AMERICANS
FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
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April 30, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: RIN 7100–AD–86: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

Dear Sir or Madam:

American for Financial Reform ("AFR") appreciates the opportunity to comment on this Proposed Rule. AFR is a coalition of more than 250 organizations who have come together to advocate for reform of the financial sector. Members of the AFR include consumer, civil rights, investor, retiree, labor, faith based and business groups along with prominent economists and other experts.

The core of this Proposed Rule builds on the set of changes in bank supervision that have already been negotiated or implemented since 2008, and clarifies how they will fit into the supervisory regime envisioned in Sections 165 and 166 of the Dodd Frank Act (DFA). These changes include the new Basel III capital and liquidity rules and the continuation of stress testing along the lines of the Comprehensive Capital Adequacy Review (CCAR). The proposed rule mandates these changes, explains how they will be used in the early remediation regime mandated by the DFA, and also implements the internal risk management requirements and single counterparty credit limits contained in that law.

These are useful steps, but AFR strongly believes that more is needed in regulation of systemically important financial institutions (SIFIs). For reasons discussed below, the combination of Basel capital and liquidity requirements and a CCAR-type stress testing regime will not be sufficient to create financial stability and competitive balance in the U.S. financial system. Other elements of the Proposed Rule have value but are also not sufficient to address the problems revealed in the 2008 financial crisis. Because of this, the Federal Reserve should use its extensive authority under Sections 165 and 166 to implement the additional steps discussed below. The issues around controlling bank risk through the Basel process and stress tests alone also underline the importance of other elements of the Dodd-Frank systemic risk regime, such as a strong Volcker Rule and reductions in bank complexity and size through the 'living will' review process.

<u>Summary Of Recommendations</u>

<u>Risk Based Capital and Leverage Limits</u>: As detailed in AFR's comment to the Basel Committee, the Basel capital requirements for SIFIs fall well short of the levels that would maximize social benefit. This is true even using the Basel committees own economic analysis. The U.S. should follow the lead of Switzerland and the U.K. in imposing capital requirements on our largest banks that exceed the Basel required levels. This could be done using contingent capital as well as additional common equity. While stress testing is a useful supplement to basic capital requirements, it is not credible that stress testing requirements alone can substitute for routine capital and leverage limits. Such limits should thus be set at a more economically efficient level. This level could be determined by re-performing the cost-benefit analysis done by the Basel Committee on Long-term Economic Impacts (LEI) using more appropriate economic assumptions.

<u>Liquidity Requirements:</u> The new liquidity requirements in the Basel process are a very positive step, as is the attention to intraday exposures. However, these liquidity coverage ratios alone are likely to prove insufficient in the face of a systemic event. Liquidity reserve requirements need to be supplemented by straightforward limitations on the extent of funding that is provided through extremely short-term debt (e.g. overnight repos) and the level of maturity transformation. It is also important to better integrate the process of liquidity stress testing with capital stress testing. Finally, liquidity regulation should be used as an opportunity to implement reforms to the repo and securities lending process called for by the Federal Reserve Bank of New York and others.

<u>Single Counterparty Credit Limits</u>: AFR strongly supports the steps taken in this rule to better measure single counterparty exposures and also to impose a 10 percent limit on exposure to a single counterparty for the largest SIFIs. However, the capital concept used to set these limits ('consolidated capital stock') is far too lax. Counterparty exposures need to be pegged to the Basel III definition of Tier 1 capital. This would greatly reduce opportunities to manipulate this metric and would improve regulatory consistency. The definition of capital is in some ways more important than the exact percentage limit.

In addition, the ability to reduce gross credit exposures through such mechanisms as credit default swaps and equity derivatives should be carefully controlled. Failure to do so could lead to the migration of substantial amounts of SIFI risk to non-regulated financial entities through a complex network of derivative relationships that would be difficult to monitor or stress test. In general, regulators need to set rules that encourage the reduction of excessive exposure concentration through real credit provision to a diverse set of non-financial counterparties, instead of ever more elaborate ways of laying off risk within the financial system.

