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Ladies and Gentlemen:

I would like to share my thoughts as a private citizen on the Committee's Discussion Paper, *The regulatory framework: balancing risk sensitivity, simplicity and comparability*, issued in July 2013 for comment by October 11, 2013.

Briefly and for perspective: I have several decades of professional experience in the financial services industry in the United States. My background encompasses roles as diverse as an equities portfolio analyst with an asset management firm, a bank regulator, the managing director in charge of the modeling group of a boutique investment bank with a client base of financial institutions, and an executive tasked with re-engineering the support functions of the investment management division of a major life insurance company. In addition, I possess a master's degree in finance.

Background:

The risk-based capital adequacy framework designed and introduced by the Committee twenty-five years ago was elegant in concept and well intentioned in its primary goal to incorporate into minimum capital requirements an explicit recognition that greater risks require greater capacities for loss absorption by capital. Secondary objectives included applicability to business models of varying size and complexity, comparability across banking institutions at a point in time, comparability within a single institution over time, a level playing field for institutions regardless of jurisdiction, responsiveness to the risk-seeking behavior of bank management, and the promotion of risk management as a serious and worthy endeavor for the industry. Over time, the guidelines evolved to accommodate observed real world shortcomings, the development of new financial products, modifications to the internal models of more complex banks, and input from the industry and its domestic regulators. However, the current scheme is highly complex, costly to implement and sufficiently challenging to smaller and less sophisticated institutions that the Committee's request for input regarding a reconsideration of the tradeoffs between the complexity imposed by model sophistication and the utility enabled by simplicity is appropriate and timely.

Complexity of the Current Guidelines:

I argue that the capital adequacy guidelines as they now stand are overly complex, and that any benefits gained from potentially more accurate risk modeling are likely to be surpassed by the attendant costs. Given the multifaceted and dynamic nature of risk, I question the presumption that some theoretically optimal level of capital capable of absorbing extremely unlikely but catastrophically damaging losses is predictable with any real utility by any conglomeration of algorithms regardless of sophistication. If it were possible to predict the future in any reliable manner, the market disruptions of recent decades would not have occurred. Hubris and excessive reliance on black box models played major roles in every crisis from the stock market crash of 1987 through the Long Term Capital Management bailout in 1998 to the crisis of 2007-2008. Financial modeling can be, and often is, a useful and worthwhile tool for planning, budgeting, risk estimation and other endeavors. However, once the connection between inputs and outputs loses clarity in a meaningful, real world context and remains hidden behind a veil of mystery, modeling becomes little more than a game, and intellectual parlor games should not be confused with insight or wisdom.

The Standards and the Committee's Objectives:

The notion that human experience and judgment can be productively superseded by a tyranny of models is ultimately unrealistic, and the attempt to do so by way of a one-size-fits-all set of rules for banks large and small places an undue burden on smaller and more regional institutions serving very specific, localized constituencies. Furthermore, the impracticality of this approach precludes achieving the Committee's objectives involving a level playing field across jurisdictions and comparability across institutions, objectives that may not be realistic under practical circumstances in any event. I would also suggest that the goal to assist investors in the conduct of their work overreaches the Committee's mandate as, unlike depositors, the great majority are professionals more than adequately trained and compensated for deciphering the complex.

Some of the complexity within the guidelines derives from the Committee's attempts to compensate for the tendency of bankers to engage in risk seeking behaviors that emphasize potential short-term profits over long-term viability. While understandable, regulations that do not address the foundational cause of this behavior – compensation incentives – cannot mitigate it, and consequently the capital adequacy guidelines are pointless in this regard. It is also the case that bankers will always devise creative ways to circumvent rules, and regulators have absolutely no chance of winning the innovation arms race. At a minimum, they lack access to the funds and human resources necessary for even a halfhearted attempt to do so.

A related point is that the Committee's wish to promote risk management as a useful and necessary component of sound organizational management is similarly unproductive. Risk management as it has evolved in corporate organizations generally is little more than a reporting function running on a parallel track with auditing. In aggressive cultures, it is viewed as a necessary-to-be-tolerated back office support function, and its practitioners are almost completely devoid of any real influence. The driver of behaviors in banks is short-term profits, and risk taking is a means to this end and one not readily controlled, again, without addressing the underlying incentives. The series of events within Bear Stearns, Lehman Brothers and

Merrill Lynch leading up to and during the financial crisis provide instructive case studies on this score.

Credit and Market Risk Emphasis:

As the Committee acknowledges, the current capital adequacy scheme emphasizes credit and market trading-related risks. It is worth considering that, as material as these risks are for financial institutions, there are others capable of inflicting grievous harm as well. Interest rate risk is one. The security around technology and internet connectivity is another and perhaps the one with which most institutions are least well equipped to cope. There are many others.

Absent from the discussions in the quest for the perfect risk based capital measure is a consideration of means, which at many institutions are limited. The need to dedicate meaningful quantities of human and other resources to satisfy an overly complex and narrowly focused rule of necessity diverts resources from other concerns that may pose risks of equal or greater gravity. A hallmark of effective risk management is proportionality in perspective: losing sense of the forest for the leaves on the trees can be fatal.

