August 26, 2011

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

Re: Assessment Methodology and Application of Surcharges to Global Systemically Important Banks

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**TCH**") and the Institute of International Bankers (the "**IIB**" and, together with TCH, the "**Associations**")[1] are writing to comment on the Basel Committee on Banking Supervision's (the "**Basel Committee**") July 2011 consultative document, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement* (the "**Consultative Document**" and, the proposals set forth therein, the "**Proposal**").

The Associations have consistently voiced strong support for ongoing regulatory reform efforts that aim to make international financial systems safer and more robust. Nevertheless, we have fundamental reservations regarding the assumptions underlying a significant add-on capital surcharge for globally systemic important banks[2] ("**G-SIBs**"), as well as the design of the Proposal and the indicator-based methodology described in the Consultative Document. We do not accept the view that more capital is always the answer and strongly believe that excessive capital requirements can inhibit the ability of banks to support economic activity and can create unjustified competitive inequities. Nor do we agree with the simplistic view that size alone creates prudential concerns, or, more broadly, that large banks are inherently problematic and do not provide important economic and other benefits or that it is not feasible to end "too big to fail." Indeed, we note that the Financial Stability Board (the "**FSB**"), in consultation with the Basel Committee, is currently embarked on a parallel effort to ensure that member nations adopt resolution protocols that clearly and effectively enable orderly liquidation without taxpayer support. The Associations strongly endorse this effort. In our view it further underscores the conclusion that the "negative externalities" associated with banks perceived as "too big

1 See *Annex A* for a description of the Associations.

2 We are using the term "**banks**" to refer collectively to bank holding companies, depository institutions and other banking organizations, headquartered both internationally and in the United States.

to fail" can be effectively addressed without the imposition of a punitive add-on capital surcharge for G-SIBs as embodied in the Proposal.

In view of the fundamental flaws in the design of the Proposal and its indicator-based methodology, recent national and international bank regulatory reform efforts as well as the uncertain benefits and potentially significant costs of, and the considerable risks to the international financial system and the global economy that could be posed by, a significant additional capital surcharge on G-SIBs, we believe that the Proposal is at best premature and must be substantively reconsidered. Certainly, the Basel Committee should not finalize and move ahead with a concept that is, by its own account, based on uncertain data points that have, in many cases, yet to be gathered or defined in a consistent way across jurisdictions.

Part I of this letter summarizes our comments; Part II discusses our reservations regarding the assumptions underlying an add-on capital surcharge for G-SIBs; Part III sets forth our reservations concerning the design of the Proposal and its indicator-based methodology; and Part IV addresses other important issues and identifies areas in the Proposal where we believe further clarification is in order.

I. Executive Summary

As discussed in Part II, the Associations have fundamental reservations regarding the assumptions underlying the imposition of a significant capital surcharge on G-SIBs, which in turn raise serious questions about the very concept. These assumptions appear to include: recent regulatory reforms have failed to address the systemic risks posed by large banks and meaningfully reduce the probability of their failure; more capital is always better; too big to fail will not be repudiated by countries; and size alone creates prudential concerns, or, more broadly, large banks are inherently problematic and do not provide important economic and other benefits. The Associations believe that these underlying assumptions are deeply flawed:

- Over the past two years, significant regulatory reforms have been introduced at the international and national levels. These reforms, including Basel III, have led to substantial increases in the amount of capital held by large banks. For example, in the United States, the heightened capital requirements under Basel III alone will require U.S. banks to increase the amount of effective Common Equity Tier 1 ("**CET1**"), calculated under the new Basel III standards, they hold by *over 100%* from the amount held at December 31, 2007. These increased capital requirements significantly reduce the potential for large banks to pose systemic risks and reduce their probability of failure. Empirical evidence shows that banks on a worldwide basis that had capital levels greater than the new Basel III CET1 minimum did not suffer serious financial distress in the recent crisis.[3]

[3] For a discussion of what constitutes "serious financial distress" for these purposes, please see footnote 8 of this letter.

- The imposition of a significant capital surcharge on G-SIBs explicitly rests on the assumption that such a surcharge is necessary to address the negative externalities and moral hazard costs associated with banks that are perceived to be "too big to fail." However, substantial reform efforts have in fact been made in some countries to end too big to fail and implement effective and credible recovery and resolution regimes. The United States, for example, has adopted a comprehensive and effective resolution regime (*i.e.*, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") as well as living will requirements) that end too big to fail as well as other systemic reforms which impose substantial costs on subject banks.

- Imposing a significant additional capital surcharge on G-SIBs will impose costs not just on banks, but also on their customers and the global economy. These costs include a potential reduction in the economic benefits that larger banks provide to businesses and consumers. Such a surcharge will also encourage business to migrate to the shadow banking sector, thereby increasing, rather than decreasing, systemic risk.

- There are significant open questions regarding the purported theoretical and policy foundations, as well as the appropriate calibration, for a G-SIB surcharge. Given these uncertainties, the imposition of a G-SIB surcharge could have economic costs and other unintended consequences and risks that are not readily apparent.

As discussed in Part III, the Associations strongly believe that the Proposal has fundamental flaws in design and with respect to its indicator-based methodology in particular. These include the following:

- The Consultative Document's lack of supporting empirical analysis concerning how the various indicators and the resultant capital surcharges are linked to a reduction in the probability of failure of G-SIBs seriously undermines the Proposal's credibility and generally hinders banks' ability to analyze it in a meaningful way.[4]

- There is a lack of transparency surrounding the assessment and calculation of the proposed surcharge that makes it impossible for a bank to calculate its surcharge or determine what steps to take to reduce its surcharge. This lack of transparency frustrates bank management's ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held. Given the potentially severe supervisory

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4 In the United States, the U.S. Court of Appeals for the District of Columbia Circuit recently invalidated a major new rule issued by the U.S. Securities and Exchange Commission because key relevant data were not provided. *Bus. Roundtable & Chamber of Commerce of the United States of America v. Sec. & Exchange Comm'n*, No. 10-1305 (D.C. Cir. July 22, 2011).

consequences of holding too little capital, the substantial uncertainty about the size of the G-SIB surcharge will require banks to hold substantial additional capital in the form of an "uncertainty surcharge." Capital is not free, and the incidence of the costs of holding more capital than is necessary or appropriate will not fall solely on banks, but also on customers of banks and overall economic activity.

- G-SIBs may be discouraged from conducting the activities measured by the indicators, including many that are beneficial from a systemic perspective (*e.g.*, making stabilizing acquisition of institutions in financial distress) and cannot be readily assumed by smaller institutions.

- The Proposal discourages banks from diversifying their assets across jurisdictions and business lines.

- The G-SIB surcharge will lead to unjustified competitive inequities between large banks subject to the surcharge, on the one hand, and other large banks and nonbank financial companies not subject to the surcharge, on the other. It also has the potential to create competitive inequities among G-SIBs given that small numerical differences in systemic importance scores could result in G-SIBs with similar real-world risk profiles being assigned to different surcharge "buckets."

- The Proposal inherently creates the incentive for G-SIBs to concentrate their activities in business lines that are not penalized under the indicator-based methodology, thereby amplifying the potential for systemic disruptions if those business lines turn out to be a primary source of problems in a subsequent financial crisis.

- Numerous specific aspects of the Proposal's indicator-based methodology are flawed, including:

    - If the G-SIBs all reduced their indicator-based risks substantially and proportionally, the surcharges would nonetheless remain the same. This aberrant result is illustrative of the analytical defects in the Proposal as described in the Consultative Document.

    - The manner in which the wholesale funding indicator is calculated will materially distort the total systemic importance score of banks whose wholesale funding ratio is higher than average.

    - Many of the indicators are inaccurate measures of systemic importance. For example, the value of underwritten transactions or of assets under custody (at least in the United States) is not indicative of systemic importance.

- The methodology creates perverse incentives to increase instead of decrease risk. For example, the cross-jurisdictional indicators encourage banks to fund foreign claims with home country liabilities, an objectively riskier practice than funding these claims with local currency liabilities.

- There is no mechanism to lower the capital surcharge as the global systemic importance of G-SIBs in the aggregate is reduced.

- Size is dubious as a separate indicator and, in any event, is significantly over-counted in determining a bank's systemic importance score.

- The Proposal may penalize well-managed banks with rising scores if they maintain or grow their share of businesses measured by the indicators while the industry as a whole contracts or even remains the same.

Furthermore, the numerous and serious gaps in the Consultative Document prevent truly meaningful analysis of the Proposal. These include the methodology used to determine the 28 banks that will initially be designated as G-SIBs, the frequency with which the denominator used to calculate the systemic importance score will be updated, the empirical analysis undertaken to estimate the cost of the proposed surcharge on growth and the manner in which indicator scores are determined. If the Basel Committee seeks the informed comment that the press release accompanying the Consultative Document invites, it must provide this information. This process is too important to be conducted except in an open and transparent manner.

As such, the Associations strongly believe that it would be premature at best to impose a significant capital surcharge on G-SIBs. The Basel Committee should substantively reconsider the Proposal in a transparent, empirically supported and validated manner that addresses the concerns highlighted in this letter. At minimum, any potentially viable capital surcharge regime should empirically justify the magnitude of the surcharge, its choice of indicators and categories and the weightings of those indicators and categories; enable banks to evaluate their structure and operations and proactively determine the potential magnitude of the applicable surcharge on an on-going basis in order to manage and/or mitigate its potential impact; provide for the reduction of the surcharge as banks reduce their systemic importance in the aggregate; take into account the regulatory environment in which banks operate, including the presence of effective and credible recovery and resolution regimes and other legislation and regulation designed to reduce systemic risk and moral hazard costs; reflect a more balanced and accurate view of systemic importance; not encourage increased risk-taking; and eliminate the other flaws of the proposed methodology set forth in the Consultative Document.

II. The assumptions underlying a punitive add-on capital surcharge are flawed.

The Associations have serious disagreements with the assumptions that underlie the proposals to impose significant capital surcharges on systemically important financial institutions,[5] such as G-SIBs. These assumptions generally appear to be: recent regulatory reforms, both nationally and internationally, have failed to address the systemic risks posed by large banks and meaningfully reduce the probability of their failure; more capital is always better; and size alone creates prudential concerns, or, more broadly, that large banks are inherently problematic and do not provide important economic and other benefits. The Associations believe that these assumptions are deeply flawed for the following reasons:

A. Recent regulatory reforms have already significantly increased the amount of capital that banks must hold, and empirical evidence demonstrates that regulatory reforms have gone a long way to addressing the potential for large banks to pose systemic risks and reducing the probability of their failure.

