August 6, 2012

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Bernanke:

We write today to impress upon the Board the importance of robust and reasoned capital standards that will preserve the safety and soundness of our financial system for years to come. Your proposed rule on capital standards misses a huge opportunity to address the too-big-to-fail issue by setting the so-called SIFI surcharge far too low. We urge you to revisit your proposed rule and modify it so that megabanks fund themselves with proportionately more loss-absorbing capital per dollar of assets than smaller regional or community banks. The surcharge on the megabanks should be high enough that it will either incent them to become smaller or will help to ensure they can weather the next crisis without another taxpayer bailout.

Placing higher capital requirements on megabanks is a common sense way to fix the dangers of too-big-to-fail. As you have said in the past, research done by the Federal Reserve and other regulators shows the tougher capital requirements will "significantly reduce the threat of a massive financial crisis" while doing little to limit economic growth.[1] The megabanks should bear their own risks and have their financial incentives positively aligned in a way that protects U.S. taxpayers.

Greater capital is essential to withstand inevitable losses in the banking industry. In the 1920s and 1930s, the big New York banks funded 15 to 20 percent of their assets with capital. This enabled them to survive the Great Depression.[2]

Section 165 of the Dodd-Frank Act provides the Board with authority to set enhanced risk-based capital requirements and leverage limits for systemically important financial institutions.[3] Section 165 authorizes the Board to "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate."[4] As the committee report accompanying the Senate-passed Restoring American Financial Stability Act makes clear, "[t]he

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[1] *See* Dave Clarke, *Bernanke Defends Capital Standards for Big Banks*, REUTERS, June 22, 2011 *available at* http://www.reuters.com/article/2011/06/22/us-financial-regulation-capital-idUSTRE75L7K620110622.
[2] *See* Charles W. Calomiris, *The 1930's Capital Crunch and Scramble to Shed Risk*, NBER Working Paper 6649 (1998).
[3] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 165(b)(1)(A)(i) (2010).
[4] *Id.*, at § 165(a)(2)(A).

standards and requirements shall . . . increase in stringency as appropriate in relation to certain characteristics of the company, including its size and complexity."[5]

Your proposed rule implementing the Section 165 enhanced prudential standards states that the capital surcharges for Systemically Important Financial Institutions (SIFIs) would be "based on the B[asel] C[ommittee] on B[anking] S[upervision] framework[.]"[6] The Basel Committee on Banking Supervision has already proposed requirements of 7 percent Tier One Common Equity and 8.5 percent Tier One Capital, with an additional proposed surcharge between 1.0 percent and 2.5 percent for globally systemically important banks (G-SIBs).[7] The G-SIB surcharge is based upon the following indicator categories: 1) cross-jurisdictional activity; 2) size; 3) interconnectedness; 4) substitutability; and 5) complexity.[8]

Your proposed rule requests input regarding the appropriate scope of application for a SIFI capital surcharge.[9] Bank of Canada Governor Mark Carney has said that "the Basel rules have always been, and continue to be, international minimums, rather than a 'one-size-fits-all' approach."[10] We agree with this view, and support the recent statement of Governor Daniel Tarullo that enhanced capital rules will be "graduated based on the systemic footprint of the institution."[11] All SIFIs are not created equal, and, when crafting capital surcharges in accordance with Basel III and Section 165, the Board should keep in mind the distinctions between money-center banks and regional banks. Systemic risk capital buffers should be imposed based upon the actual risks posed to the system, not merely in response to designation as a SIFI.

