AFR Americans for Financial Reform

Education Fund

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Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219

Ms. Ann Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Docket ID OCC-2018-0002; Docket No. R-1604

Re: Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies

To Whom It May Concern:

On behalf of the Americans for Financial Reform Education Fund ("AFR"), thank you for the opportunity to comment on these proposed changes to regulatory capital rules (the "proposal").[1] For reasons made clear below, AFR opposes this proposal to cut the minimum required leverage ratio at systemically critical banks.

If implemented, this proposal would represent a major shift in the current capital regime for the largest U.S. banks. It would cut the current required enhanced supplementary leverage ratio (eSLR) from its current level of five percent at the holding company level and six percent at the insured depository to a new level of three percent plus half of the risk-based capital surcharge for each global systemically important bank (G-SIB). Current G-SIB surcharges range from 1 to 3.5 percentage points, so this proposal would slash the eSLR at all of the largest U.S. banks. It would cut minimum required leverage at the bank holding company level between 5 percent (JP Morgan) and 25 percent (BNY Mellon and State Street). More significantly, it would cut required leverage ratios by 21 percent to 38 percent at the insured depository subsidiaries of these companies.

These cuts are likely to have a major impact. The leverage ratio is the only capital requirement that applies fully and directly to all bank activities, as opposed to just those activities that regulators judge to be risky. This makes the leverage ratio particularly critical. There is a long

[1] The Americans for Financial Reform Education Fund brings together an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/

history of failures in regulatory judgement of risk. Such failures were a major contributor to the 2008 financial crisis. By the time of the 2008 crisis regulatory risk measurements had diverged so far from the reality of market risks that risk-based capital ratios were completely uncorrelated with bank failure, while unadjusted leverage capital ratios were strongly correlated with bank solvency.[2] Investors lost faith in risk-based regulatory capital figures, hardly surprising since banks like Lehman Brothers were reporting Tier 1 capital ratios of over ten percent just weeks before their failure.

In the years prior to the financial crisis, regulators specifically acted to slash risk-based capital requirements to negligible levels for the private mortgage backed securities that were at the heart of the financial crisis, encouraging banks to hold large amounts of these "toxic" securities.[3] Regulatory decisions like this fueled the creation of systemic risk before the crisis, showing the dangers of excessive reliance on regulatory judgements of risk and how such reliance can actively create additional systemic risk.

Current market data continues to show that leverage capital plays a critical role in controlling bank risks. At the end of 2017, the six largest U.S. banks had $13 trillion in exposures under the supplementary leverage ratio metric, but just $6.3 trillion in exposures subject to risk weighted capital requirements.[4] In other words, over half of potential risk exposures were not covered at all by risk weighted capital requirements. Cutting leverage requirements for G-SIBs thus means that the majority of exposures at the largest and most complex banks will have lower equity requirements in their funding.

The proposal offers impact estimates that minimize the effect of the cuts in leverage requirements. It estimates that were this proposal to be implemented today in combination with the Stress Capital Buffer rules also recently proposed, affected bank holding companies would only be able to return $400 million to shareholders.[5] However, this estimate appears to reflect only the effect of cutting required leverage capital based on the current composition of bank balance sheets. As the proposal itself makes clear, the point of cutting the leverage ratio is

[2] Some of the research that establishes this finding includes International Monetary Fund (IMF), 2009, "Global Financial Stability Report, Chapter 3, Detecting Systemic Risk", Washington, April 2009; Detragiache, Enrica, Asli Demirguc-Kunt, and Ouarda Merrouche, 2010, "Bank Capital: Lessons from the Financial Crisis", IMF Working Paper 10/286, Washington: International Monetary Fund, December 2010; Haldane, Andrew G., 2012, "The Dog and the Frisbee", Bank of England Speech 596, presented at the Federal Reserve Bank of Kansas City's 36th economic policy symposium, Jackson Hole, Wyoming; Mayes, David G. and Stremmel, Hanno, 2012, "The Effectiveness of Capital Adequacy Measures in Predicting Bank Distress" , 2013 Financial Markets & Corporate Governance Conference; Brealey, Richard A., Ian A. Cooper, and Evi Kaplanis, 2011, "International Propagation of the Credit Crisis" , SSRN Working Paper, April, 2011; Berger, Allen N., and Christa H.S. Bouwman, 2013, "How Does Capital Affect Bank Performance During Financial Crises?", Journal of Financial Economics (JFE), Volume 109, Issue 1, July 2013 Blundell-Wignall, Adrian and Caroline Roulet, 2013, "Business models of banks, leverage and the distance-to-default", OECD Journal No. 103: Financial Market Trends, Vol 2012-2; Hogan, Thomas L., Neil Meredith, Zuhao Pan, 2013, "The Failure of Risk-Basked Capital Regulation," Fairfax: Mercatus Center at George Mason University