Internal Risk Management: The financial crisis revealed that many firms maintained the appearance but not the reality of risk management. Roger Cole, a former Director of Bank Supervision at the Board, stated that "Key people in the industry were throwing risk management out on the table as kind of a diversion."[1] It is vital that supervisors require the reality of effective risk management, and not simply the formality of a chief risk officer. Chief risk officers must be accountable to an independent risk committee on the Board of Directors. This risk committee must have members with significant knowledge of financial risk management, and must be able to support the risk manager in case of a disagreement with the CEO. AFR would also support the recommendations of Thomas Stanton in his February 13th letter to the Board on this issue.[2]

Supervisory Stress Test Requirement: The greater emphasis on stress testing post-crisis is a welcome development. A forward-looking emphasis on tail risk can do much to correct the essentially backward-looking focus on ordinary risk that was evident in pre-crisis capital regulation for bank trading books. However, the stress testing requirements in this rule do not appear to emphasize macroprudential issues sufficiently.[3] There are important differences between stress testing for single-institution solvency (microprudential testing) and macroprudential testing of the broader financial system. Macroprudential testing examines the way that the collective activities of financial institutions affect broader financial markets that intermediate bank liabilities and determine asset values. Liquidity failures in these broader markets were obviously crucial to the 2008 crisis. Macroprudential testing also allows supervisors to consider whether the overall level of capital in the system is adequate for credit intermediation, instead of simply whether capital held by individual companies will allow the survival of that individual bank.[4]

A related issue is the mandated stress tests may not be sufficiently integrated within institutions (across the different areas of capital and liquidity) or across institutions (across banks, non-banks, and market utilities). Integration of bank stress tests with the stress testing of key market utilities such as clearing houses is an obvious are for coordination. Finally, to capture all the social costs of undercapitalization stress tests should incorporate market responses across an extended time period, including 'second round' effects as markets react to the initial shock.

Debt To Equity Limits and Early Remediation Requirements: Supervisors should better integrate the 15 to 1 debt to equity limit called for in the Dodd-Frank Act with other capital requirements,

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[1]FCIC Interview with Roger Cole, formerly Federal Reserve Board, August 2, 2010, available at http ://fcic .law. stanford.edu

[2] Thomas Stanton, Letter to the Board on "Enhanced Prudential Standards And Early Remediation Requirements For Covered Companies", February 13, 2012.

[3] We realize that many of the details of the supervisory stress testing process are not specified in this rule and may still be under development; it is possible that this criticism will be addressed through the gradual development of that process.

[4] For an excellent discussion of these issues, see Greenlaw, David, Kashyap, Anil K., Schoenholtz, Kermit L. and Shin, Hyun Song , Stressed Out: Macroprudential Principles for Stress Testing (February 13, 2012). Chicago Booth Research Paper No. 12-08. Available at SSRN: http://ssrn.com/abstract=2004380 .

particularly the remediation requirements. The 15 to 1 limit should be based on the Basel III Tier 1 capital definition and made part of some type of routine requirement for systemically significant companies (which by definition are capable of posing a grave threat to financial stability when undercapitalized).

If regulators do not simply mandate the 15 to 1 leverage limit as a requirement for the largest SIFIs, then the next best alternative would be to incorporate it into the early remediation requirements. At a minimum, a 15 to 1 leverage ratio should trigger Level 1 remediation (heightened supervisory review). The current requirements for Level 1 remediation could then trigger a Level 2 remediation (initial remediation) and the level 2 requirements could trigger full remediation. AFR believes that the currently proposed remediation requirements are too lax, and this would help to address the problem.

<u>Other Early Remediation Requirement Recommendations:</u> As stated above, AFR believes that early remediation requirements are too lax in general and the triggers should either be heightened or the conditions made more stringent. Early remediation requirements should also contain a much greater emphasis on compensation restrictions, particularly at the initial remediation stage. Such restrictions are likely to have lower costs to the broader economy and the future cost of capital for the bank than other means of raising capital ratios, and they also give the proper incentives to executives.

