AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

April 11, 2011

Hon. Ben Bernanke, Chairman
Federal Reserve Board
20th Street and Constitution Avenue NW
Washington, DC 20551

Hon. Sheila Bair, Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Mr. John Walsh, Acting Comptroller
Office of the Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

Re: RINs 1557–AC99, 7100–AD61, and 3064–AD70: "Risk-Based Capital Guidelines: Market Risk"

Dear Chairs Bernanke and Bair and Acting Comptroller Walsh,

American for Financial Reform ("AFR") appreciates this opportunity to comment on the Notice of Proposed Rulemaking regarding Risk Based Capital Guidelines: Market Risk ("Market Risk NPR"). 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 the AFR include consumer, civil rights, investor, retiree, community, labor, religious and business groups along with prominent economists and other experts.

This NPR implements provisions of the Basel III agreement relevant to the use of internal risk modeling to set risk-based capital levels for financial institutions. As a general matter, AFR is highly skeptical of the use of internal bank Value at Risk (VAR) models for setting capital requirements. From the time the Basel Committee first proposed the use of such internal models, serious questions were raised about the wisdom of relying on regulated entities to calculate their own required capital ratios.[1] Observers also pointed out that such models contained an inherent,

[1] Hellwig, M (1995), "Systemic aspects of risk management in banking and finance", *Swiss Journal of Economics and Statistics*, vol 131, no 4/2, pp 723–737. Hellwig, M (1996), "Capital adequacy rules as instruments for the regulation of banks", *Swiss Journal of Economics and Statistics*, vol 132, no 4/2, pp 609–612

powerful structural tendency to reinforce economic cycles, with excessive leverage encouraged at the peak of an economic cycle as risk appears low, and abrupt and harmful deleveraging during economic downturns.[2]

The financial crisis of 2008 demonstrated in the strongest possible way the validity of these concerns. Predictions about the incentives for regulatory arbitrage and the pro cyclical nature of VAR-based capital standards were shown to be prescient.[3] Banks took advantage of low regulatory capital charges for instruments that turned out to be extremely risky – most notably, upper tranches of subprime mortgage-backed securities with investment grade ratings. They also arbitraged between the trading and banking book to take advantage of low mark-to-market capital charges. Regulatory capital arbitrage drove similar incentives across banks, increasing correlation in the financial system and "herding" into particular asset classes. Finally, just as predicted by critics of VAR modeling, leverage ratios grew sharply during the upswing of the economic cycle, and the sudden rush to deleverage as asset values dropped led to disastrous financial contagion and a self-reinforcing downward plunge in market valuations.

Despite these deep structural problems with regulatory reliance on VAR-based risk modeling by the banks they regulate, the Basel Committee has chosen to continue the use of such models in setting risk-based capital charges. But in response to the clear failure of this paradigm over the past decade, regulators are implementing a substantial set of modifications to the risk-based capital framework. These modifications are proposed in this rule. They include transfer of all securitizations from the trading to the banking book, the incorporation of a "stress test" into the VAR model that is meant to mitigate tendencies toward pro cyclicality and tail risk, an incremental capital charge for default risk, and mandatory disclosures of risk management modeling assumptions to allow for greater market discipline.

If fully and properly implemented, these changes should result in a substantial increase in risk-based capital required under the VAR regime.[4] New capital charges based on modeling a stressed time period are particularly important, as they hold the potential to reduce the pro cyclicality of VAR-based capital charges. Some of the new risk weighting procedures, such as a

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[2] See e.g. Danielsson, J, P Embrechts, C Goodhart, C Keating, F Muennich, O Renault and H Shin (2001): *An academic response to Basel II*. Repullo, Rafael and Javier Suarez, "The Pro-Cyclical Effects of Basel II", Centre for Economic Policy Research Discussion Paper 6862, June, 2008.

[3]Danielsson, Jon (2008), "Blame The Models", Journal of Financial Stability, Elsevier Press, Volume 4(4), December 2008. Adrian, T and H S Shin (2011), "Financial intermediary leverage and value at risk", Federal Reserve Bank of New York, staff report no 338. Financial Crisis Inquiry Commission (2011), *The Financial Crisis Inquiry Report*, U.S. Government Printing Office, January 2011.

[4] Basel Committee on Banking Supervision (2010), *Results of the Comprehensive Quantitative Impact Study*, Bank For International Settlements, December, 2010.

substantially higher capital charge for uncleared derivatives, should also create incentives for better risk management practices across the financial system.

The significant but basically incremental steps directed in Basel III and implemented in this NPR are the least that should be done in response to the striking failure of the previous regime. It is important that regulators implement these steps fully and rapidly. Their resolve to do so should be increased by the awareness that the true social costs of higher bank equity are likely very low, if they exist at all.[5] The costs of increased bank equity are mainly due to subsidies for bank debt through the tax system and through implicit "too big to fail" government guarantees, as well as principal-agent issues between bank management, stockholders, creditors, and taxpayers.[6] These implicit subsidies and guarantees should not be allowed to drive government policy.