Over the past two years, significant regulatory reforms have been introduced both by the Basel Committee and domestic regulators in order to address a wide variety of regulatory concerns, including capital adequacy, liquidity risk, loss absorbency, market risk, stress testing and capital planning. Many of these measures will require, or have in practice already required, G-SIBs to make major changes to their capital structures, balance sheet composition and liquidity and operational risk management functions, calling into question the need to impose an additional capital surcharge at this time. For example, the heightened capital requirements under Basel III alone will require U.S. banks to increase the amount of CET1 U.S. banks hold by *over 100%* from the amount held at December 31, 2007.[6] In addition, as a result of the imposition of Basel III's quantitative, qualitative and risk-weighting requirements, the amount of capital a bank would need to hold to satisfy the 7% minimum CET1 ratio under Basel III is nearly *triple* the amount of CET1 it would need to hold to satisfy the "well-capitalized" requirements under U.S. prompt corrective action regulations.[7] Moreover, Basel III and related enhancements to the capital framework made under Basel II.5 not only addressed aggregate capital

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[5] In that regard, please see the TCH's letter, dated June 15, 2011, to the United States Department of the Treasury, Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, available at http://www.theclearinghouse.org/index.html?f=072333.

[6] These and other figures in this letter, unless otherwise noted, are based on an analysis of the banking sector undertaken by McKinsey & Company, Inc. ("**McKinsey**") to assist TCH in its analysis of the impact of Basel III and a potential surcharge on large U.S. banks. McKinsey had access to the quantitative-impact studies and other confidential data provided by 11 large financial institutions, accounting for 59% of U.S. banking assets at June 30, 2010. Those sample data and other sources were used to extrapolate certain estimates for the U.S. banking industry at large and in other aspects of the quantitative analyses set forth herein. In addition, as discussed in footnote 8, in analyzing the performance of banks during the recent financial crisis, McKinsey examined data concerning 123 banks worldwide with more than $68 trillion in assets in aggregate.

[7] See pages B-1 through B-4 of *Annex B* attached hereto for further information.

requirements, but also the specific areas in which excessive risk was thought to be incurred. For example, Basel II.5 dramatically increases – often by 400 percent or more – the capital charge on trading positions held by large banks.

These increased capital requirements, in and of themselves, significantly reduce the potential for large banks to pose systemic risks and reducing their probability of failure in light of empirical evidence that shows that banks on a worldwide basis that had capital levels greater than the new Basel III effective CET1 minimum did not suffer serious financial distress in the recent crisis.[8] Banks satisfying this minimum CET1 ratio, therefore, proved not to be the source of systemic risks in 2007-2009. The inadequate capitalization of the weakest banks during the recent crisis should not lead to the conclusion that the strongest banks now need significantly more capital above and beyond Basel III in the form of a G-SIB capital surcharge as set forth in the Consultative Document.

Given that banks satisfying the new Basel III capital standard (on a fully phased-in basis) did not suffer serious financial distress in the recent crisis and Basel III's liquidity reforms, there would appear to be little marginal utility in imposing additional significant capital surcharges on G-SIBs.

B. Proposals to impose capital surcharges on G-SIBs cannot ignore regulatory reforms that have repudiated too big to fail and will substantially reduce the systemic risks posed by G-SIBs and mitigate the negative externalities and moral hazard costs associated with these banks.

Proposals to impose significant additional capital surcharges on G-SIBs assume that these higher requirements are necessary to address the negative externalities and moral hazard costs associated with banks with perceived implicit guarantees of governmental support.[9] As a logical

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8 In analyzing the performance of banks during the recent financial crisis, McKinsey examined data concerning 123 banks worldwide with more than $68 trillion in assets in the aggregate. The study determined that no institution that entered the 2007-2009 crisis with a CET1 ratio (calculated in accordance with Basel III rules) greater than 7% (that is, 100 basis points lower than where firms are likely to operate after considering the voluntary cushion firms will likely hold to reduce the likelihood that capital levels will fall below the regulatory minimum) experienced serious financial distress – that is, failed, was placed into governmental receivership, was acquired under duress by another financial institution or received a substantial, individually-directed governmental capital investment. Thus, the Basel III CET1 ratio requirement, by itself, would appear to have been sufficient to prevent serious financial distress at banks throughout the world even through the severe disruptions of the financial crisis. See pages B-5 through B-8 of *Annex B* for further information regarding, and a description of the methodologies employed in, this study. For purposes of McKinsey's study, a "substantial individually-directed governmental capital investment" is defined as a total government capital investment greater than 30% of the bank's Tier 1 capital as of December 31, 2007. Such 30% threshold generally filters out institutions that accepted TARP funds as mandated during the U.S. government's response to the financial crisis, but banks that received additional capital injections outside the standard TARP Capital Purchase Program process were included as having received "substantial individually-directed governmental capital investment" for purposes of this study.

9 *See, e.g.*, Consultative Document, ¶¶ 2, 3 ("The rationale for adopting additional policy measures for G-SIBs is based on the cross-border negative externalities created by systemically important banks which current regulatory policies do not fully address. . . . The negative externalities associated with institutions

matter, therefore, the need for such a capital surcharge would be eliminated or, at the very least, substantially decreased to the extent that regulatory reforms eliminate or reduce these negative externalities and moral hazard costs. Such regulatory reforms are, in fact, being implemented.

In the U.S., for example, the cornerstone of ending "too big to fail" is the orderly liquidation authority in Title II of the Dodd-Frank Act, which forbids public-sector bailouts of financial institutions and creates an effective resolution and recovery regime. The U.S. has supplemented this regime with numerous other rules designed to limit financial institutions' risk taking, and reduce systemic risk and mitigate the potential negative externalities associated with their failure, including bans on proprietary trading and investments in hedge and private equity funds (the so-called "Volcker Rule"), regular stress tests, living wills, concentration limits on expansion, the migration to centrally cleared swaps and related margin and capital requirements, the ability to require the prudential supervision of systemically important non-bank financial entities, improvements to securitization markets (including enhanced disclosures and risk retention requirements), reforms of credit rating agencies and the establishment of the Financial Stability Oversight Council to coordinate detection of and response to systemic risks. The largest banks are explicitly made subject to "heightened" prudential standards.

Had these reforms been in effect prior to the financial crisis, some of the most significant and acute instances of distress would almost certainly have been averted. For example, Lehman Brothers would have been subject to the same capital and prudential supervision requirements as JPMorgan Chase, including very high capital charges for collateralized debt obligations and other exotic securities. AIG would have been required to register as a "major swap participant", report its trading positions and subject certain of its activities (including its activities related to credit default swaps) to more robust supervision. In addition, the Financial Stability Oversight Council and the Office of Financial Research would have been gathering data on concentration risk and counterparty exposure, and empowered to act on their findings.

Outside the United States, the United Kingdom has enacted legislation putting in place a permanent special resolution regime with tools to protect financial stability by effectively resolving failing banks, and the Financial Services Authority recently proposed measures requiring large, complex financial firms to prepare and maintain recovery and resolution plans. In addition, the European Commission is preparing legislation creating a framework for bank recovery and resolution throughout the European Union that would allow for bail-ins, the establishment of bridge banks and temporary control of banks. Other elements of the European Commission's proposals anticipate the creation of group wide resolution plans under the oversight of a group resolution authority.

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that are perceived as not being allowed to fail due to their size, interconnectedness, complexity, lack of substitutability or global scope are well recognized. In maximizing their private benefits, individual financial institutions may rationally choose outcomes that, from a system-wide level, are sub-optimal because they do not take into account these externalities. Moreover, the moral hazard costs associated with implicit guarantees derived from the perceived expectation of government support may amplify risk-taking, reduce market discipline and create competitive distortions, and further increase the probability of distress in the future.")

As mentioned at the outset, because the very logic behind the imposition of a significant capital surcharge on G-SIBs rests on the existence of substantial negative externalities and moral hazard, reforms which reduce such problems and otherwise decrease systemic risk must be taken into account in order for any proposal to impose such surcharges to be consistent with its foundational premises. Nevertheless, and quite paradoxically, the Consultative Document indicates that such considerations should not play a role in the G-SIBs' additional capital surcharge equation.[10]

We strongly believe that this doubling up of approaches for G-SIBs – both (i) reforms to end too big to fail and decrease risk taking and systemic risk, which inherently involve substantial additional costs, and (ii) a significant capital surcharge – is not only inappropriate but deeply taints the logic of the whole Proposal. Indeed, the very failure to recognize, or otherwise take into account the existence of, such reforms when determining the amount of, and whether to impose, a G-SIB surcharge is indicative of a fundamental analytical flaw and internal logical inconsistency in the assumptions underlying the Proposal to impose a significant capital surcharge on G-SIBs as outlined in the Consultative Document.

C. G-SIB capital surcharges risk reducing economic and job growth.

1. Surcharges may lead to decreased availability of credit and increased costs for bank customers.

Imposing higher capital requirements on G-SIBs is not necessarily a cost-free proposition. Materially higher capital requirements on banks may lead to decreased availability of credit as firms are encouraged to shrink their balance sheets in order to address the effects of the increases. A decrease in credit availability will be exacerbated by the new liquidity requirements under Basel III, which will largely foreclose banks' ability to shrink their balance sheets by reducing the amount of high-quality liquid assets they hold, leaving banks with little choice but to reduce lending. In addition, as higher capital requirements cause G-SIBs' returns on equity ("**ROE**") to decrease, such firms acting rationally may well attempt to improve such results by increasing the price of credit to generate greater returns, thereby imposing greater costs on their customers. These bank actions could reduce job growth and, more generally, harm the broader economy at a particularly difficult economic juncture for many countries.

Some proponents of a surcharge have argued that higher capital requirements will lead investors to accept lower rates of return from banks subject to the requirements, which in turn will help to offset any decrease in ROE and reduce any negative effects from such a decrease.[11] However, we do

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10 *See* Consultative Document, ¶ 56.