Regulators must oversee SIFIs – including their capital requirements – commensurate with their size and risk, as required by the Basel rules and the Dodd-Frank statute and its accompanying legislative history.[12] Indeed, the Basel Committee has identified 29 institutions as G-SIBs.[13] Of

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[5] S. Rep. No. 111-176, 55 (2010).
[6] *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594, 604 (Jan. 5, 2010).
[7] *See* Basel Committee on Banking Supervision, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" 64 (June 2011); *see also* Basel Committee on Banking Supervision, "Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement" 15 (July 2011).
[8] *See id.*, at 5.
[9] *See Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. at 604.
[10] Mark Carney, Governor of the Bank of Canada Remarks before the Institute of International Finance, Washington, D.C., Sept. 25, 2011 at 1.
[11] Statement by Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 6, 2012 at 4.
[12] Governor Tarullo has acknowledged that the Dodd-Frank Act provides supervisors with the authority to require, on an institution-specific basis, some banks to maintain capital ratios above the minimum levels established by the Basel agreement. *See* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, "The Evolution of Capital Regulation," 13, Remarks to the Clearing House Business Meeting and Conference, Nov. 9, 2011.
[13] *See* Basel Committee on Banking Supervision, "Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement" at 10.

the eight U.S. institutions on this list, none are regional banks.[14] Examining the indicators proposed by the Basel Committee reveals the distinctions between money-center banks and regional institutions. These metrics clearly demonstrate that U.S. regulators must focus their efforts to impose enhanced capital requirements on the largest, most complex financial institutions, and not the smaller, regional institutions that engage in traditional banking services and whose systemic footprint is limited or inconsequential.

Cross-Jurisdictional Activity

Cross-jurisdictional activity includes cross-jurisdictional claims and cross-jurisdictional liabilities.

Currently, the nation's largest and second-largest banks have subsidiaries based in 37 and 50 countries, respectively.[15] Some estimate that the five largest American banks have between $45 and $80 billion in exposure to the PIIGS countries.[16] Estimates of total guarantees, including government, bank, and corporate debt range as high as $518 billion.[17] Others also note that the biggest banks have considerable direct exposure to periphery countries, as well as indirect exposure to countries like France and Germany that also have considerable exposures to the periphery.[18]

These institutions present unique challenges that regional banks do not. The international nature of such large, complex, global institutions makes front-end regulation more difficult.[19] In the event of failure, their cross-jurisdictional nature also makes orderly resolution more complicated.[20]

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[14] *See* Financial Stability Board, "Policy Measures to Address Systemically Important Financial Institutions" 4, Nov. 4, 2011 (including Bank of America, Bank of New York-Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo as the only U.S.-based G-SIFIs).

[15] *See* JPMorgan Chase 10-K at Exhibit 21; *see also* Bank of America 10-K at Exhibit 21.

[16] *Compare* Yalman Ornaran, *Selling More CDS on Europe Debt Raises Risk for U.S. Banks*, BLOOMBERG, Nov. 1, 2011 ("The five firms had total net exposure of $45 billion to the debt of Greece, Portugal, Ireland, Spain and Italy, according to disclosures the companies made at the end of the third quarter.") *with* Peter Eavis, *U.S. Banks Tally Their Exposure to Europe's Debt Maelstrom*, N.Y. TIMES, Jan. 29, 2012 ("Five large American banks, including JPMorgan Chase and Goldman Sachs, have more than $80 billion of exposure to Italy, Spain, Portugal, Ireland and Greece, the most economically stressed nations in the euro currency zone, according to a New York Times analysis of the banks' financial disclosures."). The PIIGS countries are Portugal, Italy, Ireland, Greece, and Spain.

[17] *See* Onaran, *supra.*

[18] *See* Anil Lalchand, "U.S. Bank Exposure to Peripheral Europe: More than Meets the Eye?" 2-4, DoubleLine Capital, L.P., July 5, 2011.

[19] *See* Financial Crisis Inquiry Commission, THE FINANCIAL CRISIS INQUIRY REPORT 351 (2011) ("'At the simplest level … an organization like OTS cannot supervise AIG, GE, Merrill Lynch, and entities that have worldwide offices … It's like a gnat on an elephant—there's no way.'").