Overlooked: The Nature and Role of Capital:

One significant casualty in the debate over capital adequacy standards is an appreciation of the nature of capital and the purposes it serves. As the standards require recalibration of assets to eliminate certain intangibles and incorporate on-balance sheet equivalents of certain off-balance sheet items, the equity component absorbs the adjustments to true-up the balance sheet. Consequently, confusion arises over what categories of assets or components of liabilities "count" as capital. Requirements like the liquidity coverage ratio, which is in fact an asset allocation standard, further contribute to misunderstandings around the ideas of "reserves" and "capital." The question of capital sufficiency in the context of a more conservatively calibrated balance sheet gets somewhat lost in the shuffle of rhetoric focused on minutiae.

A directly related problem is a muddled understanding of the relationships of the different components of the balance sheet to the operating plan of the institution. The most common symptom in this regard consists of the specious claim frequently made by bankers that the low profit margins of their businesses necessitate highly leveraged balance sheets in order to satisfy shareholders' return requirements. As a corollary, they claim that higher minimum capital requirements force them to invest in riskier assets for the same reason.

Now, with any business, the asset side of the balance sheet most directly reflects the primary focus of the business plan. The funding side consists of an amalgam of debt instruments (i.e., liabilities) and owners' equity that together fund the enterprise with the relative proportions of each reflecting opportunities for raising capital as determined by market conditions, regulatory constraints, investor preferences, fundraising talent and so on. Whereas the return on assets most directly derives from the skill and efficiency of management in the conduct of the main thrust of the business, the return on equity metric routinely put forth as the benchmark of management performance is less straightforward and easily manipulated with leverage. Well-informed investors know better than to consider returns on equity absent an understanding of capital structure and the risks that the use of leverage imposes.

Ultimately, discussions around leverage ratios and returns on equity should lead to more sober considerations of risk generally and, perhaps more to the point, the cost of bets ending badly. In addition to serving as a foundational source of funds, equity capital provides one other crucial service: the first line of defense against losses. Furthermore, it is important to emphasize that loss recognition occurs in nominal dollars and not risk adjusted ones, a point that is easily overlooked in a scheme focused on the idea of risk weighting; for example, if a 50% weighted asset becomes worthless, 100% of its value – not 50% -- is written off. Regardless, in its capacity to absorb the occasional "slings and arrows of outrageous fortune," an adequate capital base is a basic tool of risk management as it enables an institution to survive the inevitable turns of the business cycle and at least some of the less frequent but more disruptive shocks generated by changes in the economy. This incontrovertible fact highlights the fundamental problem with high leverage: whereas it magnifies the positive earnings impact of risks that turn out well, it greatly exacerbates the downside of risks that do not.

Consequently, when bankers claim that high balance sheet leverage is necessary to satisfy investors' demands for high returns, they misrepresent cause and effect. Investors do indeed expect higher returns from riskier enterprises, but the risks inherent in investment opportunities drive their expectations and not one absolute return standard applied to every potential investment across the board. A more solidly capitalized banking system would generate lower average returns on equity, but the system would continue to attract investors -- albeit perhaps those of a less risk tolerant variety. Meanwhile, the bankers' taste for leverage remains the product of the expectation that the benefits of their risk seeking activities will continue to accrue to them while downside costs continue to be socialized and absorbed by others.

<u>A Word on Banking and Leverage</u>:

Throughout the history of the United States, bank capital relative to assets has generally trended downward. In the mid-nineteenth century, equity ratios hovered around the 40% mark. At the turn of the twentieth century, equity coverage was about 20%. Since World War II equity-to-assets ratios loosely stabilized at plus-or-minus 10%, although the extreme leverage of a handful of global institutions with equity ratios of around 3% precipitated the 2008 crisis. The usual explanation for this historical pattern is that regulations such as the U.S. Banking Act of 1933 (i.e., "Glass-Steagal") and the introduction of deposit insurance altered the risk profile of the industry and investors' expectations of prudent capital coverage. The repeal of Glass-Steagal in 1999 did not recalibrate investor expectations toward higher coverage rates probably because, by this point, overconfidence in the risk management skills of bank management and the belief that the U.S. government would not allow critical institutions to fail were well established. Nevertheless, there is no historical support for the contention that, unique among industries, banking is by its very nature and necessity a highly leveraged enterprise. Indeed, the unprecedented interconnectivity and interdependence of the global financial system argue for more conservative capital positions.

<u>Recommendation: A More Straightforward and Stringent Capital Adequacy Standard</u>:

The financial services industry is the most vital in a modern economy. If it cannot serve in its role as financial intermediary with some minimum degree of competence, efficiency and

honesty, no other sector of the economy can function. It is for this fundamental reason that the Panic of 2008 led to the extraordinary and unprecedented government interventions to bail out some institutions and broker mergers among others. These actions remain controversial to this day, but the fear that more than a few excessively paid bankers would suffer severe consequences if governments failed to act was very real. At the time, the institutions in trouble varied greatly in terms of focus, size, global reach and management style. The problem common to all was insufficient capital.

I believe that the banking system would be more effective, more efficient and less crisis prone under a more straightforward, leverage-focused capital adequacy standard implemented and phased in over time at equity-to-assets ratios more in line with those of other industries. While the Committee should be praised for its attempt to design a sophisticated capital standard directly responsive to the exigencies of modern finance, an overly complex and resource intensive scheme enables excessive obfuscation of the facts and regulatory arbitrage. The adoption of a more straightforward approach would neither preclude the need for bankers to understand the complexity of the risks inherent in their balance sheets and operational strategies nor absolve them from the obligation to evaluate, manage and disclose them, but it would facilitate transparency and promote stability to the benefit of the economy as a whole. Sometimes simple really is better.

Sincerely,

Suzanne Booth