11 *See, e.g.*, David Miles, Jing Yang and Gilberto Marcheggiano, *Optimal Bank Capital*, Discussion Paper No. 31: Revised and Expanded Version, at 9, 10 (Apr. 2011), http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031revised.pdf; Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig and Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is* Not *Expensive*, at 1, 2 (Mar. 2011), https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf.

not believe that lower leverage will in practice lead investors to accept significantly lower ROE from banking institutions. To the contrary, any decreases in ROE on a percentage basis are likely to far exceed any offsetting benefits in the form of lower cost of equity ("**COE**").

In analyzing the impact of increased capital requirements on ROE and COE, analyses conducted on behalf of TCH estimate that, under the increased capital requirements of Basel III (even before any G-SIB surcharge), ROE is expected to fall by approximately 250-300 basis points.[12] A G-SIB surcharge of 2.5% would reduce bank ROE by an additional 200 basis points, with each additional percentage-point increase from the proposed SIFI surcharge reducing ROE by an additional 50-60 basis points. Even assuming that lower leverage does in fact lead to decreased COE, it is estimated that ROE will decrease by substantially more than COE, based on the empirical relationship between ROE-COE over time, as well as the significant tax benefits of debt in certain jurisdictions. Regardless of whether the premise regarding some relationship between lower leverage and COE proves correct, the imposition of a G-SIB capital surcharge can be expected to further decrease ROE substantially. Additionally, in the experience of our members, equity investors, whether in banking institutions or other types of entities that compete for funds, are not low ROE investors. If these investors wanted to lower the expected return of their investment portfolios in exchange for a reduced risk of loss, there are a variety of bond and other fixed-income products that would allow them easily to accomplish this result.

2. There are important economic and other benefits attributable to larger banks that will be reduced and potentially lost if a significant capital surcharge encourages, or even virtually requires, these banks to reduce their size.

We believe the view that size alone creates prudential concerns, or, more broadly, that large banks are inherently problematic is not only simplistic in the extreme, but ignores the important economic and other societal benefits of large banks. Indeed, there are important benefits attributable to larger banks that will be reduced and potentially lost if a significant surcharge is imposed on G-SIBs, encouraging, or effectively requiring, these banks to reduce their size. The preliminary results of a study being conducted on behalf of TCH[13] show that the benefits attributable to larger banks divide into three broad categories: the broad scope of products and services provided by large banks that cannot be credibly provided by other institutions, large banks' economies of scale and the enabling of innovation across banking markets.

The broad scope of products and services provided by large banks creates economic value from products that others cannot provide at all, or at least cannot provide in an equally integrated, efficient and comprehensive manner. This benefit flows to companies of all sizes, along with retail customers and governments. In retail banking, banks with scale in and across geographies confer

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12 See pages B-9 and B-10 of *Annex B* for further details concerning this analysis.

13 Supporting analytics for the benefits attributable to larger banks as well as a quantification of the value attributable to large banks will be released upon the completion of the study. The Associations would be pleased to share the results of this study with the Basel Committee when they are finalized.

benefits to individuals and small business customers through convenient local networks, as well as nationwide branch accessibility. These features increase convenience to customers, particularly by reducing travel time, and saving time and money for those who move.

In payments and clearing, banks with scale in all payments businesses and presence across geographies confer benefits to companies, governments and institutional investors such as pension funds. They do this through payments technologies, particularly ACH, wire and check processing, as well as through custody and related services. Large banks also serve as a main gateway into the ACH network for many small banks. The study's evidence preliminarily indicates that, largely because of economies of scale in processing capacity, only banks (i) with more than approximately $100 billion in assets can provide full custodial services and (ii) with over $500 billion can offer a full complement of payments products to both retail and wholesale clients.

In commercial banking, banks with scale as well as product scope and presence across geographies confer benefits to companies of all sizes, particularly through products that enable international trade and commerce. They provide sophisticated, customized products such as trade finance, international lending and cash management to end-users. They also provide "white label services" (*i.e.*, services where a large bank with economies of scale manages operations and the smaller bank brands the product), particularly cash management, for smaller banks. The study's evidence preliminarily indicates that banks providing such benefits have more than $500 billion in assets, largely because smaller players cannot provide truly global reach.

In capital markets, banks with scale as well as product scope and presence across geographies confer benefits, particularly to larger corporations and governments. These benefits are conferred by facilitating large or complex capital markets transactions, or through customized derivative products that allow companies to hedge their business risks, such as commodity prices. The study's evidence preliminarily indicates that to provide such offerings, banks must hold more than $500 billion in assets because of the scale of resources that are necessary to support large transactions or significant flow of transactions across geographies.

With respect to innovation, although large banks are not always the initial innovator, the study has preliminarily found that large banks help spread innovations across the industry, benefiting retail and commercial customers, as well as smaller banks that seek to utilize these innovations. Benefits to retail consumers have been particularly pronounced, with examples ranging from ATMs, and advances in fraud protection, to online and mobile banking. In addition, the study has preliminarily found that large banks have been particularly successful in spreading innovations that require large user bases or large investments necessary to develop new technologies. ATMs and payments instrumentalities such as ACH and wire provide two examples. Cash management platforms are an example of a technology requiring heavy investment.

The study has also preliminarily found that reducing the "size" of banks along several dimensions would significantly reduce the value of the benefits described above. For example, reducing banks' geographic scope would limit their ability to offer convenience benefits to customers, including broad and deep branch networks, and the ability to conduct transactions across borders. An additional drawback is increased risk from heightened exposure to the risks of regional economies or industries. Another is decreased local competition because, historically, competition has risen when banks are

allowed to span multiple geographies. Shrinking individual bank businesses would deprive the banks' large customers of the scope of product offerings and convenience they require. It would also reduce banks' incentive to innovate because they might not have a sufficiently large enough customer base to obtain sufficient returns on innovation investments. In light of the foregoing, it is clear that there are many ways in which big banks provide important economic and societal benefits that would be significantly diminished by the imposition of a significant capital surcharge on larger banks which encourages, or, more likely, virtually requires, that such banks reduce their size. As such, we strongly believe that a policy reflexively based on the notion that size alone creates prudential and other concerns and which inherently ignores the existence of these benefits is fundamentally short sighted and inappropriate.

3. A capital surcharge on G-SIB's will encourage the growth of the significantly less regulated and less transparent shadow banking system and therefore serve to increase systemic risk.

Demand in the economy for the products and services that G-SIBs are no longer willing and able to provide because of the higher costs imposed by a G-SIB surcharge will not, of course, simply evaporate. The provision of some of these products and services is likely to shift to the less regulated and less transparent "shadow banking" sector.[14] The Proposal particularly exacerbates this problem by imposing a surcharge on certain banks well in advance of even considering the imposition of a similar surcharge on other systemically important financial institutions. Moreover, the Proposal amplifies this problem because of the way it measures systemic importance. In particular, because the Proposal excludes shadow "banks" from the data used to determine indicator scores, banks are assessed without regard to the actual market for the activities, assets, liabilities, derivatives and exposures measured by the indicators. As banks subject to a surcharge gradually reduce the size of or abandon targeted business lines that are In effect taxed by the surcharge, "surviving" banks in the sector that are subject to the surcharge will take on ever larger shares of what business remains in the banking system and, thus, be still more heavily penalized by ever-larger surcharges. These surcharges, in turn, will drive even further business, including traditional credit intermediation, to the shadow banking sector.[15] In view of the shadow banking system's role in lowering credit standards during the last decade,[16] and the absence

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14 This migration of business to the shadow banking sector is of course already underway. *See, e.g.*, Kate Berry and Jeff Horwitz, *Regs Push MetLife Out of Banking, into Shadow System*, American Banker (July 2011) (discussing MetLife's decision to sell its bank but to continue writing mortgages). *See also* Thomas F. Cosimano and Dalia S. Hakura, *Bank Behavior in Response to Basel III: A Cross-Country Analysis*, IMF Working Paper (May 2011), at 6 (noting that even modest increases in lending costs as a result of increased capital requirements on banks "could create significant incentives for regulatory arbitrage and a shift away from traditional banking activity to the 'shadow-banking sector'").

15 The Proposal posits that smaller banks will take over this business, but this is at best uncertain, especially in view of the scale and investment required in several of the targeted business lines (*e.g.*, clearing and settling payments for customers through payment systems).

16 *See* Financial Stability Board, *Shadow Banking: Scoping the Issues*: *A Background Note of the Financial Stability Board* (April 12, 2011), at 3, available at http://www.financialstabilityboard.org/publications/r_110412a.pdf.

of regulation and transparency, a migration to that system would have negative implications for the health of the financial system as a whole.[17] In addition, the shadow banking system can exhibit volatile and intermittent flows compared with the traditional banking system's credit intermediation function. This lack of reliability as a source of funding would subject borrowers to marketplace vagaries. Both of these outcomes would actually increase systemic risk – quite the opposite of the ultimate goal of the Proposal.

D. There are significant uncertainties in the theoretical and policy foundations regarding, as well as the appropriate calibration for, a G-SIB surcharge. Given these uncertainties, the imposition of a G-SIB surcharge could have economic costs and other unintended consequences and risks that are not readily apparent.

Even accepting, for argument's sake, the appropriateness of a G-SIB surcharge, there are significant uncertainties and open questions concerning the theoretical and policy foundation of a G-SIB surcharge, including, as the Basel Committee itself readily acknowledges, questions regarding the appropriate method to calibrate such a surcharge.[18] Depending on the assumptions selected and measurement method chosen, the "systemic importance" of a bank can vary widely. The empirical measurement of systemic importance is in its infancy, and academic commentators pursuing this research regularly caution against directly adopting their work as part of a regulatory framework.[19] There has been limited research regarding capital surcharges affecting only the largest institutions. The majority of research focuses on the impact of Basel III or system-wide optimal capital levels. Finally, and perhaps most significantly, the full potential combined impact of the current financial-services regulatory reforms, including Basel III (both capital and liquidity) and the Proposal's G-SIB surcharge, has not yet been comprehensively analyzed.[20] As such, the cumulative effects of these complex rules could have economic costs and other unintended consequences and risks that are not readily apparent.

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17 *Cf.* Zoltan Pozsar, Tobias Adrian, Adam Ashcraft and Hayley Boesky, *Federal Reserve Bank of New York Staff Reports: Shadow Banking*, Staff Report No. 458, at 69 (July 2010) (questioning whether the economically viable parts of the shadow banking system "will ever be stable through credit cycles in the absence of official credit and liquidity puts").

