derivatives Under U.S. GAAP And IFRS](#)", International Swaps and Derivatives Association, 2012.

¹⁰ Duffie, Darrell, "[The Failure Mechanics of Dealer Banks](#)", Bank of International Settlements, Working Paper 301, March, 2010.

¹¹ Elias, Christopher, "[Off Balance Sheet Repo Risks Come Back to Bite](#)", Thomson Reuters News and Insight, November 17, 2011.

appears to explicitly replicate the risk adjustment methods used under Section 34 of the Standardized Approaches for assessing derivatives exposures.

The Countercyclical Buffer Should Not Be Reserved Exclusively For Periods of ‘Excessive Credit Growth’

The regulatory option to institute an additional countercyclical buffer for large banks is a valuable element of this rule. However, the proposal states several times that this countercyclical buffer will be reserved for periods of ‘excessive credit growth’ (see e.g. CFR 52805). This makes the use of the buffer dependent on the inherently difficult judgment of whether a period of rapid credit growth is ‘excessive’ or is justified by economic fundamentals. Especially during such a ‘bubble’ period, there are likely to be many justifications available for why credit growth is not in fact excessive.

Rather than make use of the countercyclical buffer dependent on spotting whether credit growth is excessive or represents a ‘bubble’, use of the buffer should be tied to readily available indicators of economic growth, employment, and financial sector profits. These metrics alone could allow raising of capital during periods when such capital is relatively easy to raise and will impose far lower costs on the economy than the deleveraging that additional capital could prevent during an economic slowdown. Such measures could include growth relative to potential growth, employment relative to potential full employment, and financial sector profitability. While macroeconomic metrics like potential growth do involve many assumptions, they are readily available as part of macroeconomic forecasting and will be less controversial than a determination of whether credit growth is excessive.

The goal of the countercyclical buffer should be to raise additional capital at times when such capital is easy to raise. The ability to draw down the buffer during periods of economic slowdown without requiring deleveraging due to asset cutbacks will bring economic benefits larger than any costs of raising capital during times of relative full employment.

Restrictions on compensation and dividend payouts for banks that fall below capital thresholds should be strengthened, particularly in the area of executive pay

This proposal enforces capital requirements through a set of tiered penalties for drawing down the 2.5 percent capital buffer or falling below various Prompt Corrective Action capital requirements. It is unclear exactly how these requirements will work together. For example, by the time a bank reaches the Adequately Capitalized level under Prompt Corrective Action it will already be subject to restrictions on capital distributions due to drawing down the capital buffer, and since capital planning will now be a regular requirement for larger banks this will not be an additional requirement either. It is thus unclear exactly how penalties will be graduated as banks approach the minimum capital requirement.

With that said, the concept of graduated restrictions on capital distributions is a sound one, and particularly given the low levels of base capital requirements in this rule, introducing such restrictions within the capital buffer range is important. However, the restrictions on capital distributions are not sufficient, particularly in the area of executive pay. The Proposed Rule restricts only forms of employee compensation that are ‘discretionary bonus payments’ to ‘executive officers’. This restriction is inappropriately narrow.

Without clear and adequate definitions of “discretionary bonus payments” and better delineation of the timing of payments that would violate the buffer rule these rules will be too easy to evade. For example, a banking organization could provide for a bonus pool to be established each year until revocation of the pool, the distribution from which is stated to be (and in fact would be) mandatory provided that the bank’s minimum capital requirements not including the capital buffer are maintained. The establishment of such a pool, though mandatory, could effectively defeat the policy and purpose of the buffer rules. In addition, section 11(a)(4)(i) of the proposed Rule could be interpreted to allow a non-cash payment notwithstanding the banking organization’s failure to satisfy the buffer capital requirements, for example by issuance of stock options. Modifications to the Proposed Rule should be made to address these issues.

