Ladies and Gentlemen:

Former FDIC Vice Chairman Thomas Hoenig laid out a number of problems with the agencies’ proposal in 2015. We agree with all of the objections that he raised at that time. Rather than adding to that critique, we will make the general point that this proposal would exacerbate the already flawed way that our banking regulations measure derivatives exposures.

We will then argue that you should oppose the proposal, as set forth in question 17, to further weaken the leverage ratio applicable only to the biggest U.S. banks. Equity funding is by far the simplest and most effective way to protect the safety of the banking system, and the leverage ratio is one of the most important reforms enacted after the financial crisis of 2008. Your agencies have a duty to protect the public, reject the financial industry’s self-interested arguments, and ensure that the largest, most systemic banks have sufficient equity funding.

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1. The current method of accounting for derivatives risks is flawed, and the agencies should not double down on this approach.

In general, determining the risks posed by derivatives is highly dependent on predictive models. Experience shows us that, like any other human creation, models are often flawed and can be subject to bias, leading to failure in practice. In particular, the models that sought to measure the risks of derivatives transactions at the largest financial institutions before the financial crisis had significant shortcomings.

As products of financial engineering, derivatives can take many forms and can be structured in ways that potentially expose banking organizations to much more risk than transactions that are tied to underlying, real world economic activity. Given the complexities involved, assessing banks’ exposures to the risks created by derivatives is extremely challenging and depends heavily on having reliable accounting measurements, financial models, and projections of risks. As we have noted before, accounting-based measures that are highly subjective can mask risk; for example, the calculation of derivative values can greatly affect a bank’s balance sheet. The difference in treatment of netting between the U.S. and Europe, for example, can cause a bank’s equity ratios to vary by as much as 44 percent. The current U.S. approach to netting is flawed, and, unfortunately, the proposal goes even farther in increasing the recognition of netting.

Rather than adopting an approach that relies on more modeling and complexity, the agencies should acknowledge the limitations and frailty of human risk management, and take a more robust approach to risk measurement than the one contained in the proposal at issue, as well as under the current approach to netting. Rather than relying on systems that lead to an under-measurement of the risks posed by derivative contracts, the agencies should move to a system, similar to IFRS, that prevents banks from using netting to obscure the risks of derivatives on their balance sheets.

2. The agencies should not further weaken the already insufficient leverage ratio that applies to the biggest U.S. banks.

We also write today to underscore some fundamental principles of leverage regulation which lead us to oppose excluding any assets from the calculation of the leverage ratio. Vice Chair Hoenig has already laid out several reasons why the proposal, addressed in question 17, would be harmful.

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4 See, e.g., Saule T. Omarova, “The Quiet Metamorphosis: How Derivatives Changed the “Business of Banking,” 63 U. OF MIAMI L. REV. 1041, 1101 (2009)(“Derivative instruments allow counterparties a virtually unlimited degree of flexibility in structuring each individual transaction, with respect to the composition of the underlying assets, methods of calculating payment obligations, and other terms, each of which may easily multiply both potential losses and potential gains under the instrument.”).
5 See Anat Admati & Martin F. Hellwig, THE BANKERS’ NEW CLOTHES: WHAT’S WRONG WITH BANKING AND WHAT TO DO ABOUT IT, at Ch. 6 (Princeton University Press 2013) (showing that the ratio of equity to total assets for JPMorgan Chase at the end of 2011 was about 8% if assets were measured according to U.S. GAAP accounting standards but only 4.5% by IFRS accounting standards used in most European countries, resulting from the disparate treatment of derivatives).
6 See Hoenig, supra, at 4-6.
We do not need to repeat them here, but we want to emphasize that this change would be unwise and unsafe. If anything, the amount of equity at the largest U.S. banks is still too low, not too high.