18 *See* Consultative Document, Annex 2 at 23 (noting regarding its empirical analysis undertaken in support of the assessment of the magnitude of additional loss absorbency that "[i]t is important to note that there is no single correct approach that is reliable enough to inform the assessment of the magnitude of additional loss absorbency . . . . All the approaches suffer from data gaps and the results are sensitive to assumptions made . . . . The estimates of the magnitude of additional loss absorbency based on the expected impact approach, assessment of the long-term economic impact and too-big to-fall [*sic*]. . . subsidies are based on imperfect models and involve numerous assumptions and judgments.").

19 *Cf*. John B. Taylor, Systemic Risk in Theory and Practice, at 51 (stating that systemic risk is still not well defined and that reform proposals relying on systemic risk to determine in advance whether a firm should be deemed systemically significant "are not ready for prime time") (2010), available at http://www.stanford.edu/~johntayl/Onlinepaperscombinedbyyear/2010/Defining_Systemic_Risk_Operationally.pdf.

20 Public sector officials have acknowledged that the aggregate impact of the current financial-services regulatory reforms in the U.S., including the Dodd-Frank Act and Basel III, have not yet been fully

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In view of the empirical evidence suggesting that recent regulatory reform efforts may have significantly reduced the systemic risk and probability of failure of large banks, the potential negative economic and other consequences of a G-SIB surcharge and the uncertainties surrounding the theoretical foundations of such a surcharge, the Associations have strong reservations regarding the assumptions underlying the very concept of a G-SIB surcharge, and strongly believe the imposition of such a surcharge at this time would be at best premature, especially given the currently fragile and volatile world market and economic environment.

III. The Associations have fundamental reservations concerning the design of the Proposal and its indicator-based methodology in particular.

As a general matter, the Associations believe that any regulatory capital proposal, at a minimum, should adhere to the following set of basic common-sense principles:

- The proposal should be transparent, unambiguous and internally consistent.
- All quantitative measurements should be commensurate with their intended purpose.
- The methodology used to measure the amount of required capital and the amount of required capital should be justified economically – *e.g.*, the costs of required capital should be commensurate with its expected benefit.
- A bank should be able to undertake capital planning in accordance with the regulation and know the consequences of its actions on its required capital.
- The proposal should not incentivize increased risk taking.

We view the satisfaction of these principles as a minimum precondition to credible and effective capital regulation. As currently presented, however, the Proposal fails to satisfy, in a meaningful way, *any* of these basic touchstones. More particularly, the Associations are deeply concerned that the Proposal is deeply flawed both in design and with respect to its indicator-based methodology.

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analyzed. *See, e.g.*, Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke's Speech on the U.S. Economic Outlook (June 7, 2011) (transcript available at http://video.cnbc.com/gallery/?video=3000026289) (noting that no one had yet done an analysis of the impact of the recent financial reform on credit and stating, "It's just too complicated. We don't really have the quantitative tools to do that.").

A. The Proposal has fundamental flaws in its design.

1. The Consultative Document's lack of supporting empirical analysis seriously undermines the Proposal's credibility and generally hinders the banks' ability to analyze it in a meaningful way.

The Proposal uses a complicated matrix of factors that suggest precision, but no substantive supporting empirical analysis is provided showing how the various indicators and the implied capital surcharge on the business lines and activities measured by those indicators are linked to a reduction in the probability of default of G-SIBs. The data and analysis provided in Annex 2 of the Consultative Document is rather limited and conclusory at best. This lack of substantive supporting empirical analysis seriously undermines the Proposal's credibility and generally hinders banks' ability to analyze meaningfully the calibration of the surcharge, the choice of categories and indicators and the weightings of those categories and indicators. It is critical to the transparency and credibility of the Proposal that the banking community understand the nexus between the systemic importance score and the expected probability of default of a G-SIB because the Proposal purports to draw this nexus. We are quite concerned that the Proposal, with its far-reaching impact and implications for banks and the global financial system as a whole, is being considered without the opportunity for truly meaningful public review and comment on the substantive empirical analysis that purports to support the FSB's and Basel Committee's policy recommendations.

2. The Proposal creates a "black box" for calculating surcharges, rendering banks unable to determine their capital surcharge or what actions to take to reduce their global footprint.

It is essential that the determination of the surcharge – including, in particular, the calculation of the "indicator-based scores" for banks, the designation of G-SIBs and the allocation of G-SIBs to "buckets" – be conducted in a transparent manner for at least two reasons. First, banks should have the information necessary to adjust their risk profiles and business models in order to adapt to the new regulatory capital regime. Second, without transparency, a cloud of uncertainty is created over each potential G-SIB, which adversely affects the market price for its securities and thereby potentially affects the availability of capital. The Proposal, however, provides little if any transparency regarding the assessment and calculation of the surcharge. Instead, it effectively creates a "black box" for determining the surcharge, rendering banks unable to calculate their surcharge or to take steps to reduce their systemic importance scores, and thereby injecting substantial uncertainty into the capital planning process. This additional uncertainty comes at a particularly inopportune time given the already acute uncertainty under which banks currently operate as a result of a multitude of new, complex rules proposed and adopted following the financial crisis. The Associations, for reasons discussed below, are deeply concerned that this uncertainty will have adverse consequences not just for banks but also for their customers, investors and the general economy.

Because the G-SIB capital surcharge described in the Proposal effectively punishes size, global footprint and certain activities, banks should have the ability to evaluate their structure and operations and proactively determine the potential magnitude of the applicable surcharge in order to manage and/or mitigate its potential impact. However, a bank cannot determine its systemic importance score – and thus its surcharge – with any degree of accuracy over time because of two

features of the Proposal's methodology for determining the surcharge. Systemic importance scores are determined on a relative basis. As a result, in order for a bank to calculate its individual systemic importance score, it will need the ability to calculate and forecast not just the amount of each of the individual indicators for it, but also the denominators of each of the respective indicators. However, the metrics chosen for the indicators are difficult to model even internally for an individual bank; modeling them for a subjective sample of 73 banks is not feasible.

Moreover, data for many of the indicators do not at present exist as acknowledged by the Basel Committee.[21] Creating a cross-jurisdictional uniform aggregated database that earns the confidence of the markets will involve substantial challenges that require addressing different business and reporting practices, different accounting regimes and currency conversion. If this database is not successfully created, the surcharges will almost certainly be unreliable and inequitable.[22] The present lack of such a database obviously creates a great deal of uncertainty in the capital and business planning of banks potentially subject to the proposed surcharge.

The inability of a bank to estimate its surcharge with any accuracy frustrates bank management's ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held. In general, given the potentially severe supervisory consequences of holding too little capital, uncertainty regarding the magnitude of the regulatory surcharge will require banks to hold a much higher amount of capital in the form of an "uncertainty surcharge." Although this result may seem to some like an acceptable, or even desirable, regulatory outcome, capital is not free, and the incidence of the costs of holding more capital than is necessary or appropriate will not fall solely on banks, but also on customers of the banks and the general economy.[23] The lack of transparency surrounding the calculation of a bank's systemic importance score also makes the banking industry more difficult to understand for investors by introducing volatility and uncertainty in capital and associated profitability projections.

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21 Consultative Document, ¶ 71 ("The Basel Committee acknowledges that the data used to construct the indicator based measurement approach currently may not be sufficiently reliable or complete. . . [T]he Basel Committee will address any outstanding data issues and re-run the indicator-based measurement approach using updated data well in advance of the implementation . . . This includes issues such as providing further guidance on the definition of the indicators, how to standardise further the reporting across the sample banks and how to address data that are currently difficult to collect or not publicly available"). Although rerunning the data and approach at a later date may prove helpful, it will be too late to mitigate the impact of the current uncertainty.

22 We strongly believe that the surcharge should not be implemented – whether formally or informally – prior to the completion of this database, regardless of whether this database is completed before the beginning of the proposed phase in period (*i.e.*, January 1, 2016).

23 See Part II.C.1 for a discussion of these costs.

3. G-SIBs may be discouraged from conducting the activities measured by the indicators, including many that are beneficial and cannot be readily assumed by smaller banks.

The Proposal would have the effect, we realize likely by design, of discouraging large banks with global footprints from engaging in a variety of core wholesale banking activities. Many of those activities, however, are important to the healthy functioning of national and international economies and financial markets, including payment systems, and cannot be readily assumed by smaller banks in view of the scale and investment required in several of the targeted business lines (*e.g.*, clearing and settling payments for customers through payment systems). Additionally, the Proposal will likely discourage banks from engaging in a variety of actions that could be beneficial to banks and the broader economy (*e.g.*, loan growth and stabilizing acquisitions of institutions in financial distress), especially in times of economic weakness, because these actions could increase a bank's systemic importance score. As discussed in Part II.C.2, by encouraging large banks to shrink, the G-SIB surcharge could destroy some of the benefits provided by large banks. That the Proposal penalizes these activities and could destroy these benefits highlights other important defects in the Proposal that will further amplify its already significant costs.

4. The Proposal discourages banks from diversifying their assets across jurisdictions and business lines.

It is well established that an undiversified portfolio of securities or other assets is subject not only to systemic (*i.e.*, market) risks but also to security specific risks, and that security specific risks can be reduced by investing in a variety of assets, the returns of which are not necessarily correlated. All else held equal, an undiversified portfolio of assets is riskier than a diversified portfolio, because the former is subject to asset specific and general market risks, whereas the latter is generally subject only to general market risks. The Proposal, however, not only fails to provide any offsetting benefits for banks with diversified assets, but actually penalizes banks for diversifying their assets geographically and across business lines. This approach is inherently flawed because it fails to accord any recognition to the risk mitigations of geographic and business line diversification, which is inconsistent with best risk management practices. Moreover, the failure to recognize these benefits results in a significant overstatement of the systemic risk posed by large banks and encourages a monoline approach to providing financial services that has proven in multiple instances (*e.g.*, Washington Mutual, Lehman Brothers and AIG) more rather than less risky. This failure constitutes another fundamental flaw in the Proposal's methodology that may increase rather than reduce the chances of G-SIB failure.