The definition of “executive officer” in section 2 of the proposed Rule does not include certain other persons who have substantial control over decisions and actions that significantly affect a banking organization capitalization and risk. The definition of “executive officer” should be broadened to include a director of the banking organization or any of its affiliates, and also to include persons in control of the banking organization or any of its affiliates or persons in control of a major business line within the bank group.

Recommendations Most Relevant To Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (RIN 3064-AD96)

These Rules Still Excessively Privilege Lending Within the Financial System

As many observers have documented, the massive growth of the financial sector in the years prior to the crisis was driven in large part by rapid growth of financial claims internal to the financial system (i.e. claims of banks on other banks and financial institutions).¹² This growth of intra-financial system exposures contributed to financial instability and lessened the contribution of the financial sector to the real economy. The favorable capital treatment of credit exposures to other banks under Basel I and Basel II capital rules may well have contributed to this expansion.

The Proposed Rule continues this favorable treatment of bank exposures relative to real economy exposures. Specifically, bank or securities firm risk exposures are generally given a risk weight of 20 percent (this applies to all U.S. banks and to foreign banks with a highly rated sovereign).

¹² [“The Turner Review: A Regulatory Response to the Global Banking Crisis”](#), UK Financial Services Authority, March 2009.

But exposures to corporate borrowers generally have a risk weight of 100 percent. Indeed, since these risk weights are applied to a higher required level of capital they can be expected to have an even larger influence on behavior under Basel III than under previous capital regimes.

Regulators should encourage real economy lending exposures by banks by closing the gap between these risk weights. If there is a specific justification for the much lower risk weights for intra-bank exposures, such as a need to hedge financial exposures with other banks, then the favorable capital treatment should be limited to this need.

Weighting for Sovereign Exposures Should Be Made More Risk Sensitive

These Proposed Rules base the risk weights for sovereign exposures on the Country Risk Classifications (CRC) established by the Organization for European Cooperation and Development (OECD). However, these ratings are not designed as sovereign debt risk classifications. In fact, the OECD web site specifically states “The country risk classifications **are not** sovereign risk classifications” (emphasis in original).¹³ The CRC ratings are not effective at distinguishing between sovereign risks among the set of high-income countries, which would generally be given a zero risk weight under this rule. Furthermore, the ratings appear biased toward European countries. For example, China is rated as a worse risk than Greece, and Brazil as a worse risk than Portugal. This is hard to justify based on the relative fiscal positions of the countries in question.

We recognize that the treatment of sovereign risk exposures is a politically sensitive area that involves many considerations that are difficult to predict and weight using purely economic models. However, the careful use of market-based metrics to supplement the CRC classifications could be a useful step. This rule does add a recent default metric to the CRC classification, but as defaults are rare some additional consideration of sovereign risk would be useful.

Risk Sensitivity of Residential Mortgage Exposures

As stated in the summary of recommendations, more sensitive capital risk weights for mortgages are a positive element of this rule. The simple division of mortgage exposures under Basel I rules into 100 percent and 50 percent risk weight baskets based on loan-to-value was overly simplistic. So long as these categories are targeted effectively, they can usefully adjust capital requirements to better reflect the mortgage risk held by the institution.

AFR recommends that the definition of Category 2 mortgages be based on mortgage product characteristics and not on borrower based underwriting characteristics such as debt to income ratios. The definition should capture loan product features which have predictive power with regard to loan performance.

¹³ OECD, “[Country Risk Classification](#)”, accessed October 2012.

AFR also urges regulators to take care not to disincentivize sustainable mortgage modifications under the Category 2 definition. While this Proposed Rule contains an exemption for modifications under the Home Affordable Modification Program (HAMP), it should clarify that other forms of sustainable mortgage modifications – modifications that reduce risk by reducing mortgage principal and / or monthly payments -- will also have such an exemption.