[3] OCC, Federal Reserve System, FCC, and Office of Thrift Supervision, "Risk Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitization", Federal Register, November 29, 2001. Available at https://bit.ly/2IvqLqw

[4] Data taken from December, 2017 Basel Pillar Three disclosures for Bank of America, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, and Wells Fargo.

[5] CFR 17321 and footnote 27.

precisely to facilitate banks changing their balance sheets by adding more so-called "low risk" activities and funding such activities with more borrowed money than they are currently permitted to. Thus, while current aggregate capital may decline by only $400 million, the ratio of aggregate capital to aggregate bank exposures may decline by significantly more.

Furthermore, the proposal also cites the estimate that equity held at insured depository institutions (IDI) within the holding company will decline by over $120 billion due to the proposed changes in the proposal.[6] This is a truly major decline. The IDI should not be viewed as interchangeable with the rest of the bank holding company, so that capital can freely be shifted throughout the bank as needed. The depository institution is directly within the Federal safety net in a way that other parts of the holding company are not. Since IDI depository liabilities are directly insured by the Federal government, it is far more difficult to resolve the IDI without public subsidy.

AFR believes that the effects of these cuts would be significant, and that they are not justified by arguments set out in the proposal. Specifically, the claim in the proposal that the leverage ratio must be calibrated as a "backstop" to the current risk-based capital ratio does not justify cuts in the current leverage ratio. First, the proposal fails to properly assess the costs of a "binding" leverage ratio at major banks and also fails to demonstrate that these costs exceed the costs of having a lower leverage ratio requirement. Second, even if the leverage ratio should be used as a backstop, the proposal fails to examine the alternative of simply raising the risk-based capital ratio. There is extensive evidence that risk-based capital ratios, particularly for G-SIBs, are likely too low. Below, we discuss these points in more detail.

Calibration of the Leverage Ratio to the Risk-Based Capital Ratio

The major justification given for cutting the leverage ratio in the proposal is that the leverage ratio should be a "backstop" to the risk weighted capital ratio and should not be "binding" on bank decision making. The leverage ratio is binding in cases where the total amount of capital required for a bank holding company's portfolio under the leverage ratio requirement exceeds the total amount of capital required under risk-weighted capital requirements. In such cases, a bank's marginal investment decision will be made based on the leverage ratio metric of risk, which applies an equal capital charge to all investments. Conversely, if the total amount of capital required under risk-weighted charges exceeds leverage capital requirements, then the leverage ratio is not binding and marginal investment decisions will be made based on regulatory risk weights.

The proposal claims that a binding leverage ratio will impose significant costs because banks will be risk insensitive when they make marginal decisions based on the leverage ratio metric, but will be properly risk sensitive when they choose based on the regulatory risk weights incorporated in risk-weighted capital. Specifically, the proposal states that a binding leverage ratio will create "incentives for firms to reduce participation in or increase costs for low-risk, low-return businesses, which may have an adverse effect on safety and soundness". The Board

[6] CFR 17321 and footnote 29.

and the OCC are therefore cutting the supplementary leverage ratio to "help ensure that leverage ratio requirements generally serve as a backstop to risk-based capital requirements".[7]

No quantitative analysis is given to back the assertion that leverage ratio requirements must play a subordinate, backstop role to risk-based capital requirements. There are several reasons to believe that the assertion is at least significantly overstated. Some of the reasons are laid out in a recent (2017) study by the European Central Bank, which, unlike this proposal, directly examined the effects on bank risk-taking of a binding leverage ratio.[8] The study found that banks newly subject to a binding leverage ratio increased their risk-weighted assets to total assets ratio by around two percentage points more than they otherwise would without a leverage ratio, but that this relatively positive minor effect was outweighed by the effect of holding more capital. On net, the study found that introduction of the supplementary leverage ratio significantly lowered the risk of failure for banks affected by a binding leverage ratio.