5. The G-SIB surcharge will lead to unjustified competitive inequalities among firms.

Imposing a significant capital surcharge on G-SIBs will lead to competitive inequities both between G-SIBs and other large nonbank financial institutions and between G-SIBs and other large banks that are not subject to the surcharge. Under the Proposal, only 28 of the 73 presumably large international banks selected for analysis (and whose data is aggregated for purposes of the denominator used for the indicator-based approach) will be subject to a capital surcharge. In addition, the 28 G-SIBs themselves will be subject to differentiated surcharges based on the yet to be defined "buckets" to

which they ultimately are assigned. Although we do not yet know the cut-off scores for surcharge versus no surcharge or for the various surcharge buckets, inherent in the very nature of the formula-based approach of the Proposal is the probability that such scores will have arbitrary effects as among banks, especially those whose scores are just below and just above a particular cut-off score. Nevertheless, fine numerical distinctions on the Proposal's normalized scale could have dramatically different effects on banks with essentially very similar risk profiles in the real world. This will necessarily lead to unjustified competitive inequalities among firms, where small statistical differences substantially increase a firm's regulatory capital requirements in relation to those of its competitor or competitors.

6. The Proposal inherently creates the incentive for G-SIBs to concentrate their activities in business lines that are not penalized under the indicator-based methodology, thereby amplifying the potential for systemic disruptions if those business lines turn out to be a primary source of problems in a subsequent financial crisis.

There are risks inherent in any rigid indicator-based methodology that effectively taxes business lines regulators deem to be "risky". Over time, banks subject to the Proposal will tend to allocate assets and deploy capital in business lines not subject to this tax, thereby concentrating risk in these non-penalized businesses. If another crises occurs, and the business lines not penalized by the indicator-based methodology turn out to be a primary source of systemic risk, then the externalities of failures of G-SIBs could in fact increase in spite of, or even because of, the additional capital surcharge. As demonstrated by the recent financial crisis, regulators are not necessarily more prescient than bank management in indentifying problem asset classes, and the Consultative Document has not provided any substantive empirical evidence in support of its selection of categories or indicators or the weighting of those indicators as discussed in Part III.A.1. The Associations are thus deeply skeptical that the proposed indicators – or indeed any set of rigidly defined indicators – will be helpful in reducing systemic risk and may, to the contrary, actually increase it.

B. Numerous aspects of the Proposal's indicator-based methodology are seriously flawed.

The Associations generally agree with the Basel Committee that no measurement approach will perfectly measure systemic importance across all global banks,[24] and perfection should not be demanded of any methodology. Nevertheless, we have serious concerns with numerous aspects of the Proposal's indicator-based methodology, including the following:

1. Under the Proposal's methodology, banks could collectively reduce their systemic importance and yet not reduce the capital surcharge applicable to them.

The deeply flawed nature of the Proposal is demonstrated by the fact that a significant and proportional downward adjustment in systemic risk among the 73 banks would not produce any change in their individual capital surcharges. The Proposal's methodology is purportedly structured in a

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24 *See* Consultative Document, ¶ 13.

manner that encourages banks to reduce the size of their indicator scores by reducing the size of certain business lines. The Proposal indicates that, after its implementation, the cut-off score and the threshold scores for buckets will be fixed for three to five years. It also appears that the denominator may be frozen during this time.[25] At the end of three to five years, the entire process, as well as the cut-off scores and threshold scores for buckets (and potentially the denominator), will be revisited and recalibrated. During each three to five year period, each bank will have an incentive to reduce the aggregate value of its systemic importance score, in order to decrease its G-SIB buffer. However, if all 73 banks in the sample reduced the magnitude of each of their indicators over the three to five year window by the same percentage (*e.g.*, by 20%), all scores would decrease (assuming the denominator was unchanged) and, during the next calibration period, the total denominator would be reduced by the same amount that each bank reduced its numerator (*i.e.*, 20%). As a consequence, every bank's score would return to its initial level (unless the threshold scores for buckets were also adjusted). This result is not sensible given that banks would have lowered their systemic importance scores and thus their systemic importance, as measured by the Proposal. We believe this result is indicative of fundamental flaws in the Proposal's methodology and alone would be sufficient to require reconsideration of the Proposal as a whole.

2. The Proposal's indicator-based methodology creates perverse incentives to increase instead of decrease risk.

a. <u>The cross-jurisdictional indicators encourage banks to fund foreign claims with home country liabilities, an objectively riskier practice than funding these claims with local currency liabilities.</u>

The focus of the cross jurisdictional activity category is to capture the "global footprint" of banks, and it is based on the assumption that the "greater the global reach of a bank, the more difficult it is to coordinate its resolution and the more widespread the spillover effects from its failure."[26] At the outset, we submit that this approach is inherently flawed because it fails to accord any recognition whatsoever to the risk mitigations of geographic diversification. This methodology creates an incentive for banks to fund local assets with home country liabilities, rather than with local liabilities – an objectively riskier practice in view of various factors, including exchange rate and exchange control risks and interest rate risks. To illustrate this issue, consider the following hypothetical bank structures:

- Structure 1: A U.S. bank holding company with subsidiaries or branches in 25 countries. Each subsidiary or branch has local currency assets funded entirely by local currency liabilities.
- Structure 2: A U.S. bank holding company with subsidiaries or branches in 25 countries. Each subsidiary or branch has local currency assets funded by U.S. liabilities.

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25 As noted in Part IV.B, we would appreciate the Basel Committee's clarifying how often the denominator used to calculate the systemic importance score will be updated.

26 *Id.* ¶ 18.

Assume the size of the local currency assets in each of the 25 branches or subsidiaries are identical in structures 1 and 2. All else held constant, Structure 2 would be the riskier structure of the two. However, according to the methodology for determining a G-SIB's score for the cross jurisdictional activity, Structure 2 would have the smaller indicator score, because in Structure 2 the bank holding company does not have any "cross-jurisdictional liabilities" for purposes of this indicator.[27] In other words, the proposed methodology would penalize a G-SIB for holding local assets in foreign jurisdictions that are funded by local liabilities, and instead encourage it to fund those assets with liabilities in its home country, even though match funding with local liabilities is far less risky. Thus, the methodology would incentivize cross border funding of foreign operations, a practice that is objectively riskier as described above. This is simply not sensible.

b. <u>The indicators' failure to account for the risk of assets, derivatives or exposures held by a bank is inconsistent with the stated aim of the Proposal to reduce the probability of failure of G-SIBs.</u>

Each of the cross-jurisdictional activity, size, interconnectedness and complexity categories contains an indicator or indicators that attempt to quantify the amount of assets, derivatives or other exposures held by a bank. None of these indicators, however, takes into account the risk profile of those assets, derivatives or exposures for purposes of determining a bank's indicator-score. For example, the complexity category does not differentiate between (i) a $100 billion available for sale portfolio of local currency and investment grade sovereign debt, whether held for liquidity or as a safe investment of excess liquidity and (ii) a $100 billion local currency trading portfolio of illiquid non-investment grade securitization tranches, even though the bank with the former portfolio has sharply less liquidity and credit risk and, therefore, a lesser risk of failure. Similarly, the intra-financial system assets indicator does not differentiate between a loan to a banking organization on the verge of receivership with little balance sheet equity and a loan to banking organization that holds twice the required minimums of CET1 under Basel III, even though the risk of loss is far greater with respect to the latter loan. This failure to account for the riskiness of the assets, derivatives and other exposures of G-SIBs is not consistent with the goal of reducing the probability of default of G-SIBs and highlights another serious flaw in the Proposal's methodology.

3. The Proposal lacks a mechanism to lower the capital surcharge as the global systemic importance of G-SIBs in the aggregate is reduced.

The Proposal provides that individual G-SIB systemic importance scores will be updated annually based on changes in the bank indicator amounts, and that the cut-off score and the threshold scores for the surcharge buckets will be initially fixed for three to five years and then reviewed. Notably, however, the Proposal does not appear to provide for a reassessment of the overall calibration of the surcharge itself and an adjustment downward if warranted. Given that the calibrations of the surcharge appear to have been based on current estimates and judgments regarding the probability of default of G-SIBs and the costs of such default, a meaningful reduction in the magnitude of either of these key variables would provide a compelling justification for reducing the size of the capital surcharge as a

[27] Structure 1 and Structure 2 are equivalent with respect to the other individual indicator for this category – cross-jurisdictional claims.

whole and therefore reducing the size of the buckets. The introduction of a mechanism to lower the surcharge (if warranted) would also encourage G-SIBs collectively to "reduce their systemic importance," one of the objectives of the Proposal.[28] However, the Proposal appears to lack any mechanism whereby the absolute magnitude of the surcharges themselves can be reviewed and adjusted if warranted in light of any reductions (or increases) in the expected probability of default of G-SIBs. The failure to provide for such a mechanism underscores a structural flaw in the design of the Proposal.

4. The methodology for determining the score for the wholesale funding ratio indicator is flawed.

The Proposal states that "[t]he maximum possible total score a bank could have (*i.e.*, if there were only one bank in the world) is 5" and that each of the five categories is normalized to a score of one.[29] However, the denominator used to determine the score for the wholesale funding ratio is defined as the average instead of the sum of all banks' ratios. As a consequence, the score for this indicator could be larger than 1 for approximately half of the 73 banks, if their scores were symmetrically distributed around the average value. Independent of the shape of the distribution of scores, of necessity some banks will have a wholesale funding ratio greater than average and consequently will have an indicator score greater than 1, which could in certain circumstances violate the rule that the maximum category score for any bank is 1. In fact, if 72 banks had a wholesale funding ratio of zero and one bank had a non-zero wholesale funding ratio, then the average value of the ratio would be the ratio of that bank divided by 73, and this bank's indicator score would be 73. As a consequence, the maximum total score of one bank would be approximately 29 (that is, 73 divided by 3, plus 4.67, which is the maximum total score for all of the other indicators), instead of 5.[30]

This example illustrates the potentially enormous weight assigned to the wholesale funding ratio. The Proposal however asserts, regarding its decision to define the denominator for the wholesale funding ratio as an average, that "[t]he choice of normalization is arbitrary, but chosen because it delivers the score in units that are comparable to the other indicators."[31] In fact, as just demonstrated, the choice to define the denominator for the wholesale funding ratio as an average, instead of a sum, is not comparable with the other indicators and will materially distort the total score of all banks whose wholesale funding ratio is higher than average by implicitly assigning a very high

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[28] *See Id.* ¶ 55.

[29] *Id.* ¶ 17.

[30] As discussed further in Part IV.D, the Proposal's use of the term "weighting" is unclear. For example, paragraph 17 of the Proposal states that if the size indicator for a bank accounts for 10% of the sample aggregate size variable, it will contribute 0.10 to the total score for the bank, and it does not multiply the .10 by 20%[30] – that is, it fails to multiply the score by the weighting of the indicator, but rather appears to be multiplying the indicator score by a fraction equal to one over the number of indicators in the category (which in the case of the size indicator equals 1) and adding that to the total systemic importance score.

