AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
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August 26, 2011

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: Consultative Document -- Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement

Dear Madam or Sir:

American for Financial Reform ("AFR") appreciates this opportunity to comment on this Consultative Document regarding Global Systemically Important Banks (G-SIBs). AFR is a coalition of more than 250 American organizations who have come together to advocate for reform of financial sector regulation. Members of the AFR include consumer, civil rights, investor, retiree, labor, religious and business groups along with prominent economists and other experts.

AFR believes the proposed minimum additional capital requirements of 1 to 2.5 percent for systemically important banks in this Consultative Document are far too low. They are too low given the Committee's own assessment of the socially optimal level of equity capital for an ordinary bank, let alone for a systemically important bank. (Furthermore, based on the assumptions of the Committee itself this assessment is already an underestimate even for an ordinary bank). .

AFR urges the Committee to increase these minimum levels. At a minimum, the Committee should incorporate provisions into Pillar 2 of the accord advising individual country regulators on increases in G-SIB surcharges above these floor levels. In particular, those countries that wish to avoid or minimize an implicit government guarantee for their financial system should be strongly advised to set higher G-SIB capital charges than the minimum set out here. As the Dodd-Frank Act passed in the U.S. Congress has the explicit goal of avoiding government guarantees or support for our largest banks, this would be particularly relevant for the United States.

In addition, the relatively low level of G-SIB surcharges set here underline the importance of strict oversight of the capital conservation buffer and aggressive implementation of the countercyclical capital surcharge also set out in the Basel accord.

On other issues, AFR applauds and strongly supports the restriction of the G-SIB surcharge to Tier 1 common equity, the most reliable form of capital. AFR also strongly supports the Committee's statement that these surcharges should be seen as a floor or minimum and individual country regulators may diverge above them. Indeed, given the low level of surcharge proposed here, this is the only sensible way to view these requirements.

Finally, although AFR supports the general categories of G-SIB indicators set out here, we caution the Commission against excessive reliance on the indicator metric in setting capital levels, and also against using these indicators in an overly rigid manner. The numerical weighting of the various indicator factors and the limitations on supervisory discretion imply a greater degree of rigor for these indicators than they are likely to have. The simple linear, additive use of indicators here is likely to be shown to be inadequate by emerging academic research in systemic risk. To avoid threshold effects created by small changes in an imperfect indicator, the Committee should attempt to align the indicator-based "buckets" which determine capital charges with natural breakpoints in the distribution of bank size and complexity.

Proposed Capital Surcharges For Systemically Significant Banks Are Too Low

Surcharges Are Clearly Far Below the Economically Optimal Level

Conceptually, the most straightforward way of setting bank capital levels is to balance the social benefits of higher equity capital (most notably the decline in the likelihood of financial crises) with any social costs of higher capital requirements, such as increased borrowing costs. To reach the economically optimal level, bank capital levels should be increased as long as such an increase brings higher benefits than costs.

In August, 2010 the Basel committee on long-term economic impacts (LEI committee) released an assessment of the costs and benefits of higher capital regulations for the entire banking system (not just systemically important banks).[1] The LEI committee found the optimal level of common equity capital in its preferred scenario was 13 percent under Basel II metrics (which equates to roughly 10.5 percent under new Basel III metrics). This level is significantly higher than the 7 percent base level of common equity capital required for all banks in Basel III (4.5 percent plus 2.5 percent conservation buffer).

As discussed further below, there are many reasons to believe that the preferred LEI scenario is flawed and the resulting capital level is too low. However, if the LEI Committee estimate is taken at face value, it implies a 3.5 percent surcharge would be necessary simply to bring the required capital for systemically significant banks up to the capital level the Committee has determined is economically appropriate for all banks.[2] But the G-SIB capital surcharges

[1] See Basel Committee, *An assessment of the long-term economic impact of stronger capital and liquidity requirements* (August 2010) at http://www.bis.org/publ/bcbs173.htm

[2] See page 25 of the Consultative Document, where this calculation is performed.

recommended in the Consultative Document range from 1 to 2.5 percent, depending on bank size.[3] This is significantly below even the 3.5 percent level that the Committee estimated to be the optimal level for banks generally.

Furthermore, the true economically optimal level of additional capital for G-SIBs is almost certainly much higher than the 3.5 percent surcharge necessary to satisfy the LEI Committee estimate. This is both because optimal capital for G-SIBs is larger than for ordinary banks, and also because of issues with the scenario used by the LEI committee to set optimal capital levels.

- **The benefits of higher capital levels for systemically important banks are clearly much greater than the benefits of higher capital for ordinary banks –** Systemically significant banks create much higher social costs when they fail than ordinary banks do. This is the entire point of designating them as "significant". Therefore, higher capital levels which reduce the risk of failure bring greater benefits when applied to G-SIBs than when applied to ordinary banks.