The authors give several reasons why the leverage ratio still worked to improve bank safety and soundness in this case. First, banks' marginal incentives to take on investments with high risk weights under a binding leverage ratio are not unlimited. They operate only on the margin. As banks increase their investments in assets with high risk weights, the absolute level of capital required under the risk-weighted charges will increase and eventually the leverage ratio will no longer be binding. The claim in this proposal that cuts in the leverage ratio would only permit bank holding companies to release $400 million in capital indicates that, at least at the holding company level, banks are already close to the crossover point and have limited scope to take on investments with a higher risk weight at the current level of the eSLR.

Second, the absolute increase in overall required capital under the leverage ratio itself acts to constrain bank risk taking, by ensuring that bank equity holders have more "skin in the game" than they would under a less stringent capital regime.

While the ECB study examines the European capital rules, it is conceptually highly applicable to the U.S. situation. The ECB study findings imply that despite the unsupported claims in the proposal, lowering leverage ratios could and likely would increase bank risk of failure. It is puzzling that the agencies have not performed a similar analysis for U.S. banks.

Beyond the issues laid out in the ECB study, the proposal also does not take seriously the likelihood that the leverage ratio will restrict activities that are in fact risky and, as in the 2008 financial crisis, risk-based capital will again fail to properly assess such activities. There is only one mention in the proposal of the possibility that the leverage ratio could protect "against underestimation of risk both by banking organizations and by risk-based capital requirements". Beyond this single mention, the assumption in the proposal is that the leverage ratio constrains banks from "lower-risk, lower return businesses". This is despite the fact that during the financial

[7] CFR 17320
[8] Smith, Jonathan Acosta, Michael Grill, and Jan Lang, "The Leverage Ratio, Risk-Taking, and Bank Stability", European Central Bank, Working Paper No, 2079, June, 2017. Available at https://bit.ly/2N0kEhp

crisis the activities that showed the greatest losses were precisely those that were expected to carry the least risk and were treated as low-risk under risk based capital rules.[9]

The specific examples given in the proposal of so-called "lower risk" businesses that would be facilitated by cutting the leverage ratio are "secured repo financing, central clearing for market participants, and taking custody deposits for clients". It is ironic that the agencies would call these businesses "lower risk", since these markets in fact pose significant systemic risk.

Many economists believe that breakdowns in the system of secured repo financing were critical during the financial crisis. A post-crisis white paper by the New York Federal Reserve stated that breakdowns in the tri-party repo market "had the potential to destabilize the financial system", and that the Federal Reserve was forced to take "extraordinary actions" such as providing large amounts of direct financial assistance to primary dealers in order to "avert a collapse in confidence in the tri-party repo market".[10]

As for derivatives central clearing, no one disputes that the failure of a bank that was a clearing member of a major derivatives central counterparty (CCP) would create enormous risk to the financial system, and that this risk increases with the volume of cleared derivatives. As a recent report by the Commodity Futures Trading Commission (CFTC), puts it, "A clearinghouse will incur market risk only if and when a clearing member fails to meet a payment obligation to the clearinghouse. The credit risk that a clearinghouse takes is thus also that of its members….clearing members are essential to the functioning of a clearinghouse".[11] A failure of a major derivatives CCP would in turn have enormous implications across the financial system. A recent Treasury report on capital markets stated that "CCPs are critical infrastructures…that continue to pose systemic risks…and are uniquely interconnected with other U.S. financial institutions".[12]

It may be that regulators view individual repo or cleared derivatives transactions as lower risk even though the overall infrastructures for repo transactions and derivatives clearing are clearly systemically risky and their failure could have catastrophic consequences. We suggest that this is a short-sighted view. The solvency of the private banks at the heart of the system of derivatives clearing and repo transactions is directly connected to the stability of the relevant infrastructures. At the very least, regulators owe the public a detailed explanation of how and why they believe that reducing capital requirements for derivatives clearing, secured repo transactions, and other similar activities would not increase risk to the systemically critical infrastructure for these activities. Such an explanation could, for example, explain whether and how margin requirements in the relevant markets were adequate to protect against the public despite the significant cut in underlying equity capital that backs them which is proposed here.

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[9] See page 6 and following in Hannoun, Herve, "The Basel III Capital Framework: A Decisive Breakthrough", Speech at Seminar on Financial Regulation, Hong Kong, December 22, 2010. Available at https://www.bis.org/speeches/sp101125a.htm

[10] https://www.newyorkfed.org/medialibrary/media/banking/nyfrb_triparty_whitepaper.pdf

[11] Commodity Futures Trading Commission, Supervisory Stress Test of Clearinghouses, A Report By Staff, November, 2016. http://bit.ly/2Aozueg

[12] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunites: Capital Markets, October, 2017. http://bit.ly/2fPPMR3

Risk Based Capital Requirements are Too Low

Even if one were to accept that a binding leverage ratio has significant social costs – and as discussed above, we do not believe this is supported by compelling evidence – an alternative way to ensure that the risk based capital ratio is binding is simply to increase risk-based capital requirements. This would change the relationship between leverage and risk-based capital requirements while increasing or at least maintaining overall capital ratios.