[31] *Id.* fn. 11.

weight to this one indicator. This untoward result is indicative of deep flaws in the design of the Proposal.

5. The wholesale funding ratio indicator's focus on the source of funding is incorrect. A bank's score for this indicator is also erroneously inflated because it does not measure the tenor of the wholesale funding.

The wholesale funding ratio is also flawed in another respect. Longer-term funding generally puts less pressure on capital than results from short-term funding. In a crisis, if an institution has wholesale funding with a tenor, for instance, of three years, then the roll-over risk is much further out, and at a time, potentially, when the crisis will have been resolved. We therefore believe that the term of a bank's funding is a more relevant factor to systemic risk in a crisis than the source of its funding (*i.e.,* whether it is from retail or wholesale sources). Although the Basel Committee notes its concern about the risk inherent in short-term financing, the wholesale funding ratio indicator does not address this concern because it does not measure the tenor of the wholesale funding and, as a result, it inflates the indicator.

6. The assets under the custody of a failed bank remain available to customers.

The Proposal states that the failure of a large custodian bank holding assets on behalf of customers could disrupt the operation of financial markets.[32] The Proposal thus appears to assume that assets held under custody at a failed bank would become inaccessible to the customers as a result of the failure. We do not believe that assumption is warranted. Under U.S. law, it is quite clear that assets held by a bank as custodian are not part of the bank's receivership estate in a failure.[33] To the extent there is uncertainty regarding the status of assets in other jurisdictions upon a custodian's failure, the Basel Committee should undertake the research necessary to establish the systemic significance of custodial relationships. We do not believe that assets under custody is inherently indicative of systemic importance.

7. The market for underwriting services is deep and competitive.

The Proposal asserts that the failure of a bank with a large share of underwriting of debt and equity instruments in the global market may significantly impede new securities issuances. We do not believe this is accurate. The markets for such services are deep and highly competitive. In past failures of major investment banks (which were not purchased), underwriting functions were easily replicated. As a result, there is no basis to conclude that the failure of a G-SIB, even one with a

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[32] *See Id.* ¶ 37.

[33] In addition, under U.S. law, the actual liquidation of a large bank that goes into receivership is rare. In almost all circumstances, the Federal Deposit Insurance Corporation, as a receiver, transfers the assets, liabilities and operations of banks that go into receivership to successor buyers, most often contemporaneously with the receivership. In addition, Title II of the Dodd-Frank Act, has created similar provisions for holding companies engaged in financial activities that are not themselves banks.

significant share of underwriting market, would impede new securities issuances. Accordingly, we believe that the value of underwritten transactions is not indicative of systemic importance.

8. A gross notional measure of OTC derivatives overstates the risks associated with holding such derivatives.

The OTC derivatives indicator in the complexity category calculates the value of OTC derivatives on a gross notional basis. Most OTC derivatives activity is conducted, however, pursuant to legally enforceable netting arrangements. As a result, the exposure of such derivatives is limited to a net obligation.[34] The Proposal's failure to recognize legally enforceable netting arrangements overstates the risks associated with holding such derivatives. It also effectively penalizes the banks that spent the time and resources to establish such netting arrangements by failing to take account of the success of efforts to reduce risk. For example, if one were to assume two banks with 1000x of gross notional exposure on the same book of business and one has netted down to 10x and the other to 1x, the OTC indicator would treat the 10:1 difference in risk as between the two banks in this example as non-existent – clearly an absurd result from a risk perspective. These results are indicative of an overall flawed and internally inconsistent approach to capital regulation, one which ignores the role that sound risk management practices play in reducing the chances of financial distress while at the same time assessing a capital surcharge purportedly aimed at reducing the probability of failure of G-SIBs.

9. If exposure as defined for purposes of the Basel III leverage ratio is the individual indictor for size, the Associations believe it is very important that the Basel Committee address concerns with respect to the breadth of that measure, including, among other concerns, reasonable assumptions with respect to drawdowns on commitments and recognition of legally enforceable netting.

Under the Proposal, the "size" category is measured using total "exposure" as defined in the denominator of the Basel III leverage ratio. The Associations believe that this exposure test would provide a seriously inaccurate evaluation of size unless it is adjusted to address the concerns that TCH has raised in prior letters with respect to the breadth of that measure.[35] These concerns include (i) the inclusion of gross "sold" credit derivative positions without recognition of off-setting hedges and (ii) the failure to use reasonable conversion factors for off-balance sheet commitments (*e.g.*, an assumed 100% draw-down on liquidity facilities, which is not justified by the available empirical data). Until these issues are resolved, the Basel III definition of exposure is not a meaningful indicator of size. Also, as remarked in Part III.B.2.b, we do not believe that a risk insensitive measure is a sensible way to

34 Over the years, individual banks and trade associations have made a substantial effort to analyze the enforceability of netting in various jurisdictions, and there is little question as to the legal validity of such arrangements.

35 *See* letter to the Basel Committee, from TCH, dated April 16, 2010, available at http://www.theclearinghouse.org/index.html?f=072391; letter to U.S. Department of Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Reserve Bank of New York, from TCH, dated November 4, 2010, available at http://www.theclearinghouse.org/index.html?f=072377.

determine a surcharge that aims to reduce the risk of failure.

10. Size is significantly over-counted in determining a bank's systemic importance score.

There is significant overlap between the size category, on the one hand, and the interconnectedness, substitutability, cross-jurisdictional activity and complexity categories, on the other. The size of a bank would, at the level of the largest banks, tend to correlate positively with the total value of its cross-jurisdictional claims and liabilities (which are the indicators of the cross-jurisdictional activity category); the amount of assets under custody it holds, payments cleared and settled through payment systems and transactions in debt and equity markets it has underwritten (which are the indicators of the substitutability category); its intra-financial system assets and liabilities and wholesale funding ratio (which are the indicators of the interconnectedness category); and its holdings of available for sale and trading book securities and Level 3 assets and the notional value of OTC derivatives outstanding (which are the indicators for the complexity category). As a consequence, size is significantly over-counted in the determination of a bank's systemic importance score. This over-counting is especially problematic given that size, by itself, is a poor indicator of systemic importance. As the FSB has acknowledged, the relevance of size depends on other factors, including a bank's business model and group structure and complexity.[36]

Indeed, the very rationale the Proposal provides for a separate size category demonstrates that size is over-weighted. It does not follow that "[t]he larger the bank the more difficult it is for its activities to be quickly replaced by other banks."[37] How quickly and easily a bank's activities are replaced depends more on the nature of those activities than their sheer volume. Many of the services provided by G-SIBs (*e.g.*, deposit taking, lending and underwriting services) are in deep, competitive markets, with multiple institutions capable of quickly supplying replacement services in the event of a failure of a G-SIB.

Given the substantial overlap between the size category and the indicators of the other categories, the fact size by itself is a poor indicator of systemic importance and the dubious rationale for having a size category, this indicator points to a deep structural flaw in the indicator-based methodology – namely, an over reliance on size as an indicator of systemic importance.

11. The Proposal may penalize well-managed banks with rising scores if they maintain or grow their share of businesses measured by the indicators while the industry as a whole contracts or even remains the same.

In determining a bank's systemic importance score, the Proposal compares big banks to big banks – that is, an individual bank's indicator score is determined by dividing the bank's amount for a particular indicator by the aggregate amount for that indicator for all banks in the sample. Because the

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36 Financial Stability Board, *Report to G20 Finance Ministers and Governors, Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* (Oct. 2009), at 9, available at http://www.bis.org/publ/othp07.pdf.

37 Consultative Document, ¶ 27.

Proposal determines systemic importance in this way, the Proposal's methodology could disadvantage well-managed banks if, by virtue of their safety and soundness, they maintain or grow their share of businesses – either organically or through acquisition of institutions in financial distress – measured by the indicators during periods when the industry shrinks as a whole or even remains the same. We do not believe it is at all sensible to penalize these banks under such circumstances.

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In view of the flaws discussed in this letter, the Proposal fails to satisfy any of the principles of effective capital regulation listed at the outset. For example:

- The Proposal lacks transparency and does not permit for meaningful capital planning because banks cannot determine their capital surcharge or what steps to take to reduce their systemic importance scores. It also lacks internal consistency because it is premised on the existence of substantial negative externalities and moral hazard yet, paradoxically, explicitly forbids the consideration of reforms designed to address such issues when determining a G-SIBs' score. It therefore violates the first and fourth basic principles outlined above, which generally require that a regulatory capital proposal be transparent and internally consistent and enable a bank to undertake capital planning in accordance with the proposal's requirements, respectively.

- It fails to provide any substantive empirical analysis linking the indicator-based methodology of the Proposal to its intended purpose (*i.e.*, reducing the probability of default of G-SIBs) or justifying the Proposal from an economic perspective, thereby violating the second and third basic principles, which require that a regulatory capital proposal's quantitative measurements be commensurate with their intended purpose and that its calibration be justified economically, respectively.

- The Proposal increases risk taking by encouraging banks to fund local currency assets with home country liabilities and punishing banks that diversify across jurisdiction and business lines. It also may increase systemic risk by encouraging business to migrate to the shadow banking sector. As a consequence, it violates the fifth basic principle, which requires that a proposal not encourage increased risk taking.

We believe that the failure to satisfy these common sense basic touchstones is indicative of the fundamental flaws in the design of the Proposal and its indicator-based methodology discussed above and that, as a consequence, it would be at best premature to implement the Proposal. We strongly believe that the Proposal should be reconsidered in a transparent and empirically supported and validated manner that addresses the concerns highlighted in this letter.

IV. Other Concerns and Requests for Clarification

A. The Associations would appreciate additional information on the methodology used to determine that 28 banks will initially be designated as G-SIBs.

The Proposal states that based on the result of applying the indicator-based methodology, the Basel Committee determined that the number of G-SIBs will initially be 28. No criteria or other explanation was provided for how the Basel Committee arrived at this number, other than noting that one bank was added based on the supervisory judgment of its home country supervisor. The Associations believe that a transparent process requires additional information regarding the criteria the Basel Committee used to determine that 28 banks would initially be designated as G-SIBs.

B. The Associations request that the Basel Committee clarify how often the denominator used to calculate the systemic importance score will be updated.