In addition, regulators should remain aware that capital level held by the key banking entities that failed during the crisis of 2008 was both higher than the regulatory capital requirements under Basel II and demonstrably lower than the level needed to prevent institutional failure and financial contagion.[7] The fact that the capital requirements under the previous regulatory regime were clearly too low to accomplish regulatory goals justifies a significant increase now.

Although they are a step in the right direction, the rules laid out here may still turn out to be inadequate over time. These rules are specifically directed at some of the key instruments that caused problems in the last crisis, such as securitizations and re-securitizations. As the financial sector evolves, it seems almost certain that new arbitrage techniques will emerge that permit arbitrage of these rules just as the Basel II rules were arbitraged.[8] The emergence of new instruments may also weaken the stressed VAR capital requirement set out in this rule, as this requirement is "calibrated to reflect *historical* data from a continuous 12-month period that reflects a period of significant financial stress appropriate to the bank's *current* portfolio."[9] As current portfolios evolve and new instruments and investment strategies are created, less historical data will be available that represents an appropriately stressed period.

In light of these concerns, AFR has several broad recommendations for strengthening the rule:

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[5] Admati, Anat R., DeMarzo, Peter M., Hellwig, Martin F. and Pfleiderer, Paul C. (2011), *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is not Expensive* (March 16, 2011). Rock Center for Corporate Governance at Stanford University Working Paper No. 86 ; MPI Collective Goods Preprint, No. 2010/42. Elliot, Douglas (2010), *Basel III, The Banks, and The Economy*, Brookings Institution, July 26, 2010.

[6] Elliot, Douglas (2009), *Quantifying the Effect on Lending of Increased Capital Requirements*, Brookings Institution, September 21, 2009.

[7] Kuritzkes, Andrew and Hal Scott (2009), "Markets Are the Best Judge of Bank Capital", *Financial Times*, September 23.

[8] Blundell-Wignall, Adrian and Paul Atkinson (2010), "Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity", *OECD Journal – Financial Market Trends*, Volume 2010, Issue 1.

- Disclosures should be strengthened, particularly in the area of the qualitative disclosures required for valuation procedures and stressed VAR. Purely qualitative disclosures may be of limited utility in this area. Correlation assumptions and specific quantitative valuation assumptions may be required for market observers to tell if a bank has truly applied stringent standards. The market may be able to act more quickly than regulators in disciplining banks for any attempt to weaken these assumptions.

- Regulators are given very significant discretion in determining the application of these rules. In light of this, it would be useful to announce more specific and standardized quantitative benchmarks for various areas of the rule, e.g. standard increases in correlation for periods of market stress. This would help examiners check bank assumptions more easily and would help guide risk management practices in regulated banks. Such benchmarks may be particularly important in the calculation of stressed VAR, which is a key mechanism to address the pro-cyclicality of the current system but is an area where only very general guidance is currently given.

- Regulators should consider further limiting the trading book treatment of financial assets, even beyond the new treatment of securitizations given here. The downward spiral in prices during the financial crisis showed the risks involved in mark-to-market treatment of risks held on the trading book. Such valuations are inherently highly volatile, and most volatile during times of crisis. Financial institutions may develop instruments that replicate some of the risky and opaque character of securitization tranches but are not captured by the definition of securitization here, and may once again use the trading book to get more generous capital treatment for such assets.

Even if these recommendations are followed, some of the basic structural aspects of risk-based capital regulation – such as the dependence on historical data and the division of assets into different risk "buckets" that can vary greatly in treatment – render regulatory arbitrage and other weaknesses a continuing possibility. The Basel III framework partially recognizes this through providing supplemental liquidity, leverage, and capital standards in addition to the risk based standards. But regulators must remain vigilant to ensure that the same problems that appeared in the past do not reemerge in this regime.

Thank you again for this opportunity to comment on this NPR. If you have the further questions, please contact David Arkush, Director of Public Citizen's Congress Watch at (202) 454-5130 or Heather McGhee, Director of the Washington Office of Demos at (202) 559-1543 ext. 105, Co-chairs of the AFR Systemic Risk and Resolution Authority Taskforce.

Sincerely,

Americans for Financial Reform

[9] CFR Vol. 76, No, 7, p. 1900. Emphasis added.

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
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans for Fairness in Lending
- Americans United for Change
- Calvert Asset Management Company, Inc.
- 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
- 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
- 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 Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People's Action
- National Training and Information Center/National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- 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

- 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

Partial list of State and Local Signers

- 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
- 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
- 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