[20] *See* Daniel K. Tarullo, "Regulating Systemically Important Financial Firms," speech delivered at the Peter G. Peterson Institute for International Economics (June 3, 2011) at 4 ("The legal and practical complexities implicated by the insolvency of a SIFI with substantial assets in many countries will make its orderly resolution a daunting task, at least for the foreseeable future."); *see also* Michael Hirsh, "The Resurrection", NAT'L JOURN., Mar. 28, 2011 ("'Citibank is a $1.8 trillion company, in 171 countries with 550 clearance and settlement systems,' says one senior Federal Reserve Board regulator who would speak frankly only on condition of anonymity. 'We think we're going to effectively resolve that using Dodd-Frank? Good luck!'").

Size

An institution's size is significant because the IMF reports that the size of an institution, relative to its home country GDP or relative to the financial system, seems to play a key role in decisions about whether the bank receives a bailout in the event of distress.[21]

In 2006, before the financial crisis, the top 10 banks held 68 percent of total bank assets.[22] By the end of 2010, they held 77 percent of total banking assets.[23] During the financial crisis, the six largest banks, in particular, experienced the most dramatic growth, with the nine largest banks and securities firms consolidating into what are now the six largest bank holding companies.[24] As a result of these mergers, three of the four largest megabanks grew by an average of more than $500 billion.[25]

The assets of the six biggest U.S. banks currently equal 62 percent of U.S. Gross Domestic Product, up from 18 percent in 1995.[26] Together, these six banks are now twice as large as the rest of the top 50 U.S. banks combined.[27] The assets of the largest regional bank amount to 2.2 percent of U.S. GDP; 2.8 percent of U.S. commercial banking assets; and 2.6 percent of U.S. commercial banking deposits.[28] A $50 billion BHC's assets amount to approximately 0.3 percent of U.S. GDP; 0.4 percent of U.S. commercial banking assets; and 0.6 percent of U.S. commercial banking deposits.

Interconnectedness

Interconnectedness is measured by intra-financial system assets, intra-financial system liabilities, and the ratio of wholesale funding.

It has been estimated that in mid-2008, the five largest broker dealers collectively financed 42 percent of their assets through repo borrowing.[29] The largest banks have been transformed "since the early-1980s from low return on-equity (RoE) utilities that originate loans and hold and

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[21] *See* İnci Ötker-Robe, Aditya Narain, Anna Ilyina, & Jay Surti, *The Too-Important-to-Fail Conundrum: Impossible to Ignore and Difficult to Resolve*, IMF SDN/11/12, May 27, 2011, at 8.
[22] *See* Cady North, *Too-Big-to-Fail Banks Get Bigger After Dodd-Frank*, BLOOMBERG GOVERNMENT (Mar. 2011) at 10.
[23] *See id.*
[24] *See* Simon Johnson & James Kwak, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 180 (Pantheon, 2010).
[25] *See id.*
[26] Calculation based upon FFIEC data and Bureau of Economic Analysis data; *see also* Johnson & Kwak, *supra*, at 203.
[27] Calculation based upon FFIEC data, excluding assets of Metlife. The six largest (JPMorgan, Bank of America, Citigroup, Wells Fargo, Goldman, and Morgan Stanley) have $9.51 trillion in assets, while the rest of the top 50 (excluding MetLife) have $4.48 trillion in assets.
[28] *See* Press Release, National Income and Product Accounts Gross Domestic Product, Bureau of Economic Analysis, May 31, 2012; *also* U.S. Bancorp, Bank Holding Company Performance Report, March 31, 2012; *also* Board of Governors of the Federal Reserve System, Insured Commercial Bank Assets and Liabilities, Domestic and Foreign Offices (4.20), March 31, 2012.
[29] *See* Testimony of Marc Jarsulic, Chief Economist, Better Markets, Inc., before the Senate Committee on Banking Housing and Urban Affairs Subcommittee on Financial Institutions and Consumer Protection, "Is Simpler Better? Limiting Federal Support for Financial Institutions" 13, May 9, 2012.

fund them until maturity with deposits, to high RoE entities that originate loans in order to warehouse and later securitize and distribute them, or retain securitized loans through off-balance sheet asset management vehicles."[30] As a result of this transformation, "the nature of banking has changed from a credit-risk intensive, deposit-funded, spread-based process, to a less credit-risk intensive, but more market-risk intensive, wholesale funded, fee-based process."[31]

Substitutability

The measures of substitutability include assets under custody, payments cleared and settled through payment systems, and values of underwritten transactions in debt and equity markets.

