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September 25, 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,

Thank you for the opportunity to comment on the hearing scheduled for October 2, 2018 on the implementation of S.2155. Three of us sent you a letter on March 6, 2018 when the law was being discussed.¹ We were concerned that the “tailoring” proposed in S.2155 would be used to lower equity requirements and thus endanger the financial system. These concerns are even stronger today. We are alarmed by the recent push from some industry participants and policymakers to weaken capital regulation, since capital regulation, when implemented properly, is the most essential, beneficial, and cost-effective part of banking regulation.

Effective capital regulation requires that financial institutions obtain a substantial part of their funding from equity by issuing stock or retaining earnings. Substantial equity means significantly more than current regulations require: at least 15 percent of properly measured assets, compared to levels such as 3 percent under Basel III or 5 percent for the largest Bank

¹ <https://www.gsb.stanford.edu/sites/gsb/files/admati-pfleiderer-seru-letter-s.2155-final.pdf>

Holding Companies in the U.S.² Equity capital automatically absorbs losses and reduces the chances of insolvency, bankruptcy, financial crises, and bailouts. Equity capital makes the financial system on its own resilient to losses, and also insulates the system against regulators' failure or inability to spot risks ahead of time or to properly regulate risk-taking.

The flaws in current regulation go beyond dangerously low equity requirements. The rules allow banks to count as regulatory capital some debt securities that are much inferior to equity for loss absorption. These are referred to as Tier 2 capital, contingent capital, or Total Loss Absorbing Capacity (TLAC). These securities are poor substitutes for equity in capital regulations. Shareholders absorb losses automatically through declines in the share value, while the other securities involve triggers and complex mechanisms to impose losses on creditors. In the financial crisis, the holders of such securities were paid in full and did not absorb losses even as the issuing institutions received massive supports from governments and central banks.

The use of asset risk weights to calibrate capital requirements is also inherently flawed. In the financial crisis and more recently in Europe, many institutions collapsed from losses on securities considered perfectly safe by such regulations. Risk weights distort banks' investment decisions away from lending to consumers and businesses and toward securities, many constructed to meet risk weights. Risk weights encourage innovation to manipulate rules in ways that often increase systemic risk.

Financial institutions often complain that raising equity is costly. This complaint ignores the distinction between private and social costs. Equity appears costly to banks because the use of debt allows them to enjoy higher subsidies through tax savings and the ability to shift risks to the taxpayers. But more equity capital is not more expensive to society as a whole, which pays those subsidies. Banks clamouring for looser capital requirements are, in effect, clamouring for taxpayer subsidies, subsidies that perversely increase systemic risk. You must resist. Bank stocks have boomed in the last few years, even as capital requirements have risen, showing how empty is the claim that banks cannot function with higher equity capital requirements.

Regulators and bankers may tell you that the Fed's stress tests should reassure us about the safety of banks, despite banks' extensive reliance on borrowed money. However, risks facing financial institutions are inherently difficult to predict, describe, and quantify, and they are hard to anticipate both by the banks and by their regulators. Stress tests are based on models with numerous questionable assumptions. These models cannot reliably identify major sources

² A 2010 letter from twenty finance and banking scholars whose signatories include Nobel-prize winners William F. Sharpe and Eugene F. Fama states that "if at least 15 percent of total, non-weighted assets were funded with equity, the social benefits would be substantial. And the social costs would be minimal, if any," <https://www.gsb.stanford.edu/faculty-research/excessive-leverage/healthy-banking-system-goal>

of risk and their consequences in the highly complex and interconnected system. Stress tests gives a false sense of safety.

The claim that some institutions should be allowed to operate with less equity because they are not “systemic” is also false. Many crises, including the huge banking crisis of the Great Depression and the Savings and Loan debacle of the 1980s, involved the simultaneous failure of many small institutions. During the financial crisis of 2008-2009, thousands of banks of all sizes, not just the largest, as well as some non-banks, required support that was delivered through trillions in loans and investments by governments and central banks in US and Europe. Creditors run on small banks as well as on big ones if they are concerned about the safety of their funds. Proper equity requirements are critical for institutions of all sizes.

You might also hear that current capital requirements lead big banks to trade less than they used to trade, thus making some markets less “liquid.” But this claim too argues for *more*, not less, equity. It is actually poor-capitalization of banks and the many prior debt commitments hanging over them that distort their trading decisions. If banks have enough equity that their debt is close to being risk free, the distortions that arise from overhanging debt would disappear.

We do not write in support of all regulations. Many regulations are not targeted at documented market failures or are too complex and costly relative to their benefits. These regulations are wasteful for society. Regulating the mix of funding to require more equity and less short-term debt, however, goes to the heart of fragility in banking. It removes distortions caused by government subsidies and can be done simply and transparently. Indeed, requiring more equity capital is a step toward de-regulation since it would enable the simplification or elimination of complex, expensive or counterproductive regulations, and promote competition and innovation.

The current high profitability of banks and strong economy provide regulators with a golden opportunity to strengthen and improve equity requirements so the financial system can continue to function well in a downturn.

Historically, regulators have eased off in the boom, often caving in to pressure from enthusiastic bankers, and thereby making the subsequent crisis worse. We must not repeat the same mistakes.

At this hearing, we urge you to press the banking regulators to answer the following question:

Over the 10 years since the crisis, regulators have substantially increased capital requirements. The economy is booming, lending is up, and bank profits are high. Now that we have all learned that the scare stories about capital are false, why would you not complete the job, raising equity capital requirements further so that the financial system can easily weather the next downturn? You need only to require firms to retain earnings

rather than pay them out to shareholders. Why repeat the errors of the past by loosening capital requirements in the boom that always precedes a bust?

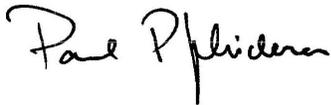
Sincerely,



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The Honorable Elizabeth Warren
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The Honorable Chris Van Hollen
The Honorable Thom Tillis
The Honorable Catherine Cortez Masto
The Honorable John Kennedy
The Honorable Doug Jones
The Honorable Jerry Moran