Finally, early remediation requirements should contain sufficient flexibility to allow regulators to act in a countercyclical manner. Particularly during periods of economic weakness, regulators should require banks to reach desired capital levels through increasing retained earnings (preventing capital and compensation distributions) rather than cutting back assets through reductions in lending. A greater emphasis on cutting back assets may be more appropriate during an asset bubble. This would better integrate financial stability supervision with the other mandates of the Federal Reserve, namely restricting inflation and maintaining full employment.

<u>Other Cross-Cutting Issues</u>: Credit exposures to related off-balance sheet entities like Special Purpose Vehicles and sponsored money market funds should be incorporated into stress tests for capital and liquidity, as well as exposure limits, in any case where the failure of such an entity exposes the bank to reputational risk. This should be done even if the bank is not formally obligated to provide liquidity to such an entity. The 2008 crisis clearly showed the importance of reputational factors and the ways in which they create informal credit commitments.

Finally, regulators should proceed with rigorously implementing restrictions on bank activity, such as the Volcker Rule, which will simplify bank activities in ways that increase the reliability of the stress tests and exposure limits mandated in this rule.

<u>**Detailed Discussion**</u>

Risk Based Capital and Leverage Limits

In August, AFR wrote a letter to the Basel Committee laying out the conceptual flaws in the Committee's proposed requirements for additional capital for global SIFIs.[5] That August 26th letter is incorporated by reference here. These flaws include the following:

- According to the Committee's own cost-benefit analysis, SIFI capital requirements under the largest surcharge permitted under Basel (2.5 percent) remained a full percentage point lower than the economically efficient minimum capital requirement for all banks.

- Yet SIFI capital requirements should logically be larger than those for all banks – SIFI failure creates much larger economic costs than the failure of smaller banks, and the costs of a capital surcharge applied to SIFIs alone would clearly be lower than the same capital charge applied to all banks.

- The Committee cost benefit analysis assumed a pre-crisis target return on equity for banks of 15 percent, which is likely inappropriately high going forward.

- The cost-benefit analysis implicitly assumed that all private costs of higher SIFI capital were passed directly on to lenders, and were not reflected in lower executive compensation, lower profits, or greater lending by smaller banks.

- The cost-benefit analysis did not include systemic costs of undercapitalization short of failure.

For these reasons as well as others, it likely that the Basel capital level for large banks is a very significant underestimate of the economically efficient capital level for systemically important institutions. Indeed, prominent economists have argued there is very little if any social cost of increased bank capital.[6] The lack of any clear longitudinal relationship between gradual declines in capital levels and improvements in economic growth would tend to support this idea.

Despite all these issues, the proposed rule seems to state that U.S. supervisors would set U.S. capital levels for systemically significant institutions at the Basel minimum levels, and rely on individual institution stress testing for any upward divergence from that level.[7] Yet stress testing has a highly uncertain record as an early warning device for financial crises.[8] As we discuss

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5 Americans for Financial Reform, Letter To Basel Committee on G-SIB Consultative Document, August 26, 2011.

6 See D.Miles, Jing Yang and Gilberto Marcheggiano, *Optimal bank capital,* Bank of England External MPC Unit DP No.31, January 2011; 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.

7 This is our interpretation of the statement on CFR 599 that "The Board intends to propose a quantitative risk-based capital surcharge in the United States based on the BCBS approach", combined with the capital stress testing procedures in the rule.

8 Borio, Claudio, Matthias Drehmann, and Kostas Tsatsaronis, "Stress Testing Macro Stress Testing: Does It Live Up to Expectations?", Bank for International Settlements Working Paper 369, January, 2012.

further below, there are numerous methodological uncertainties in mapping macroeconomic stress scenarios to particular asset values and liquidity channels, particularly those that rely on traded financial markets, and the field of macroprudential stress testing is in the early phases of development. However useful stress tests may be as a means of exploring scenario possibilities, or a means of restoring confidence and determining appropriate recapitalization once a crisis has occurred, it is extremely premature to rely on stress testing to play a central role in setting basic capital levels.