Recommendations Most Relevant to Modeling Choices Under the Standardized Approaches (RIN 3064-AD96) And/Or Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (RIN 3064-AD97)

The Standardized Approaches Still Permit Excessive Bank Reliance on Internal Models

Ideally, the Standardized Approaches would provide an external check on the use of bank internal models to manipulate risk-adjusted capital metrics and the valuation of derivatives and securities exposures. Such an external check should provide a conservative valuation of risk exposures to protect taxpayers from a tail risk event such as a market failure or a liquidity shock. Yet as discussed below some of the key valuation metrics here (such as Expected Future Exposure for derivatives) do not appear to be conservative. Furthermore, even under the Standardized Approaches banks will still be able to rely on internal models for key determinants of capital and liquidity exposures such as collateral haircuts, derivatives valuations, and the extent of repo exposures. Finally, the Market Risk approaches continue to rely on bank provided value-at-risk models even for Standardized Approach calculations, although the outputs of such models are adjusted upward to account for the experiences with undercapitalization exposed during the financial crisis.

Exposure Calculations For Derivatives Are Not Sufficiently Conservative

In general, risk exposure calculations in capital rules should be floored at a level sufficient to protect the public against the failure of taxpayer-insured depository institutions or systemically critical banks in ‘tail risk’ events. This calls for conservative exposure measurements to be used by regulators. Yet the derivatives exposure calculations in Section _34 of the Standardized Approaches, which are also used in the Advanced Approaches, appear far from conservative.

Current Credit Exposure

The provision of the rule dealing with current credit exposure is very brief (Section __.34(a)(1)(i) and (a)(2)(i) in the Standardized Approaches):

The current credit exposure for a single OTC derivative contract is the greater of the mark-to-market value of the OTC derivative contract or zero...

The net current credit exposure is the greater of the net sum of all positive and negative mark-to-market values of the individual OTC derivative contracts subject to the qualifying master netting agreement or zero.

Unfortunately, this language completely ignores the major risk in mark-to-market risk calculations, namely that the mark is inaccurate. For the mark to be accurate it must be transactable. That means that it must be current. Thus the rule must require that the mark reference prices that are fresh as of the close of trading of the immediately preceding business day.

It also means that the mark must reference actual transactions. It is common practice for banks to enter into derivatives for which there are no available market prices. Any mark ascribed to a position that is not based on an actual transaction or set of transactions is mere conjecture. The mark must not be that which is provided by the trading desk that is incented to show a given outcome. Such a mark is at best an estimate and at worst a biased figure.

Third party indices are often used for marks. By definition, this means that there is no continuously traded market for the contract. If third party indices are permitted, the marks should not be given the same weight as a mark referencing an actual transaction. Such marks should be subject to a factor such as 0.5 for in-the-money marks and 2.0 for out of the money marks.

Potential Future Exposure

The Proposed Rule establishes a grid for PFEs (Section __.34(a)(1)(ii) in the Standardized Approaches). There are several concerns with this table.

First, the table ascribes a “0” PFE for interest rate derivatives having a duration of less than one year. Presumably, the Agencies have concluded that interest rate contracts can be liquidated or replaced instantaneously because the interest rate market is very liquid. This is an inappropriate conclusion for two reasons:

- It misinterprets the premise that should be behind the concept of PFE. PFE should capture the risk of market moves between the effective time of the current mark and the liquidation or replacement of a defaulted position. Marks will be set as of a prior moment in time, most likely the close of trading of the prior business day. The word “future” when used in the term potential future exposure must mean the time period starting as of the current mark and ending when the bank covers the position. The idea that there is “0” risk associated with covering an interest rate derivatives position is irrational. This is especially so given that there very well could be a correlation between the potential default of the counterparty and interest rate levels. For instance, the counterparty could default because it could not meet a margin call. At a minimum, the PFE should cover one day historic price moves at a 99% confidence interval or higher.
- The PFE for these derivatives assumes that all interest rate derivatives can be covered by taking a position in a liquid market. This is clearly not the case. The PFE must address the potential that an interest rate derivative may not be readily covered in the market. A separate category must be established for interest rate contracts that are not liquid enough

to be cleared. Assuming that a PFE in excess of “0” for liquid interest rate contracts is adopted, the PFE for illiquid contracts must be multiple of that level since the difference between a liquid interest rate contract and an illiquid one is so great.