The largest U.S. banks have substantial footprints in both commercial banking and capital markets activities. George Washington University Law Professor Arthur Wilmarth estimates that these firms were responsible for, "about $9 trillion of risky private-sector debt … in the form of nonprime home mortgages, credit card loans, CRE loans, LBO loans and junk bonds … [and] $25 trillion of structured-finance securities and derivatives whose value depended on the performance of that risky debt, including MBS, ABS, cash flow CDOs, synthetic CDOs and CDS[.]"[32]

There is still a high degree of concentration among the largest institutions across various financial products:

- As of September 30, 2010, the six biggest banks accounted for 35 percent of all U.S. deposits and 53 percent of all banking assets;[33]
- The six largest banks also service roughly 56 percent of all mortgages, and nearly two-thirds of the mortgages in foreclosure;[34]
- In 2011, the top 10 banks underwrote 70 percent of the municipal bond offerings, with the top three – JPMorgan, Citi, and Bank of America Merrill Lynch – underwriting 38.3 percent of all business.[35]

Finally, the largest U.S. bank is also the second-largest player in the settlement of contracts in the $1.8 trillion-a-day tri-party repo market.[36]

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[30] *Id.*, at 22.
[31] *Id.*
[32] Testimony of Arthur E. Wilmarth, Jr., before the Subcommittee on Financial Institutions and Consumer Protection, Senate Committee on Banking, Housing, and Urban Affairs, "Enhanced Supervision: A New Regime for Regulating Large, Complex Financial Institutions" 9, Dec. 7, 2011.
[33] *See* Robert G. Wilmers, 2010 Annual Report to Shareholders, February 18, 2011 *available at* http://mtb.mediaroom.com/2010message.
[34] *See* Robert G. Wilmers, 2011 Annual Report to Shareholders, February 23, 2012 *available at* http://mtb.mediaroom.com/2011message.
[35] *See* Robert Slavin, *Top Firms Still Take Biggest Slice*, THE BOND BUYER, Mar. 1, 2012.
[36] *See* Darrell Duffie, *Replumbing Our Financial System: Uneven Progress* 8, Apr. 23, 2012 *available at* http://www.darrellduffie.com/uploads/working/DuffieReplumbingApril2012.pdf.

Complexity

The measures of complexity include over-the-counter derivatives notional value, Level 3 assets, and trading book and available for sale securities values.

Professor Wilmarth told the Subcommittee on Financial Institutions and Consumer Protection that "eighteen major L[arge] C[omplex] F[inancial] I[nstitution]s ... were the dominant players in global securities and derivatives markets during the credit boom."[37] In 2010, the trading revenues of the six largest U.S. institutions represented 93.1 percent of such revenues at all American banks.[38] The top five commercial banks are responsible for 96 percent of the notional value of derivatives contracts at U.S. banks and 86 percent of the industry's credit exposure.[39] Five of the six largest bank holding companies – Bank of America, Citigroup, Goldman Sachs, J.P. Morgan, and Morgan Stanley – are part of the so-called "G14 institutions" that do most of the trading in OTC derivatives world-wide.[40] The largest banks also hold the vast majority of their derivatives exposure in their insured depository institution affiliate.[41]