AFR recommends that the Federal Reserve should instead attempt to set basic U.S. SIFI capital standards at their economically efficient level, which would be higher than the Basel level. This level could be determined by performing a cost-benefit analysis similar to that performed by the Basel Committee on Long-Term Economic Impacts in support of setting the Basel standard, except incorporating more realistic assumptions about the costs and benefits of capital requirements in general and SIFI capital standards in particular. Performed in an impartial manner, we believe that such a cost-benefit analysis would result in considerably higher capital requirements.

The Basel capital standards are specifically intended as a minimum level, not a maximum, and the setting of those minimum levels was heavily influenced by political considerations involved in reaching a global consensus. Some of the countries in the Basel Committee may have a different set of political goals in setting capital standards – in particular, they may be more comfortable than the United States in permitting public bailouts of their banking system. As former Federal Reserve governor Kevin Warsh recently stated[9],

> "My concern is that the [Basel] negotiation, while well intended, is between banking systems that at their core are fundamentally different and aspire to fundamentally different things. The largest banks in Japan, Germany, for example, have long been akin to national champions. Perhaps they reason that their banks need less capital than ours because their sovereigns more assuredly stand behind them."

<u>Liquidity Requirements</u>

A liquidity run is a more basic and central mechanism of bank failure than a capital shortage. But for many years regulatory supervision did not explicitly address liquidity shortfalls. This inexplicable omission is finally being corrected in the latest Basel agreement. Given that liquidity runs were clearly the central mechanism of the 2008 crisis the importance of adequate liquidity controls can no longer be denied.

This Proposed Rule would implement the various Basel liquidity requirements and would also require stress testing of liquidity adequacy. These rules require that banks stockpile assets that

[9] Quoted in Morgenson, Gretchen, "Telling Strength From Weakness", New York Times Business Section, April 29th, 2012

are likely to remain liquid even in an emergency situation, and do so in amounts adequate to meet liquidity needs for at least 30 days. These requirements are a positive step that should be helpful in improving the safety and soundness of banks. However, the new Basel liquidity buffers are unlikely to fully address liquidity issues, and will be difficult to expand further. Liquidity buffers should be supplemented by clear limitations on extremely short-term debt and reforms to the repo process.

Addressing liquidity needs through a requirement to stockpile particular assets poses some obvious problems that are difficult to address. If regulators are overly lenient in the type of assets that may be stockpiled for liquidity purposes, then such instruments may not be reliable or trustworthy in an emergency. However, if they are overly restrictive then they may create 'fire sale' effects on pricing when banks simultaneously attempt to sell large amounts of a narrow asset class into stressed markets. (In other words, markets may freeze and formerly safe assets may become illiquid). If an asset has truly reliable 'flight to quality' properties (such as U.S. Treasuries have traditionally had) then this may not be such a large problem, but there are a limited number of such safe assets available in the global economy.

These problems can be managed to a degree. Regulators should take a macroprudential approach to liquidity needs by carefully examining markets for possible crowded trades and modifying permissible liquidity holdings in response to potential systemic issues. It is unclear in the current rule if regulators plan to do this. Another element is additional research on the 'flight to quality' under conditions of market stress, and an attempt to find additional assets which meet this standard. In the extreme, liquidity buffer requirements can be met through cash. However, the issues with a pure liquidity buffer approach still limit the extent to which such an approach can be used.

Unfortunately, research indicates that the current buffer in the Basel agreement will not fully address liquidity issues. A recent IMF study found that the overall U.S. banking system would have met Basel liquidity coverage ratios prior to the 2008 crisis, so that these liquidity requirements would not have provided a sufficient warning of the threats to liquidity in the system.[10] This may reflect an even deeper issue with stockpiling assets to meet a true liquidity run – by definition, a true bank run is an unexpected withdrawal of counterparty funding on a level that simply cannot be met by a fractional reserve bank.