There is ample analytical evidence that current risk-based capital levels are too low from a cost-benefit perspective. Cost-benefit analyses of capital requirements are highly model and assumption dependent, and we realize that such estimates can be questioned. But there is by now a large and impressive academic literature finding that current risk based capital levels, including the G-SIB surcharges at the largest systemically critical banks affected by this proposal, are either at the low end or clearly below the range of socially optimal levels. This literature includes several academic papers from Federal Reserve staff.[13] An extensive literature review from the Peterson Institute finds that current equity capital requirements are about one-third too low.[14] Other research by expert and reputable sources such as the Federal Reserve Bank of Minneapolis finds that current capital requirements are even farther below the socially optimal level and should be drastically increased to avert the costs of potential financial crisis.[15] The clear indication from this research is that the optimal way to align leverage ratios with risk based capital ratios is not to slash leverage ratio requirements, but to increase risk-based capital requirements.

The weight of the literature points clearly to the conclusion that cutting the absolute ratio of capital to total exposures, as this proposal would do, is not justified by the evidence and would be socially harmful. It is striking that the Agencies appear not even to have considered the option of increasing capital requirements or to have analyzed the research on this issue.

Other Questions

Question 1: To what extent would the proposed eSLR standards appropriately balance the need for regulatory standards that enhance systemic stability with the long-term goal of credit availability, efficiency, and business growth? What alternatives, if any, should the Board and the OCC consider that would more appropriately strike this balance?

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[13] Firestone, Simon, Amy Lorenc, and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S.", Finance and Economics Discussion Series 2017-034. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.034; Passmore, Wayne, and Alexander H. von Hafften (2017). "Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?," Finance and Economics Discussion Series 2017-021. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.021

[14] Cline, William, The Right Balance for Banks: Theory and Evidence on Optimal Capital Requirements, The Peterson Institute, May, 2017.

[15] https://www.minneapolisfed.org/research/staff-reports/capital-requirements-and-bailouts ; https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-2016.pdf?la=en

If the Board and the OCC wish to change the calibration of the leverage ratio to risk-based capital, they should consider the option of increasing risk-based capital rather than cutting leverage ratio requirements.

Question 2: How would the proposed calibtration of the eSLR standards affect business decisions of GSIBs and covered IDIs?

As the proposal indicates, the change in the eSLR standards would increase incentives for GSIBs and covered IDIs to expand businesses that have low equity funding requirements under risk-based capital rules. These businesses range from cleared derivatives to dealing in sovereign debt with a zero risk weight. The Federal Reserve and OCC should consider whether these businesses are truly "low risk" as described in the proposal, particularly when funded with larger amounts of leverage.

Question 5: Should the Board and the OCC consider alternative approaches to address the relative bindingness of leverage requirements to risk-based capital requirements for certain firms? Specifically, what are the benefits and drawbacks of excluding central bank reserves from the denominator of the supplementary leverage ratio as an alternative to the proposal?

We would be concerned that the exclusion of central bank reserves would undermine the purpose of the leverage ratio as a guarantee that all exposures of the bank are backed with equity capital. While central bank reserves are government-backed and are not exposed to immediate risk of loss, we would be concerned that such reserves could be re-deployed rapidly in ways that would not be reflected immediately in leverage ratio calculations.

We also urge the Federal Reserve and the OCC to take steps to address the interaction of this proposal with recently passed legislation (S 2155) that would exclude central bank reserves associated with activity by custody banks from the leverage ratio. In combination with the very large reduction in the eSLR that would be created by this proposal, the implementation of S 2155 would reduce leverage ratios at custody banks well below the 3 percent requirement faced by non-GSIB banks. Since custody banks play a systemically critical role in finance, this would be entirely inappropriate. In light of the passage of S 2155, this proposal should at least be significantly modified to reduce or eliminate the leverage ratio reductions for custody banks.

Thank you for the opportunity to comment on these proposals. If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672. Thank you for your attention to this letter.

Sincerely,

Americans for Financial Reform Education Fund