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Congress of the United States
House of Representatives

FINANCIAL SERVICES COMMITTEE
Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity
Subcommittee on Domestic and International Monetary Policy, Trade and Technology

FOREIGN AFFAIRS COMMITTEE
Subcommittee on International Organizations, Human Rights, and Oversight
Subcommittee on Middle East and South Asia

September 24, 2009

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

The Honorable Timothy Geithner
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Chairman Bernanke and Secretary Geithner,

As you know, excessive leverage was a key component of the financial crisis. Investment banks leveraged their balance sheets to stratospheric levels by using short-term wholesale financing (like repurchase agreements and commercial paper). Meanwhile, some entities regulated as bank holding companies (BHCs) used off-balance-sheet entities to warehouse risky assets, thereby evading their regulatory capital requirements. These entities' reliance on short-term debt to fund the purchase of oftentimes illiquid and risky assets made them susceptible to a classic bank panic. The key difference was that this panic wasn't a run on deposits by scared individuals, but a run on collateral by sophisticated counterparties.

The Treasury highlights this very problem in its policy statement before the recent summit of G-20 finance ministers in London. To address this problem, the Treasury advocates stronger capital and liquidity standards for banking firms, including "a simple, non-risk-based leverage constraint." The U.S. is one of only a few countries that already has leverage requirements for banks. Leverage requirements supplement risk-based capital requirements that federal banking regulators have in place pursuant to the Basel II Accord, an international capital agreement. While important features of our system of financial regulation, leverage requirements only apply to banks and bank holding companies and therefore have not covered a wide array of financial institutions, including many that are systemically important. Moreover, leverage requirements have generally not captured the considerable risks associated with off-balance-sheet activities.

Of course, the Administration looks to address the shortcomings in the existing regulatory system through a proposal to regulate large, systemically-significant financial institutions as Tier 1 Financial Holding Companies (FHCs). Building upon its existing authority as the consolidated supervisor of all BHCs (which includes FHCs), the Federal Reserve would be responsible for overseeing and regulating the Tier 1 FHCs under the plan. In the legislative draft of the proposal, the Federal Reserve would have the authority to prescribe capital requirements and other prudential standards for these institutions that are stronger than those for all other BHCs. To that point, the text specifically says, "The prudential standards shall be more stringent than the standards applicable to bank holding companies to reflect the potential risk posed to financial stability by United States Tier 1 financial holding companies and shall include, but not be limited to—(A) risk-based capital requirements; (B) leverage limits; (C) liquidity requirements; and (D) overall risk management requirements."

The application of leverage limits – as advanced by the Treasury's G-20 policy statement and by the Administration's financial regulatory reform plan – is a simple and elegant way to limit risk at specific financial institutions (and within the overall financial system). The financial crisis has underscored the importance of leverage requirements and manifested the problems associated with relying upon risk-based capital requirements alone. While the ostensible purpose behind the Basel II Accord was to align economic and regulatory capital, the agreement's reliance upon the ratings of credit rating agencies and on the internal risk assessments of the banks themselves has been seriously called into question by recent events. A leverage requirement has the advantage of setting a minimum standard irrespective of what more subjective and assumption-based capital calculations may suggest.

Nevertheless, there are some open questions regarding exactly how a leverage requirement should be applied. Some scholars and policy experts have advocated putting in place a leverage requirement for banks and other financial institutions that is set in statute. As Congress moves forward on comprehensive financial regulatory reform, it may consider such a requirement. I would therefore be interested to hear your views regarding the wisdom of such an approach.
As you know, setting capital standards requires decisions regarding what institutions would be covered, how capital would be defined, and what levels the requirements would be set. In light of that, what specific difficulties would you anticipate Congress facing with respect to specifying such a requirement? In addition, would a statutory requirement be too inflexible and place too many constraints on regulators with respect to refining regulatory capital requirements and negotiating with bank regulators from other countries?

Thank you for your consideration of these questions. I look forward to your responses.

Sincerely,

Keith Ellison
MEMBER OF CONGRESS