For these reasons, supervisors need to consider additional protections against liquidity threats. Fortunately, there are simple additional safeguards that would provide a valuable complement to the Basel liquidity requirements. AFR recommends a simple restriction on the level of extremely short term funding, which would render a bank's funding structure more stable to short-term

[10] International Monetary Fund, "Global Financial Stability Report" April, 2011, Chapter 2. The study did find that investment banks in particular would have fallen to 95 percent of Basel liquidity requirements as early as 2006, which may have provided some warning. But the eventual shortfall that developed was of course much greater.

disruption and panic. Before its failure, Lehman Brothers was required to roll over 25 percent of its funding an overnight basis. It is obvious from both common sense and economic theory that such extreme levels of short term funding can pose a major threat to financial stability.[11] The Dodd Frank Act provides explicit authority for limiting short term debt exposure, and the New York Federal Reserve, the Basel Committee, and others, have recommended limits on overnight repo.[12]

The most extreme form of short-term credit is of course intraday credit, and this form of credit is also the most difficult to monitor and control. The repo lending system is central to the problem of short term and intraday credit. The instability created through repo lending was also central to the financial collapse in 2008. The Federal Reserve Bank of New York (FRBNY) has been working with industry since the crisis to improve the functioning of the repo system on a voluntary basis. Reports by the review committee recommended a wide variety of improvements to repo to reduce intraday credit exposures and also to improve the stability of repo in general. Unfortunately the FRBNY has recently reported that after almost three years of work, the task force had not succeeded in materially reducing the systemic risk or intraday exposures created in the repo market.[13] This is a central problem and the lack of progress shown by working with industry on a purely voluntary basis shows that a more prescriptive approach is necessary. These new liquidity rules should be used as a vehicle for mandating specific reforms to repo recommended by the Federal Reserve Bank of New York and others.[14]

The rule also contains extensive requirements for liquidity stress testing. Such stress testing may reveal problems created by excessive reliance on short-term funding. But it is less reliable than a simple limit on such funding. Methods of addressing rollover risk that may work in a stress test can have unintended consequences when actually used. (For example, drawing on too many lines of credit to address the failure to roll over debt may send a negative signal about bank viability). In addition, there are doubts about the ability to use the stress testing framework to sufficiently model extremely low-frequency high variability events like liquidity crises.[15]

Another issue related to liquidity stress testing is the need to incorporate macroprudential (systemic) aspect to such testing. As discussed above, the need to sell liquidity buffer assets into the market means that stress testing the entire market environment is particularly important. In

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[11] For one example of this growing literature, see Acharya, Viral V., Gale, Douglas M. and Yorulmazer, Tanju, Rollover Risk and Market Freezes (February 17, 2010). EFA 2009 Bergen Meetings Paper. Available at SSRN: http://ssrn.com/abstract=1325887

[12] Committee on the Global Financial System, "The Role of Margin Requirements And Haircuts in Procyclicality", CGFS Papers Number 36, Bank of International Settlements, March, 2010; Federal Reserve Bank of New York, "White Paper: Tri Party Repo Infrastructure Reform", May 17, 2010.

[13] Federal Reserve Bank of New York, "Statement on Release of The Tri-Party Repo Reform Task Force's Final Report", February 12, 2012.

[14] As AFR has stated in previous comments on financial system utilities, triparty repo banks should be regulated as critical financial system utilities. This would be an alternative route to implement triparty reforms in particular.

[15] European Central Bank, "EU Banks Liquidity Stress Testing", November, 2011.

addition, recent liquidity crises have been triggered by drops in asset values for secured funding. Numerous interactions can be expected between the decisions of different banks and non-bank actors in the financial markets. It is extremely important to include a macroprudential perspective in liquidity stress testing.

A further important concern is the integration of liquidity stress testing with capital stress testing. There are numerous interactions between the liquidity and capital situation of the bank (to take only the most obvious, if a bank is downgraded due to a declining capital position, the terms of funding will change). It would be a mistake, both analytically and organizationally, to silo liquidity stress testing away from capital stress testing.

Single Counterparty Credit Limits

Counterparty exposure limits are an old theme in banking regulation, and were imposed for many decades under Section 23 of the Federal Reserve Act (Regulation F). However, the definition of 'exposure' in pre-crisis rules exempted many critical forms of credit exposure, including derivatives. An important step taken in Sections 610 and 611 of the Dodd Frank Act was to expand the definition of 'exposure' to include derivatives exposures and various off balance sheet exposures as well.

This proposed rule implements new counterparty exposure limits, and follows the lead of this expansion of the 'exposure' definition in Dodd Frank. The range of credit exposures included in Section 252.92 (n) and (p) of the rule is a very valuable update of prior definitions of exposure in banking law. It represents a major step forward and a very positive element of the rule. The proposed rule takes the additional step of lowering those limits to 10 percent of capital for the largest banks ($500 billion or more in assets). AFR supports this step. It is important to create firewalls that prevent the failure of any single institution from causing the failure of other institutions central to our financial system.

However, the reality of this counterparty exposure limit depends not simply on the percentage figure chosen, but on the definitions of capital and net exposure used to implement the limit. These are potentially problematic. First, the exposure limit is expressed as a proportion of 'consolidated capital stock'. This is an extremely expansive definition of capital that appears to include all of the instruments included as 'capital' under the Basel II definitions of Tier 1 and Tier 2 capital, and some additional instruments as well. A central finding of the financial crisis was that only common equity was reliably loss absorbing. The new Basel accord reflects this finding through its redefinition of capital. There are many advantages to coordinating regulatory capital definitions around a limited number of capital definitions that include only instruments that are reliably loss absorbing. Reintroducing rejected concepts of capital for regulatory purposes is a mistake that would increase regulatory complexity and render exposure limits easier to game. Regulators should define appropriate exposure limits that are based on Basel III Tier 1 capital.

Another set of issues revolves around the movement from gross to net exposures. Since net exposures will be only a small fraction of gross exposures, particularly for derivatives, this is a critical issue. AFR would like to raise two issues here. First, net exposure calculations should be calculated using methods that are resilient to systemic events. The extreme changes in relative interest rate and currency valuations seen, for example, during the 1998 Asian currency crisis may have a sudden and radical effect on net derivatives exposures. Some form of value-at-risk margin forecasting should of course already be part of the risk management process for any sophisticated bank with a significant derivatives portfolio; stress testing of these exposures should be integrated into the broader stress testing program at the bank.

Second, the rule appears to allow the direct reduction of counterparty exposures through the use of credit default swap hedges on the counterparty. This effectively encourages an increased systemic use of credit default swaps to loosen regulatory constraints. This could increase threats to financial stability. The widespread use of credit default swaps increases systemic wrong way risk, since CDS loss exposure is likely to be highest when the financial system as a whole is under stress. Stress testing an extensive set of credit relationships mediated through CDS will be complex, particularly since many CDS counterparties may be non-regulated institutions. A problem of individual institutional stability may be replaced by a problem of network fragility.[16] Of course, the exposure limitation will also limit CDS exposure to any one institution, which may increase the robustness of the network. However, the study of such complex financial networks is in its infancy and regulators should be wary of the potential risks arising from the decentralized network of credit insurance that may be created by this rule

More generally, regulators should create rules that encourage the reduction of excessive exposure concentration 'organically', through real credit provision to a diverse set of non-financial counterparties. Encouraging ever more elaborate ways of laying off risk within the financial system is unlikely to be productive and may create unforeseen risks. Many observers have pointed to the massive increase in the size and complexity of intra-financial sector relationships as a significant contributor to the crisis.[17] Regulators should generally be seeking to discourage such exposures where possible.

Debt to Equity Requirement

The Dodd Frank Act mandates the imposition of a 15 to 1 absolute leverage requirement on any systemically significant company for which the Board determines that the imposition of such a requirement is necessary to mitigate the risks that the company poses to the financial stability of the United States. Of course, the Board already has the ability under other legal authorities to

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[16] Markose, Sherri, et. al. "Too Interconnected to Fail", University of Essex Economics Department Discussion Paper 683, February, 2010.