While the banking industry and its allies argue that margin is “risk-reducing,” and therefore different from other assets, this label is misleading as it applies to the economics of a bank’s balance sheet. As Vice Chair Hoenig explains, under GAAP, banks can move customer margin off their balance sheet if their customers are entitled to the income from investing the customer margin; but if the bank elects to keep the income from investing the collateral, it is rightly counted as the bank’s asset. In the sense that customer margin invested by the bank creates an income stream that needs to be replaced if and when it is otherwise pledged, sold, or transferred, it behaves the same as any other asset. As a result, it requires a commensurate level of equity funding that can absorb losses or be deferred in the event that the funding stream is reduced or eliminated.

Further, it is important to note that the rules governing margin allow banks to invest customer collateral in instruments such as money market funds, which were a central cause of fragility during the financial crisis, and municipal bonds, which are considered low-risk (i.e., receive low risk weights) but which can be risky for the banks and may cause municipalities to borrow excessively. Banks are also permitted to use customer collateral in repurchase (“repo”) and reverse repo transactions, so long as they provide a guarantee to the customer.

“Risk-based” capital regulation has inherent flaws. In short, risk-based calculations rely upon flawed models to make predictive measurements of risk and create an artificial bias towards assets that regulators consider to be safer than they actually are. A leverage ratio, particularly if it is appropriately high, recognizes the inherent uncertainty in risk modeling and its associated projections. Incorporating subjective, politically motivated determinations about which assets are safe or not would be a first step toward making the leverage ratio more like risk-based capital. If margin is excluded, why not Treasury securities? It would be the beginning of the slide down the slippery slope.

7 See 17 C.F.R. § 1.25; see also Anat Admati & Martin Hellwig, “Bank Leverage, Welfare, and Regulation,” at 18 (Jan. 2019) (“Money market funds are another set of shadow banks that played a detrimental role in the crisis … [T]he run by customers on these funds, and the run by these funds on banks, were crucial in the collapse of money markets after the Lehman bankruptcy; the government even had to provide the money market funds with a kind of deposit insurance to end the runs. Even so, the regulation of money market funds has not changed much. The dependence of banks on the funds is still a source of substantial systemic risk.”), available at https://admati.people.stanford.edu/sites/g/files/sbiybj1846/f/publications/admati-hellwig-cigi-chapter-jan-2019.pdf
8 See 17 C.F.R. § 1.25.
3. The agencies should act in the public interest, and reject the banking industry’s self-interested arguments.

The banking industry has lobbied for these changes, invoking arguments that capital regulation is harming the markets, their customers, and by extension the economy. There is little evidence that this is the case. In fact, the banking industry has been making these claims to oppose increased capital regulation for years.10

First, proponents of weaker standards should present clear and compelling evidence that the rules that they are complaining about are having real and tangible impact on their customers, jobs, and the real economy. Instead, the evidence shows that the economy is strong and the banking industry just experienced another record year of profitability.11 Trading revenue is high relative to overall bank revenues, and compliance costs are near 20-year lows.12 The largest U.S. banks’ investment banking businesses have “strongly supported economic activity,” and they have been “actively engaged in derivatives clearing activities.”13 The percentage of derivatives contracts that are centrally cleared has increased slightly since banks began reporting this data in 2015, suggesting that the leverage ratio’s treatment of margin for cleared derivatives has not disincentivized clearing.14

Second, the banking industry is rehashing two old, but related, claims against equity requirements: that they force activities to move either to the “shadow banking system,” a system in which activities similar or identical to banking are provided by other types of institutions (such as money market funds), or that they push business overseas as a result of an “unlevel playing field.”15 In fact, the largest U.S. banks are still highly dominant in the derivatives markets.16 Indeed, their capitalization is a source of strength—not weakness—that has enabled them to capture market