The Proposal notes that "bank scores will be updated annually based on new data applied to the numerator in calculating the score."[38] However, the Proposal does not state whether the denominator will also be updated at that time. This omission could be interpreted to imply that the denominator will be updated every three to five years, at the time the threshold scores are updated. The Associations would appreciate the Basel Committee's clarifying how often the denominator will be updated.

C. The Associations request additional information regarding the empirical analysis undertaken to estimate the costs of the proposed surcharge on growth.

The Associations have serious concerns with the empirical analysis undertaken to estimate the costs of the proposed surcharge on growth. The Proposal indicates that a one percentage point increase in capital applied to G-SIBs would dampen growth by an additional 0.08 to 1.46 basis points per year for an eight year implementation period, and for a four year implementation period, the range of impacts is 0.17 to 3.17 basis points per year on average over the transition.[39] These estimates were based on a study by the Macroeconomic Assessment Group (the "**MAG**"), which collected information regarding G-SIB lending and assets as a percentage of the total lending and assets of fifteen major economies. In discussing the results of this study, the Proposal notes that the top thirty G-SIBs (ranked according to the Proposal's indicator-based methodology) accounted for a very wide range of the total lending and banking assets in each of the economies represented in the study (*e.g.*, ranging from 4% to 75% with respect to lending to the non-financial private sector). The Proposal also notes that the unweighted mean of these G-SIB shares is 31% in the case of non-financial private lending and 38% for assets. It is at best unclear how the likely home-country impact of requiring G-SIBs to hold additional capital could be inferred from a study apparently based on unweighted mean data. Moreover, the wide range of the results observed would make any estimate of the impact of the

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[38] *Id.* ¶ 69.

[39] *Id.* ¶ 78.

surcharge on individual nations questionable. We urge the MAG to clarify, in its final report, its analysis and provide significant additional support for its conclusions.

We believe that even these wide spreads in anticipated decline in growth, approximately 18 times, are at best estimates. In any event, the Proposal's own estimates demonstrate the need to proceed with caution. If the higher end of the range were realized (much less exceeded) would the macroeconomic impact be acceptable?

D. The Associations request that the Basel Committee clarify its use of the term "weighting" as it applies to the determination of a bank's indicator scores.

We note that the Proposal states that the score for a particular indicator is calculated by "dividing the individual bank amount by the aggregate amount summed across all banks in the sample for a given indicator. The score is then weighted by the indicator weighting within each category."[40] However, when giving an example of this calculation, the Proposal states that if the size indicator for a bank accounts for 10% of the sample aggregate size variable, it will contribute 0.10 to the total score for the bank, and does not multiply the .10 by 20%[41] – that is, it fails to multiply the score by the weighting of the indicator, but rather appears to be multiplying the indicator score by a fraction equal to one over the number of indicators in the category (which in the case of the size indicator equals 1) and adding that to the total systemic importance score. The Associations would appreciate the Basel Committee's clarifying its use of the term "weighting" and providing additional examples regarding how the indicator scores are supposed to be calculated.

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40 *Id.* ¶ 17.

41 *Id.*

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If you have any questions, or need further information, please contact Paul Saltzman, President and General Counsel of TCH, at (212) 613-0318 (e-mail: paul.saltzman@theclearinghouse.org), Eli Peterson, Vice President and Regulatory Counsel of TCH, at (202) 649-4602 (email: eli.peterson@theclearinghouse.org), Sally Miller, Chief Executive Officer of IIB, at (202) 663-5325 (e-mail: smiller@iib.org) or Richard Coffman, General Counsel of IIB, at (646) 213-1149 (e-mail: rcoffman@iib.org).

Very truly yours,

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Executive Vice President and General Counsel
of The Clearing House Payments Company L.L.C.

Sally Miller
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Institute of International Bankers

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United States Department of the Treasury

The Honorable Neal Wolin
Deputy Secretary
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The Honorable Jeffrey A. Goldstein
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ANNEX A

The Associations

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the United States. *See* The Clearing House web page at www.theclearinghouse.org.

The IIB is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership is comprised of internationally headquartered banking and financial institutions from 38 countries around the world. The IIB's mission is to help resolve the many special legislative, regulatory, tax and compliance issues confronting internationally headquartered institutions that engage in banking, securities and other financial activities in the United States. Through its advocacy efforts the IIB seeks results that are consistent with the U.S. policy of national treatment and appropriately limit the extraterritorial application of U.S. laws to the global operations of its member institutions.

ANNEX B

Contents

- **Impact of Basel III capital requirements**
- Assessing capital needs from crisis experience
- ROE impact

Estimates of additional capital requirements are based on data from 10 US banks, which account for 54% of total US banking assets

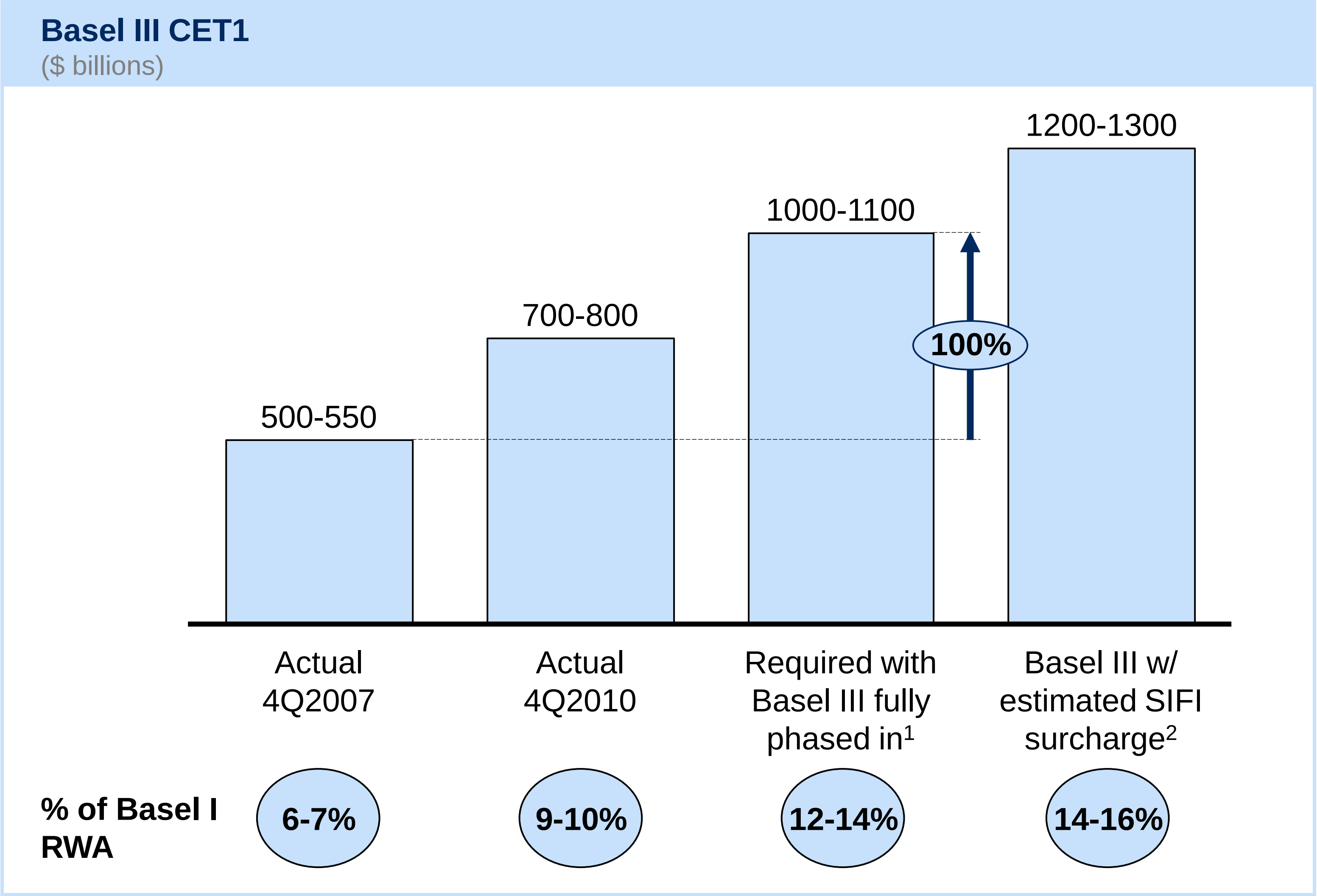
Banks for which we have current capital data

Bank of America
BB&T
BNY MELLON
citi
Capital One
JPMorganChase
KeyBank
PNC BANK
usbank Five Star Service Guaranteed
WELLS FARGO

Total assets	
USD billions	8,823
(% of US market)	(54%)

SOURCE: TCH member data, BHCPR assets data from 2010 Q4

Relative to pre-crisis levels, Basel III requires US banks to hold over 100% more common equity



1 Fully phased in at CET1 as 7% of RWA

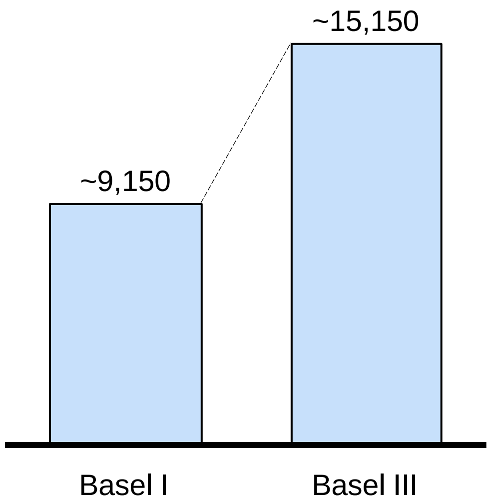
2 Estimated SIFI surcharge of 100-250bps for the industry

SOURCE: TCH QIS6 member data, SNL

How we estimate that Basel III is equivalent to 12-14% capital under Basel I

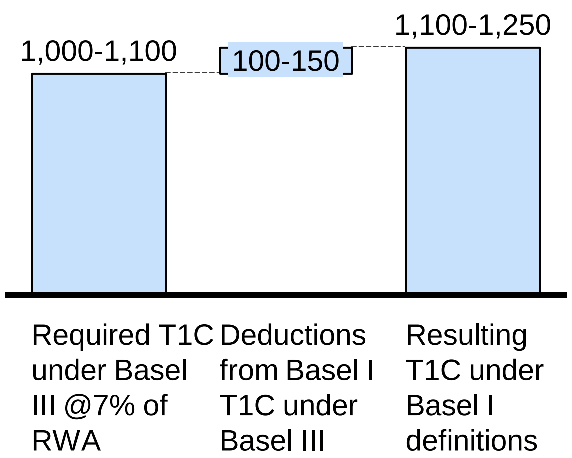
Tier 1 common equity and RWA under Basel I and Basel III