[17] UK Financial Services Authority, "The Turner Review: A Regulatory Response to the Global Banking Crisis", March, 2009. Federal Reserve Flow of Funds data shows intrafinancial system debt exposures growing from less than one-fifth of total U.S. debt in 1990 to one-third in 2008.

impose such a requirement should it determine that it is reasonable. This leverage limit is hardly radical. Prior to 2004, under the net capital rule investment banks were required by the SEC to maintain a 12 to 1 debt to equity ratio. AFR believes that an impartial cost-benefit analysis of leverage and capital requirements such as the one suggested earlier in this comment could justify such a leverage limit as a general requirement for SIFIs.

If the 15 to 1 limit is not adopted as a general requirement for SIFIs, the next best alternative is to integrate it into early remediation requirements. A simple way to do this would be to set this leverage ratio to trigger the initial stage of early remediation (heightened supervisory review). Other capital ratios for this stage of remediation could also be heightened appropriately. As discussed below, this would permit the triggering conditions for the other stages of early remediation to be lowered as well.

It is important not to wait until a company is in the process of failure to impose an increased leverage requirement. Once a major financial company starts to fail it is difficult to demand a sudden increase in capital. If the 15 to 1 limit is not integrated into the broader set of capital requirements that are planned for by company risk managers, then the company is unlikely to be able to undertake such an increase when it is in a stressed condition. Regulatory forbearance will be a strong temptation.

Early Remediation Requirements

AFR has several recommendations related to early remediation requirements. First, the triggering conditions for early remediation simply appear to be too lax. For example, level 2 remediation (initial remediation) would apparently be triggered when a SIFI has already fallen below at least some of the Basel III SIFI capital requirements and also evidences "multiple deficiencies" in meeting risk management and liquidity risk standards. Yet the company would still be permitted to pay out up to 50 percent of net income in dividends and stock buybacks, and would be subject to no compensation limits whatsoever. If the requirements under level 2 remediation are kept constant, then the triggering capital levels should certainly be heightened, possibly to those currently used to trigger heightened supervisory review.

As context here, historically banks have typically tried to maintain capital ratios significantly in excess of regulatory minimums. If this pattern continues in the future, falling below Basel III minimums in any area will be sign of significant risk management issues at the bank. It is important for regulators to intervene early in such cases. Had regulatory intervention to conserve capital occurred at an earlier point in the financial crisis, $80 billion in bank capital could have been preserved.[18]

[18]Rosengren, Eric, "Dividend Policy and Capital Retention: A Systemic First Response", Speech at 'Rethinking Central Banking' Conference, October, 2010.

AFR has two additional recommendations in this area. First, the rules should place a greater emphasis on restricting compensation and bonuses as a means of preserving capital in the early remediation process. This should be done early in the remediation process; certainly compensation increases and bonuses should be sharply restricted even at the initial remediation stage. If a bank is truly troubled, then high-level executives will unfortunately have every incentive to increase compensation as much as possible before they lose their jobs at higher levels of remediation or resolution. Compensation restrictions will prevent this outcome. If a bank's problems are temporary, then compensation restrictions for high-level executives are preferable as a means of raising capital when compared to either dividend restrictions, which could increase future costs of raising capital, or cutbacks in lending, which may have negative economic effects.

Second, regulators should retain flexibility to require different methods of raising capital depending on the point in the economic cycle and the impact of each method on the overall economy. For example, if the broader economy is weak, cutbacks in lending to non-financial (real economy) companies may have a more negative effect on economic growth than restrictions on compensation or dividends. However, if the economy is strong and asset price inflation is significant, a reduction in assets may be more appropriate than an increase in retained earnings. At that point in the economic cycle, such a reduction in assets may have a beneficial effect on an overheated economy, while the effect on competitive position of a reduction in dividends or compensation could be more significant. Such flexibility in recapitalization methods could allow regulators to better integrate capital regulation with other missions of the Federal Reserve such as price stability and full employment.

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

Sincerely,

Americans for Financial Reform

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
- Americans for Democratic Action, Inc
- American Income Life Insurance
- 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
- 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 Council of Women’s Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- 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
- 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

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
- 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
- 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