Beyond interest rate contracts, the other categories for contracts must also address the difference between liquid and illiquid contracts. The credit category recognizes the distinction between investment grade and other names appropriately. However, the other categories must address the issue as well.

Exposure For Credit Derivatives

The rule caps the future exposure for the seller of a credit derivative at the net present value of future premiums (Section 34(a)(ii)(E) in the Standardized Approaches). This is problematic and the reasoning is unclear. While the exposure of a buyer of a credit derivative may be limited to future premiums, the exposure of the protection seller is clearly linked to the total amount of protection being provided. The exposure of the credit seller is similar to the exposure on a credit guarantee provided to the name on the credit derivative. This is the exposure measure that should be used.

Encouraging Migration to Central Counterparties

Some criticism of derivatives rules has emerged based on the idea that default fund capital charges for banks that are clearing members of central counterparties are excessive. It is claimed that such capital charges will discourage membership in clearinghouses and lead to capital charges for clearing members that are in excess of capital charges for uncleared derivatives. As these charges may impact pricing to outside customers of the clearinghouse, they may lead derivatives users to forego central clearing.¹⁴

To the extent this is an issue, it should be addressed not by reducing capital charges for clearing members, but by addressing some of the issues in the exposure calculations for uncleared derivatives pointed out above. As PFE calculations for cleared derivatives are greatly reduced in these rules, even a moderate increase in exposure calculations for uncleared derivatives will restore incentives for clearing. Certainly regulators should not address this issue by reducing capital protections for clearinghouses, which are systemically critical institutions.

The Rules Place an Excessive Reliance on Credit Default Swaps (CDS) As a Credit Risk Mitigant

These rules permit an extensive role for CDS in reducing effective credit risk and thus bank capital charges. In particular, CDS are one of the major permitted hedges for Credit Valuation Adjustment (CVA) charges. This is likely to give a significant impetus to the CDS market. The

¹⁴ Quarry, Jason, Barrie Wilkonson, Toby Pittaway, and Jay Cheah, “[OTC Derivatives Clearing: Perspectives on the Regulatory Landscape](#)”, Oliver Wyman Corporation, May 31, 2012.

absence of liquidity in many single-name CDS will frequently lead to reliance on CDS indices for hedging purposes.

As we saw in the case of JP Morgan's 'London Whale' such hedging can easily conceal proprietary speculation and in any case is heavily reliant on models to determine the actual effectiveness of a hedge. In addition, CDS markets are complex and fragile and can be pushed away from fundamentals by heavy trading activity. As the Bank of England has stated with regard to sovereign CDS markets¹⁵:

“given the relative illiquidity of sovereign CDS markets a sharp increase in demand from active investors can bid up the cost of sovereign CDS protection. CVA desks have come to account for a large proportion of trading in the sovereign CDS market and so their hedging activity has reportedly been a factor pushing prices away from levels solely reflecting the underlying probability of sovereign default.”

CVA charges are an example of a type of risk that was traditionally handled through supervisory means such as credit exposure limits for particular types of counterparties, but is now being pushed out to heavily model-dependent and potentially fragile trading markets. Regulators should consider the wisdom of heavy dependence on such markets for core bank hedging purposes. The new standards concerning eligible risk mitigants in these Proposed Rules do represent an attempt to standardize CDS terms to provide somewhat more stability and certainty to market participants. But it is highly questionable whether those changes can truly stabilize these markets.

Thank you for the opportunity to comment on these Proposed Rules. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

¹⁵ p. 81, Bank of England, "[Quarterly Bulletin: Q2 2010](#)", Volume 50 Number 1.

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services

- Home Defender's League
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group

- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Affiliates

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY

- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG

- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET

