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March 6, 2018

Honorable Michael Crapo
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown,

Excessive and inefficient reliance on debt throughout the financial system was a key cause of the global financial crisis. The crisis exposed the inadequacy, poor design and ineffective enforcement of the regulations in place to prevent this excessive borrowing and the buildup of risk throughout the system. Indeed, many government policies perversely encouraged dangerous conduct and excessive borrowing. Regulatory reforms in recent years have attempted to ensure that banking institutions use more equity funding so that they are better able to withstand losses without becoming distressed or insolvent. However, these changes in so-called capital regulations fall far short of what is needed to provide the safety our citizens deserve and to reduce the distortions that government guarantees and subsidies to the banking sector create.[1]

The substantial benefits of well-designed capital regulations come at virtually no cost to society. If banks view funding with more equity as costly, it is only because they are able to benefit from outsized explicit and implicit subsidies when they borrow, subsidies that they do not receive when they fund with equity. Subsidies come at taxpayers' expense. They also perversely encourage and reward excessive risk taking, reckless and even unlawful practices, and inefficient size and complexity that make governance and regulation more challenging.

[1] The existence and significant magnitudes of these subsidies have been well documented. See, for example, Bryan Kelly, Hanno Lustig and Stijn Van Nieuwerburgh, "Too-Systemic-to-Fail: What Option Markets Imply about Sector-Wide Government Guarantees," *American Economic Review*, 2016, pages 1278-1319, and Gandhi, Priyank and Hanno Lustig, "Size Anomalies in U.S. Bank Stock Returns," *Journal of Finance,* 2015, Pages 733–768.

Given the importance of making the financial system safer and removing the distortions caused by government subsidies, we are alarmed and concerned that S.2155 contains some measures that are clearly moving us in the wrong direction by further weakening the most important leverage regulations. These proposed changes expose the public to unnecessary harm with no justification or offsetting benefits.

Current "leverage ratio" requirements allow major institutions to have only 5% or 6% equity relative to total assets. For context we note that these levels of indebtedness and risk taking would not be sustainable without government guarantees and support. Financial institutions persist with dangerously low equity levels, along with poor levels of disclosure and inadequate risk controls, because their creditors are unusually passive, since they are backed by deposit insurance, the use of collateral for non-deposit borrowing, and expectations of support from central banks and governments. We urge you to avoid making changes and allowing exemptions that would lead to the weakening of leverage requirements. [2]

Specifically we are concerned with following proposed changes:

- **Section 401 [Requirement for tailoring]:** Stating that regulators "shall" tailor requirements for specific institutions sounds benign, but tailoring is very likely to lead to weakening of the rules in a race to the bottom.[3] Financial institutions will attempt to argue that regulations should be reduced when in fact they should be increased given the significant benefits and no meaningful costs involved. Arguments framed in terms of cost-benefit considerations are often flawed by falsely considering purely private costs as costs to society. As discussed above, the cost of requiring higher levels of funding through equity rather than debt are entirely private costs due to the loss of subsidies. What the large banks lose is much more than offset by savings to the taxpayers and the substantial benefits for society as a whole from reducing risk and improving incentives.

- **Section 401 [Institutions with $50-$250 billion in assets]:** Exempting institutions with assets between $50 billion and $250 billion from enhanced supervision is potentially quite dangerous. These institutions are not community banks. The failure of one or more of them will cause significant disruption and collateral harm, particularly in the context of overall market turmoil. The Savings and Loans crises along with some other banking crises have also shown that even small institutions that all take similar risks and tend to fail at the same time can be dangerous and costly.

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[2] Many writings linked here https://www.gsb.stanford.edu/faculty-research/excessive-leverage explain why claims that equity (or "capital") requirements are "costly" are based on fundamentally flawed or misleading reasoning and analyses. Importantly, it is best to build up equity buffers when banks are profitable, and the easiest way to accomplish this is by reducing payouts to shareholders. Money paid to shareholder is no longer available to make loans or pay debts, and it we find it disturbing that dangerous institutions whose failure can cause significant havoc and present policymakers with stark choices again are allowed to pay virtually their entire profits to shareholders and managers, thus increasing their fragility and the fragility of the entire system.

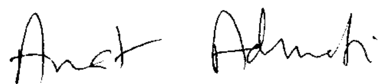
[3] See, for example, Sumit Agarwal, David Lucca, Amit Seru and Francesco Trebbi, "Inconsistent Regualtors: Evidence from Banking," *Quarterly Journal of Economics*, 2014, pages 889-938.

- **Section 401 [Foreign subsidiaries]:** It is critical that foreign institutions operating in the U.S. are regulated according to the risk that they pose to the U.S. economy and citizens. The financial entanglement of foreign subsidiaries with their often very large parent institutions must be taken into account in determining the rules, and this means that regulations should be based on the size and systemic risk of the worldwide entity. We must do what we can to protect our citizens through effective rules for all corporations operating in the U.S.

- **Section 402 [Weakening leverage regulations]:** This section proceeds on a misguided and dangerous path to reduce the denominator of the leverage ratio by ignoring certain assets. This step would move the rules in entirely the wrong direction and will likely lead to further erosion in financial stability. It would also exacerbate distortions that are already pervasive in banking, where investments are too often evaluated based on how the rules treat them rather than on whether they are worthy from society's broader perspective. (For example, AAA-rated yet risky mortgage securities or loans to governments may be more attractive to banks than making worthy business loans.)

Regulators have many tools to protect the public and improve the financial system. Whereas the benefits of some rules may be too small to justify their complexities and their costs, better regulation of the indebtedness of financial institutions is a highly beneficial and cost-effective way of addressing conflicts of interests between those in the financial sector and the rest of society. We would be happy to discuss the issues with you.

Sincerely,



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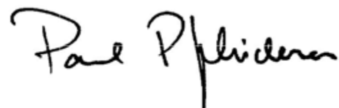

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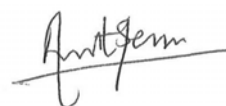

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