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14 See OCC, Quarterly Report on Bank Trading and Derivatives Activities, supra, at 15.
16 See OCC, Quarterly Report on Bank Trading and Derivatives Activities, supra, at Table 1, Table 2 (showing that the four largest insured banks account for almost 90 percent of the notional derivatives at insured banks and thrifts, and that the five largest BHCs account for almost 90 percent of the notional derivatives at all BHCs); see also Gruenberg, “An Essential Post-Crisis Reform Should Not Be Weakened,” supra.
share from international competitors,\(^{17}\) will help them to lend throughout another economic downturn, and gives them the balance sheet capacity to absorb additional derivatives business in the event that one of their competitors is unable to continue providing services to customers. Even if that were not the case, failure to properly oversee one segment of the financial system is not an excuse to deregulate the others. The crisis made clear that regulators must monitor the entire system more effectively, do better in enforcing regulations, and intervene when risks build up. We all will suffer terrible consequences from failing to do so again.

Finally, in a common tactic, the banking industry has framed this change as benefitting its nonfinancial customers, the “end users.”\(^{18}\) While it is often argued that regulations, in particular greater equity, decreases market liquidity and forces banks to raise costs on its customers, the opposite is in fact true: increased equity funding actually increases liquidity and lowers banks’ funding costs.\(^{19}\) If your agencies are truly concerned about costs to the real economy, there are more pressing issues that need addressing. For example, the Federal Reserve should strengthen and finalize its proposed rules restricting financial holding companies’ involvement in merchant banking and physical commodities activities.\(^{20}\) The lack of proper oversight of these activities causes documented harms to end users and consumers.\(^{21}\)

### 4. Conclusion

Strong equity requirements and prompt action when a bank’s equity is depleted by losses are among the most effective regulations that help reduce the risks presented by a bloated and out-of-control financial system. Unfortunately, as if to underscore the effectiveness of capital regulation, the banking industry and its allies in policymaking positions have targeted a number of the capit

Too often, the conversation around regulation has focused on the interest of the private sector and neglected regulators’ duty to protect the public from excessive risk-taking.\(^{22}\) This is particularly

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\(^{18}\) See Noam Scheiber, “The Breakup,” The New Republic, June 16, 2010 (“Anyone could see that the banks were reviled in the aftermath of the crisis. But the end users-like airlines, which use derivatives to lock in fuel prices—were sympathetic, and they hailed from every congressional district in the country. ‘What they wanted was, “Hey, let’s get the dopey end users to go out and be the face of reform,’” recalls another person who participated in the strategizing. “‘We don’t have the credibility,’” available at https://newrepublic.com/article/75614/the-breakup.

\(^{19}\) See Admati & Hellwig, Bank Leverage, Welfare, and Regulation, supra.

\(^{20}\) See Board of Governors of the Federal Reserve System, Regulations Q and Y; Risk-Based Capital and Other Regulatory Requirements for Activities of Financial Holding Companies Related to Physical Commodities and Risk-Based Capital Requirements for Merchant Banking Investments, 81 Fed. Reg. 67,220 (Sept. 30, 2016).


\(^{22}\) See Anat R. Admati, “The Compelling Case for Stronger and More Effective Leverage Regulation in Banking,” Working Paper at 8 (Sept. 2014) (“The case for much more equity in banking … is based on the appropriate comparison of the costs and benefits to society of different funding mixes for banks. None of the private costs to bankers or shareholders from using more equity translate to a cost to society, because they are entirely based on
true in the case of derivatives. Instead of perpetuating a system that favors special interests over the public interest, your agencies should strengthen and simplify—not weaken—the capital and leverage rules, especially for the biggest U.S. banks.

Sincerely,

Anat R. Admati (admati@stanford.edu)  
Paul Pfleiderer (pfleider@stanford.edu)

See, Omarova, “The Quiet Metamorphosis,” supra, at 1104 (“Although the OCC routinely conditions the authorization of each specific bank's derivatives program on a supervisory assessment of its internal risk management system, the main emphasis in its interpretations is consistently on the profitability of derivatives activities for commercial banks and the importance of expanding their client base and enhancing their competitiveness vis-a-vis other providers of financial services.”). 