In 2007, Bank of America, Citigroup and JPMorgan Chase guaranteed asset-backed commercial paper in an amount that exceeded the total value of their combined Tier 1 capital by 50 percent.[42] According to some estimates, The U.S. banking system currently holds approximately $7 trillion in deposits, but the credit market includes $2.7 trillion in bank and leveraged loans, $3.3 trillion in commercial mortgages, $1.3 trillion in subprime mortgages, $5.8 trillion in non-agency prime residential mortgages, and $2.6 trillion in consumer loans.[43]

Concentrating complex, structured securities upon leverage loans and risky mortgages within the largest, most complex megabanks created what Professor Wilmarth calls a "pyramid of risk" caused by "multiple layers of financial bets."[44]

Global Megabanks Are Distinguishable from Regional Banks

In contrast to global banks, regional banks primarily serve business and consumer customers in their local markets. In 2011, regional banks made 1.9 million small business loans totaling $73 billion and provided $254 billion in commercial and industrial loans to medium-sized firms.[45] These banks focus on traditional lending, with loans accounting for two-thirds of their assets

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[37] Wilmarth Testimony, *supra*, at 8 n.25.
[38] *See* Wilmers, *supra*, note 30.
[39] *See* Office of the Comptroller of the Currency, *OCC's Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2011* at 1 (2012). The five referenced banks are JPMorgan Chase, N.A., Bank of America, N.A., Citibank, N.A., Goldman Sachs Bank USA, and HSBC Bank USA, N.A.
[40] *See* Jarsulic Testimony, *supra*, at 4.
[41] JPMorgan holds 99 percent; Bank of America holds 73 percent; Citigroup holds 104 percent; Goldman Sachs holds 92 percent. *See* Office of the Comptroller of the Currency, OCC's Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2012, at Table 1, Table 2.
[42] *See* Jarsulic Testimony, *supra*, at 11.
[43] *See* Viral V. Acharya, Thomas Cooley, Matthew Richardson & Ingo Walter, Manufacturing Tail Risk: A Perspective on the Financial Crisis of 2007–2009, 4 Foundations and Trends in Finance 249, 276-77 (2010).
[44] Wilmarth, *supra*, at 9.
[45] *See* Fact Sheet, "Regional Banks: Powering the Main Street Economy". Information provided by regional banks, or publicly available regulatory data.

(compared to about one-third for money-center bank holding companies (BHCs)). Commercial and industrial loans are 21 percent of regional bank lending compared to 11 percent at a typical money-center BHC.[46] In the last two years, lending at the four largest U.S. banks fell 4.9 percent – with their share of national loans shrinking by 2 percent – while regional banks increased their lending by 9.8 percent.[47]

Regional banks' risk-adjusted return on capital is also generally higher than those of large, complex banks – meaning that they have relatively safe assets and make steady returns.[48] Large, complex banks engage in activities like securities trading and underwriting, investment banking, and derivatives origination and trading, which are volatile and unpredictable.[49] Regional banks, by contrast, have limited financial market activity, with less than one percent of notional derivatives contracts and about one percent of trading assets.[50] Moody's recently downgraded the ratings of the six largest U.S. banks due to the "volatility and risks that creditors of firms with global capital markets operations face."[51] In doing so, Moody's noted that "these risks have led many institutions to fail or to require outside support."[52] They did not downgrade any regional banks.

Though some regional banks exceed the $50 billion threshold for "systemically important" banks, some have suggested that this designation is intended to be over-inclusive, in order to lessen the perception that the SIFI designation is synonymous with "too big to fail" status.[53] The former director of the Federal Reserve's Division of Banking Supervision and Regulation has reportedly said that, "nobody really regards $50 billion as systemically risky."[54] Markets have generally absorbed the failures of regional banks.[55] In 2008, the failure of the $307 billion thrift Washington Mutual came at "zero cost" to taxpayers, according to the FDIC.[56]

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[46] *See id.*

[47] *See* Laura Marcinek, *Biggest U.S. Banks Shrinking Loans as Regional Lenders Fill Gap*, BLOOMBERG, June 26, 2012.