- **The costs of higher capital levels are clearly much lower when limited to systemically important banks –** The LEI report calculated the impact on borrowing costs for a capital increase across the entire banking system, not just G-SIBs alone. The impact of an increase limited to only the largest and most interconnected global banks would clearly be much smaller, because smaller and less interconnected banks not designated as systemically significant could increase their lending to make up for any increases in costs for the largest banks. This substitution will greatly lower and could even eliminate the impact on overall borrowing costs of higher capital levels limited to the largest banks.

- **The LEI committee scenario assumes a target return on equity of 15 percent – a level the BIS itself believes is inappropriate.** Costs for the LEI report are calculated based on the assumption that banks must maintain a 15 percent rate of return on equity. This is the same rate of return targeted at the height of the financial bubble, when banks were operating with very low capital levels and profiting from an asset bubble. The BIS itself has recently stated that a 15 percent return on equity is inappropriately high, and investors will also require lower returns as they see banks are a less risky investment.

  The LEI report itself calculates that if the target return on equity is set at 10 percent – a level that is still somewhat higher than the overall level of return in the economy – the estimated impact of higher capital on borrowing costs is cut roughly in half.[4] Given the economic principle that social costs correlate with the square of the distortion, it is likely

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[3] There is also a 3.5 percent surcharge cited as a hypothetical future possibility, but it would not be applicable to any currently existing bank in the world.

[4] See pages 4-5 of Basel Committee, *An assessment of the long-term economic impact of stronger capital and liquidity requirements* (August 2010).

that this would cut the overall economic costs of additional capital requirements by more than half.

The three issues above are only the most obvious reasons to believe that the socially optimal capital surcharge for G-SIBs is far in excess of 3.5 percent. The LEI committee cost estimate also assumes that any additional costs of capital are passed through completely into borrowing costs for non-financial users of capital. Other possibilities – such as declines in compensation for bank executives, scaling back of the trading book instead of cuts in lending, declines in intra-financial sector lending, cuts in operating costs, increases in non-lending charges – are not incorporated into the analysis.

Furthermore, the LEI analysis is based on a macroeconomic modeling procedure that effectively assumes a social cost of capital through increased borrowing costs. As several recent observers have pointed out, there is no good empirical evidence for this, and many reasons to believe that the social (as opposed to private) costs of capital are very limited.[5] Bank leverage rates effectively doubled over the last century and it is unclear what if any impact there has been on either growth or interest rates.[6] While the LEI assumptions are not unreasonable, they are also not substantiated by evidence, and there are both theoretical and empirical reasons to believe the costs of capital are much lower.

There is thus overwhelming reason to believe that the 1 to 2.5 percent surcharge on systemically important banks is a large, probably a very large, underestimate of the actual socially optimal level of additional bank capital that should be held by systemically important banks.

The “Expected Impact Approach” is Theoretically Problematic and Applied In An Arbitrary And Unclear Manner

For the reasons given above the recommended levels of capital for systemically important banks are clearly far too low to be socially optimal. Another way advanced by the Committee to justify the selected capital levels is the “expected impact approach”. This approach would equate the expected social costs of failure – or the probability of failure times the loss given failure -- between systemically important banks and other banks.

This criterion is problematic from the beginning when compared to a straightforward cost-benefit approach. It does not incorporate the fact that the cost of higher capital charges limited to G-SIBs will be lower than the cost of imposing higher capital throughout the banking system. In addition, the reference non-systemically important bank to be compared to the G-SIB is defined as one “just below” the G-SIB indicator cutoff. This choice makes the optimal level of G-SIB

[5] See D.Miles, Jing Yang and Gilberto Marcheggiano, *Optimal bank capital*, Bank of England External MPC Unit DP No.31, January 2011; Admati, Anat R., DeMarzo, Peter M., Hellwig, Martin F. and Pfleiderer, Paul C., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is not Expensive* (March 23, 2011). Rock Center for Corporate Governance at Stanford University Working Paper No. 86

capital a function of the exact cutoff point chosen for the G-SIB definition. This standard could theoretically work if there was an accurate and continuous metric of systemic risk that aligned perfectly with the costs of failure, and capital varied continuously with this metric. But given the current highly imperfect measurements of systemic risk that are available it is hard to align the comparison with a bank "just below" the risk cutoff with any clear measure of net social benefit at all.

