UNITED STATES SENATE

Ending Too Big To Fail:

Terminating Bailouts for Taxpayer Fairness Act

I. *Sec. 3 Establishes Enhanced Capital Rules to Ensure that Megabanks Gamble with Their Own Funds – not Taxpayer Dollars.*

Experts on both the left and the right agree that capital is a vital element of financial stability. Adequate capital levels lessen the likelihood that institutions will fail, and they lower the costs to the rest of the financial system and the economy if one does fail. Requiring banks to have more capital simply means that they must fund themselves with equity investments, rather than debt. Unlike debt, equity holders do not have a hard claim against the issuer; banks can lower or suspend payouts to equity holders without risking default. Converting a substantial portion of debt into equity would lessen financial pressure on institutions by replacing obligatory payments (including interest) with discretionary equity payouts.

Unfortunately, the existing international capital rules are insufficient to prevent another crisis. The rules are still too complex – the Bank of England's Andy Haldane has estimated that an average large bank would have to conduct more than 200 million calculations in order to determine their regulatory capital under the Basel II framework, which Basel III builds upon. The ratios are also too low – based upon average bank risk weights of 40 percent, the 10 percent risk-weighted Basel III ratio would allow institutions to leverage 25 times their equity, meaning that a bank would become insolvent if its assets declined by as little as 4 percent.

Requiring the largest banks to fund themselves with more equity will provide them with a simple choice: they can either ensure they can weather the next crisis without a bailout or they become smaller. Banks will argue that making them have more equity will require them to reduce lending and cause the economy to contract. But banks are not required to sell assets to meet the new rules – the will simply be required to raise more money by selling stock, rather than going to the debt markets. Banks have a range of options to meet the new standards including seeking out equity investments, retaining earnings, limiting dividends and stock repurchases, curtailing bonuses, or some combination thereof.

- **Community banks, mid-sized, and regional banks will have an 8 percent requirement.**

  According to the FDIC's Community Banking Study, community banks currently maintain leverage capital ratios approaching 10 percent of assets. FDIC Director Tom Hoenig has suggested that banks be required to fund themselves with $1 in equity for each $10 in assets. The Systemic Risk Council, chaired by Sheila Bair, argues that the minimum leverage ratio for capital to total assets should be 8 percent, and could in fact be double that amount.

- **Megabanks will meet a new 15 percent requirement.**

  This level is consistent with historic capital levels that banks maintained before the advent of the "safety net" – the variety of explicit and implicit government guarantees that support financial institutions. In the last 130 years, U.S. banks' assets have grown from 20 percent of GDP to 100 percent of GDP, while their capital ratios declined from about 25 percent to around 5 percent of total assets. Professor Allan Meltzer of Carnegie Mellon University estimates that large New York banks in the 1920s funded themselves with Tier 1 capital ranging from 15 to 20 percent of their assets, while Hoenig puts that number between 13 and 16 percent.

  Regulators may increase capital ratios as banks increase in size. Setting capital levels for the largest megabanks at levels required by the private market, absent government support, will ensure that they have an adequate cushion of equity in the event that the FDIC must put a megabank through orderly liquidation under Title II of Dodd-Frank.

- **New rules will focus on common equity and other truly loss-absorbing forms of capital.**

  The legislation focuses on core shareholder equity, without intangible instruments or goodwill. Haldane has found that simple measures of equity and leverage actually have predictive value that is ten times greater than that of complex risk-weighted asset measurements. Prior to the crisis, Lehman Brothers ostensibly had a capital ratio of 11 percent, yet its assets were sold in bankruptcy for nine cents on the dollar. During the crisis, markets ignored certain instruments that qualified as Tier 1 capital but were not reliable buffers against loss and focused on whether institutions had sufficient levels of common equity.

- **Capital ratios will be based on total assets to prevent megabanks from gaming the system.**

  Risk-weighting can obscure banks' true capital situations, distorting the views of markets and regulators, and undermining investor confidence. Basel II relied on a risk-weighting system that inaccurately assigned safe ratings to mortgage-backed security collateralized debt obligations (CDOs) and credit default swaps (CDS) that actually amplified risk instead of mitigating it. According to regulatory filings, Bank of America has reduced its ratio of risk-weighted assets to total assets by 19 percent since the beginning of 2009. Risk weighting now allows the three largest U.S. banks to shrink their balance sheets between 46-48 percent. There are indications that things may not change significantly under Basel III. Megabanks have already said that they will "manage the hell out of [Risk Weighted Assets]," and the JPMorgan London Whale incident resulted in part from risk models aimed at "optimizing regulatory capital."

  U.S. accounting rules for derivatives allow banks to net out all derivatives that they have with counterparties, and ignore counterparties' credit risk. Hoenig has argued that banks should adopt the European approach to netting – an idea that was also proposed by U.S. regulators during the Basel 3 negotiations – which would effectively increase the biggest banks' balance sheets by about $4 trillion in assets.

- **Affiliates and subsidiaries of large bank holding companies will be separately capitalized.**

  Financial companies operating under one holding company will be adequately capitalized, as would be required if they were stand-alone companies. This will ensure that highly leveraged lines of business do not threaten the wellbeing of other affiliates or the entire enterprise. Sheila Bair has said that creating stand-alone subsidiaries will make large, complex banks easier to put into resolution if they run into trouble.

- **Regulators will replace BASEL 3 with new capital rules that require more and purer forms of capital, don't rely on risk weights, and are simple and easy to understand and comply with.**

  Our economy benefitted from regulators' refusal to sign on to Basel 2. With strong new capital rules, the U.S. will continue to lead by example in the financial community. Regulators will continue to have legal authority to adopt strong rules for liquidity and other metrics. They will also have the option of using tools like risk-based capital measures for larger banks or supervisory authority to ensure that banks to not over-invest in the riskiest assets.

II. New Measures Will Ensure That the Government Safety Net Begins and Ends at the Commercial Bank and that Non-Bank Subsidiaries Will Not Benefit from Subsidies.

- **Sec. 4 tightens rules that allow banks that have access to the safety net to transfer assets into taxpayer-backed affiliates.**

- **Sec. 5 prohibits the Federal Reserve or other banking regulators from allowing non-depositories access to Federal Reserve discount window lending, deposit insurance, and other facilities that were used to bail out the financial sector in 2007-08.**

  Nonbank financial companies will be prohibited from transferring assets or liabilities into federally supported banks. The sweep of the federal safety net was expanded during the financial crisis of 2008, when Goldman Sachs and Morgan Stanley converted to bank holding companies, in large part to participate in Federal Reserve programs, including the Federal Reserve's discount window. The Federal Reserve has also extended the safety net to cover repurchase agreements, or "repos," and derivative dealing activities. Richmond Federal Reserve President Jeffrey Lacker estimates that 57 percent of the entire financial sector – more than $25 trillion in liabilities – is now covered by the safety net.

  Support provides certain bank subsidiaries with higher credit ratings, encouraging institutions to shift their risk to these subsidiaries. For example, Bank of America moved $15 trillion in derivatives contracts from its broker-dealer, Merrill Lynch, to its insured depository institution affiliate in response to a credit downgrade. The result is that taxpayers would subsidize, and ultimately backstop, potentially risky investments. This move reportedly saved the bank $3.3 billion in additional collateral payments.

  This legislation limits federal support commercial banks, as was originally intended when the safety net was created. Hoenig and Dallas Fed President Richard Fisher have argued that taxpayers should not subsidize risky activities. We agree.