[48] *See, e.g.*, Christopher Whalen & Dennis Santiago, "Are There Any Low Beta Financial Institutions? Creating Opportunities Based Upon Reduced Volatility, Enhanced Risk Adjusted Returns" 6-7, Institutional Risk Analytics (Feb. 2012).

[49] *See id.*, at 9.

[50] *See* Fact Sheet, "Regional Banks: Powering the Main Street Economy".

[51] Moody's Investor Service, Rating Action: Moody's downgrades firms with global capital markets operations, June 21, 2012.

[52] *Id.*

[53] *See* Daniel K. Tarullo, "Regulating Systemic Risk" 7, remarks at the 2011 Credit Markets Symposium, Charlotte, N.C. (Mar. 31, 2011) ("Part of the rationale for setting the statutory standard of $50 billion in assets for bank-affiliated firms was that the failure of some of these firms, while likely to cause some noticeable disruptions in financial relationships, would not be regarded as necessarily endangering the financial system. Any link between the list of firms and T[oo] B[ig] T[o] F[ail] is thereby attenuated.").

[54] Robin Sidel & Jean Eaglesham, *Vital? Not Us, Say Small Banks*, WALL ST. J., May 13, 2011.

[55] *See id.* ("Some analysts said the failure of a bank near the bottom of the systemically important list likely would cause little more than a ripple for the U.S. financial system. J.P. Morgan swooped in when Washington Mutual Inc. was seized by regulators in 2008, and PNC Financial Services Group Inc. quickly absorbed National City Corp.").

[56] *See* Dan Fitzpatrick & John D. McKinnon, *Panel Tries to Unravel WaMu's Failure*, WALL ST. J., Apr. 13, 2010. Though it is not a regional bank, markets also experienced very little disturbance when commercial lender CIT Group, went bankrupt with $71 billion in assets. *See* Tiffany Kary, Dawn McCarty & Lester Pimentel, *CIT Files Bankruptcy; U.S. Unlikely to Recoup Money*, BLOOMBERG, Nov. 1, 2009 *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a3.t_GrxbL2U.

Conclusion

As we have discussed at length, robust capital buffers will more appropriately align financial incentives and prevent future financial sector bailouts. However, in order to do so properly, you must have the Board revisit the proposed rule to implement Basel III and modify the rule to include a SIFI surcharge significant enough to change the incentives for the largest banks.

We agree with the Board's belief that enhanced capital requirements for the largest, most complex institutions will "meaningfully reduce the probability of failure of the largest, most complex financial companies and would minimize losses to the U.S. financial system and the economy if such a company should fail."[57] And, we further agree that G-SIFI capital surcharges "would help require that these companies account for the costs they impose on the broader financial system and would reduce the implicit subsidy they enjoy due to market perceptions of their systemic importance."[58] However, the proposed rule is ultimately just a baby step in the correct direction. The Board must do more in order to protect taxpayers and the financial system.

Properly constructed capital standards will take into account the extent to which institutions are already subject to capital requirements imposed by their respective regulators. Regulation of these institutions should not dramatically scale up or fall off a cliff once particular benchmarks have been reached. As Governor Tarullo has argued, $51 billion bank holding company should not be treated significantly differently from a $49 billion bank holding company, and we are encouraged to hear him say that that, "the supplemental capital requirement for a $50 billion firm is likely to be very modest."[59]

Oversight should not remain constant once particular thresholds have been crossed, so that a large regional bank that makes loans to consumers and small businesses is not treated the same way as a trillion-dollar money-center bank. Rules for capital and leverage should move on a sliding scale, with a focus on the largest and most complex megabanks.

Thank you for considering our views on this important matter.

Sincerely,

Sherrod Brown
Sherrod Brown
United States Senator

David Vitter
David Vitter
United States Senator

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[57] *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. at 604.
[58] *Id.*
[59] Daniel K. Tarullo, "Regulating Systemically Important Financial Firms" 6, speech delivered at the Peter G. Peterson Institute for International Economics (June 3, 2011).