Even given this problematic criterion for setting additional required capital, the Committee seems to implement it in an arbitrary and confusing manner. The Consultative Document states that the Committee proceeded by assuming that the failure of the largest systemically important bank would impose economic costs three to five times higher than the failure of the reference bank just below the indicator cutoff. Increased capital levels are therefore set to cut the estimated failure rate of the largest G-SIB to a level one-third to one-fifth that of the reference bank.

Obviously, the assumption regarding the relative economic costs of G-SIB failure is critical here and drives the entire analysis. Although it is possible we are overlooking a reference or a discussion elsewhere in the paper, this vital assumption does not appear to be justified either by reference to research or by original in-depth analysis. The report appears to state that the assumption can be justified by assuming the indicator metric laid out earlier in the report is a proxy for the costs of bank failure. Given the somewhat ad hoc and admittedly simple nature of the indicator metric this is also a highly arbitrary assumption which seems unlikely to be true and must in any case be justified.

Finally, even using this expected impact approach, the additional capital required to properly equate bank failure risks between G-SIBs and other banks may be significantly higher than the level proposed by the Committee. The proposed maximum level of 2.5 percent does align with the failure probabilities determined using historical net losses during stressed periods, as measured in bank accounting statements. However, the level implied by modelling bank failure probabilities using asset prices (the 'Merton Method') is much higher, more than double the 2.5 percent level recommended in the consultative document.

There are several reasons to believe that a method based on asset prices may be more appropriate. It is well understood that during financial crises the recognition of losses in asset value in bank accounting statements may be significantly delayed or may not align with more transparent measures in asset markets.[7] In addition, bank accounting losses during financial crises may be reduced by government interventions to support the banking system. This is of course particularly likely to be true for large interconnected banks such as G-SIBs, who are

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[6] See D. Miles, op. cit., and Bank of England, *The Role of Macroprudential Policy*, November 2009.
[7] Vyas, Dushyantkumar, "The Timeliness of Accounting Write-Downs by U.S. Financial Institutions During the Financial Crisis of 2007-2008" (December 6, 2010). Journal of Accounting Research, Forthcoming; Laux, Christian and Leuz, Christian, "Did Fair-Value Accounting Contribute to the Financial Crisis?", Journal of Economic Perspectives 24 (1): 93-118

likely to get special benefits from governments. Bank regulators who want to avoid such an implicit government guarantee could benefit by instead tying their capital levels to the losses implied by asset prices.

The Analysis of Optimal Capital Levels for G-SIBs Should Not Be Limited To Risk Of Failure

All of the methods set out above – both the calculation of the socially optimal level of bank capital and the "expected impact approach" – are based on the idea that the only social benefit to increased bank capital is a reduction in the risk of bank failure. This is incorporated into the modelling approach by assuming that a bank can impose social costs only if it fails, and the benefits of increased bank capital are therefore modelled solely as a reduction in failure probability.

However, a G-SIB can impose social costs due to undercapitalization even if it does not fail. An overleveraged G-SIB that avoids failure through a "fire sale" of assets to pay back debts could have significant impacts on asset markets, and could possibly create a market panic that leads to the failure of other institutions. Likewise, high levels of borrowing by G-SIBs in order to accumulate assets could help create a self-reinforcing bubble in asset markets that increases instability for other economic actors.

The existence of these kind of "leverage externalities" are becoming widely acknowledged in the academic literature.[8] They are especially important because they are an externality. Unlike the risk of failure, systemic externalities created by excessive leverage will not be incorporated into private market discipline of the individual bank. The exact measurement of their impact is still a frontier area of research. But the Committee does not appear to have taken them into account at all in setting minimum capital requirements. Taking this factor into account would further increase the optimal level of G-SIB capital charges.

The Committee Should Increase G-SIB Capital Surcharges

For the reasons above, the minimum G-SIB capital charges laid out in this advisory document clearly appear to be below the socially optimal level. The Committee should thus increase these minimum levels based on addressing some of the issues laid out above. Since many of these issues are referenced and discussed in the Committee's own analytic documents, the Committee has the analytic capacity to incorporate them into a more complete assessment of optimal capital charges.

If the Committee chooses not to increase minimum G-SIB capital charges, it should at a minimum issue an advisory recommendation to national regulators based on a more accurate

[8] For examples of this literature see Geanakoplos, John, *The Leverage Cycle*. Cowles Foundation Discussion Paper No. 1715; Jeanne, Olivier, and Korinek, Anton, *Managing Credit Booms and Busts: A Pigouvian Taxation Approach*. CEPR Discussion Paper No. DP8015.

analysis of optimal G-SIB charges. This analysis should incorporate specific estimates of the higher benefits of increased G-SIB capital charges compared to capital charges for other banks, the lower costs of capital charges that are limited to G-SIB banks alone, a realistic target for the post-crisis return on equity for banks, and some of the externalities of G-SIB leverage exclusive of bank failure. Such advisory material should be specially targeted to countries that wish to avoid or minimize an implicit government guarantee for their largest banks.

The low level of G-SIB capital surcharges in this proposal also underlines the significance of the fact that the Basel recommendation is a floor and not a ceiling on permissible action by national regulators. AFR strongly endorses the Committee restatement of this position in point 74 of the document.

Indicators of Systemic Importance

AFR supports the general range and type of indicators of systemic importance set out in this consultative document. Size, interconnection, substitutability, and complexity are all likely to be closely connected to the costs of bank failure and the difficulty of rapid resolution of the bank once it has failed.

Given the Simplicity of the Indicator Metric Excessive Dependence on the Metric To Set Capital Charges Should Be Avoided

As the Committee is well aware, measurements and metrics of systemic risk are a very active area of academic research.[9] Many of these sophisticated metrics developed by academics are network-based. Almost none use simple sums of bank assets or simple linear metrics of risk such as are proposed in this consultative document. Such linear metrics will probably not track more sophisticated approaches well in terms of the actual risk measurement, although they may result in designating a similar set of banks that are clearly significant by any measure.

However, as the document points out, there are supervisory advantages to a simple metric, especially as no academic consensus has emerged. This is particularly true if the only purpose of the metric is G-SIB designation and very rough classification, and market concentration in banking activity means that the banks designated are not strongly dependent on the indicator metric.

But flaws in the risk measurement approach will become more problematic the more dependent capital surcharges are on the precise level of the risk metric. The “expected impact” capital approach discussed above seems to be very sensitively dependent on the actual risk metric, and this means that its connection to social benefit is uncertain.

[9] Tobias Adrian and Markus K. Brunnermeier (2009), "CoVar." Federal Reserve Bank of New York Staff Report No. 348; Viral V. Acharya, Lasse H. Pedersen, Thomas Philippon, and Matthew Richardson (2010). "**Measuring Systemic Risk"**. Working Paper, New York University Stern School of Business;Gauthier, Celine, Lehar, Alfred and Souissi, Moez, *Macroprudential Capital Requirements and Systemic Risk* (December 2010).

Of course the different risk “buckets” used to set capital surcharges are tied to the metric as well. Given the uncertainty in the state of systemic risk measurement, regulators should attempt to set the lines between capital “buckets” at natural break points in the distribution of bank size and complexity. The reference to a cluster analysis in point 55 of part II.B of the document seems to indicate that regulators have pursued this approach, which we applaud. However, the emphasis on “equal sized” buckets mentioned in the same point in the document would work against this division. We believe that the Committee should emphasize natural breakpoints in the distribution more than maintaining equal size buckets. This will avoid arbitrary distinctions in capital requirements based on imperfect metrics.

Avenues Should Be Kept Open To Modify The Metric, Especially In The Area of Interconnectedness

The document indicates that although supervisory discretion will be allowed to modify the proposed metric, such discretion will be limited. The Committee may wish to consider allowing more avenues for discretion. Research is likely to create many opportunities for improving these metrics, and the data to implement more sophisticated metrics may be limited to single nations.

For example, the “interconnectedness” indicator proposed here takes into account only the total sum of intra financial system assets. Individual country regulators are likely to have network data that allows them to determine not simply the sum of within-financial system assets, but the actual financial connections that exist. This may permit a better measure of risk – for example, financial connections to other systemically important institutions within the same region may be greater contributors to risk than connections to small foreign institutions. In such cases, regulators should have the ability and the incentive to develop and experiment with the use of more accurate metrics.

Finally, an overly rigid metric may open up opportunities for banks to “game” the metrics by adjusting their exposures so they are just below the threshold for a higher capital level. This would not be problematic if the risk metric was highly accurate and capital requirements varied continuously with the metric. But it could be an issue given that the metric is approximate and there are strongly discontinuous threshold effects for capital. This is another reason that indicator thresholds should be aligned as far as possible with natural breakpoints in the distribution of bank size and complexity.

Thank you for the opportunity to comment on this consultative document. Should you have questions, please contact Marcus Stanley, AFR’s Policy Director, at Marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans for Fairness in Lending
- Americans United for Change
- Calvert Asset Management Company, Inc.
- Campaign for America’s Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
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- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
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- Communications Workers of America
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- Consumers for Auto Safety and Reliability
- Consumer Federation of America
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- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
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- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
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- The Fuel Savers Club
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- The Seminal
- TICAS
- U.S. Public Interest Research Group

- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
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- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY

- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
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- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG

- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
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- Virginia Poverty Law Center
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- WashPIRG
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- UNET
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