Industry RWA
$ billions, as of 12/31/2010



Basel III RWA (including changes under Basel II and Basel II.5) is an increase, of approximately 66% over Basel I RWA, as of 4Q 2010

Industry Tier 1 common capital
$ billions, as of 12/31/2010



The $1,000-1,100 of required T1C under Basel III equates to $1,100-$1,250 once Basel III deductions from T1C are removed

Capital ratio calculations

Basel III CET1 (adjusted) as % of Basel I RWA
= Basel III T1C with deductions / Basel I RWA
= 1,100/9,150
= 12%

= 1,250/9,150
= 14%

SOURCE: TCH QIS6 member data; SNL

Contents

- Impact of Basel III capital requirements
- **Assessing capital needs from crisis experience**
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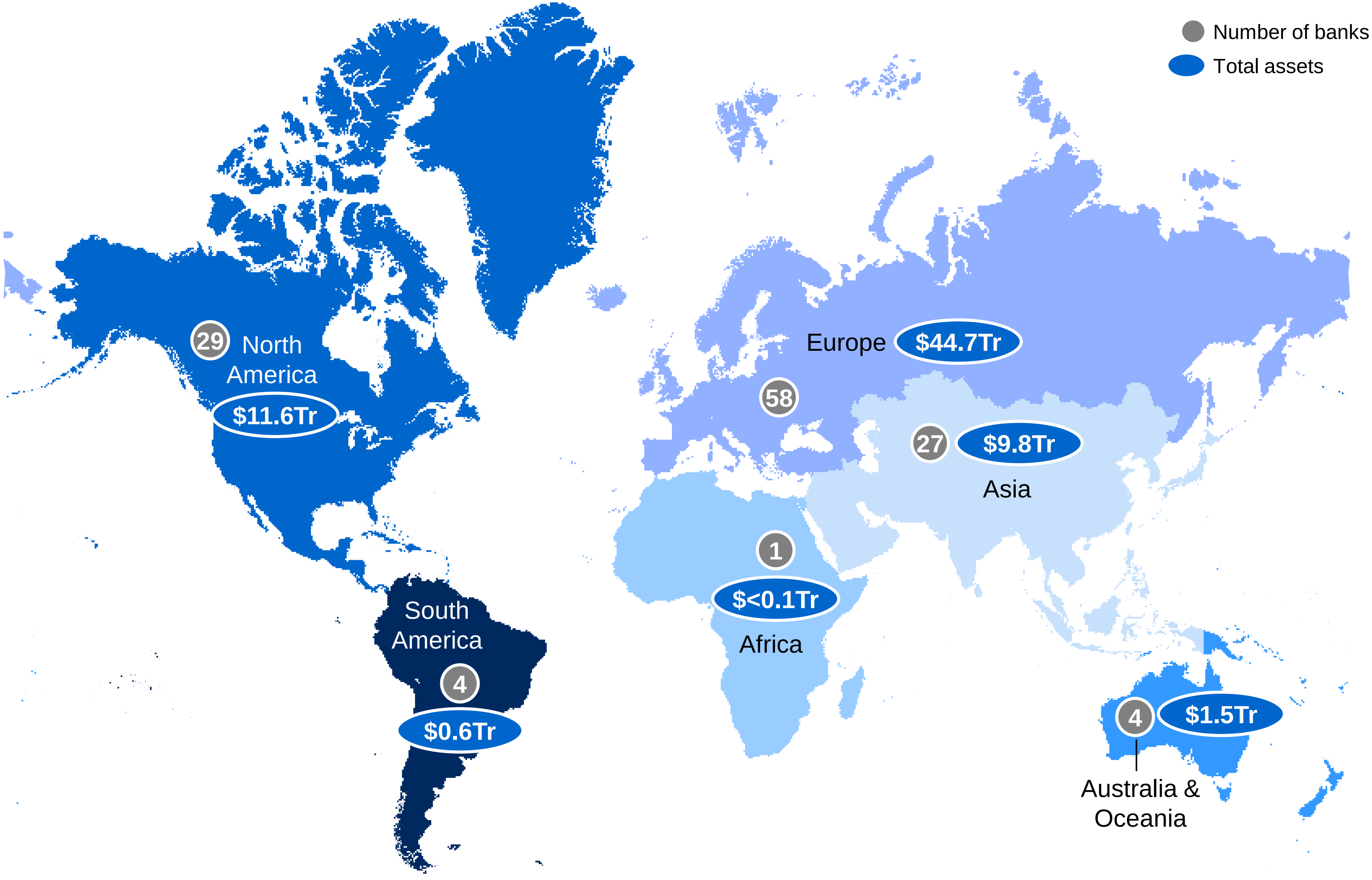
Methodology for analyzing the relationship between pre-crisis bank capital ratios and the likelihood of a bank going into distress

Approach	▪ Analyzed the relationship between capital ratios of large global banks, at the onset of the financial crisis (defined as December 2007), and subsequent Bank distress during the crisis – Initial capital ratios as defined in both Basel III and Basel I terms used to study relationship to Bank distress
Banks in sample	▪ 123 large global banks with minimum asset size of $30 billion – Represent $68.2 trillion in total assets – About 85% of developed-market banking and 65% of total banking assets worldwide – Broker-dealers excluded as risk-weighted assets data unavailable in December 2007.
Definition of distress	▪ An institution is defined as distressed if any of the following conditions was met 2007-09: 1. Bankruptcy 2. Government takeover or placement into government conservatorship 3. Merger under duress with another bank 4. Receipt of a substantial direct government capital investment or bailout[1] ▪ Using the above definition, a total of 35 banks were deemed distressed (28% of banks in the sample, covering 30% of the assets)
Adjustments for Basel III	▪ Adjustments developed to convert December 2007 capital and RWA for each bank into estimates of what Basel III capital ratios would have been, had Basel III rules existed at the time – Adjustment factors estimated for different type of banks (e.g., by country, by mix of business such as wholesale vs. retail, trading assets)

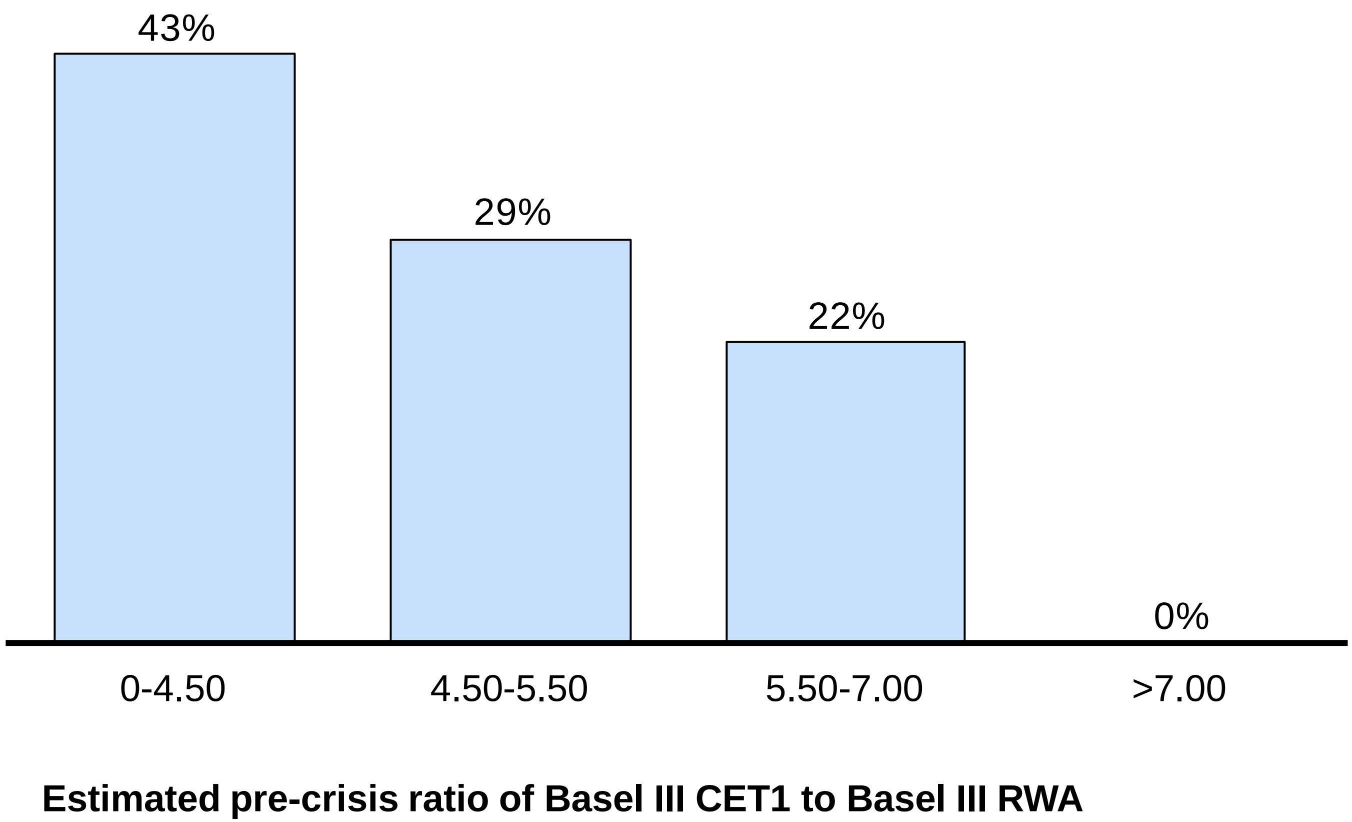
1 Defined as total government capital investment greater than 30% of the bank's starting Tier 1 capital as of December 31, 2007

The sample includes 123 banks worldwide, with more than $68 trillion in assets



Measured under Basel III definitions, no bank with a Basel III common equity to RWA over 7.00% experienced distress

Likelihood of Distress vs. Starting Capital Ratio, Percent

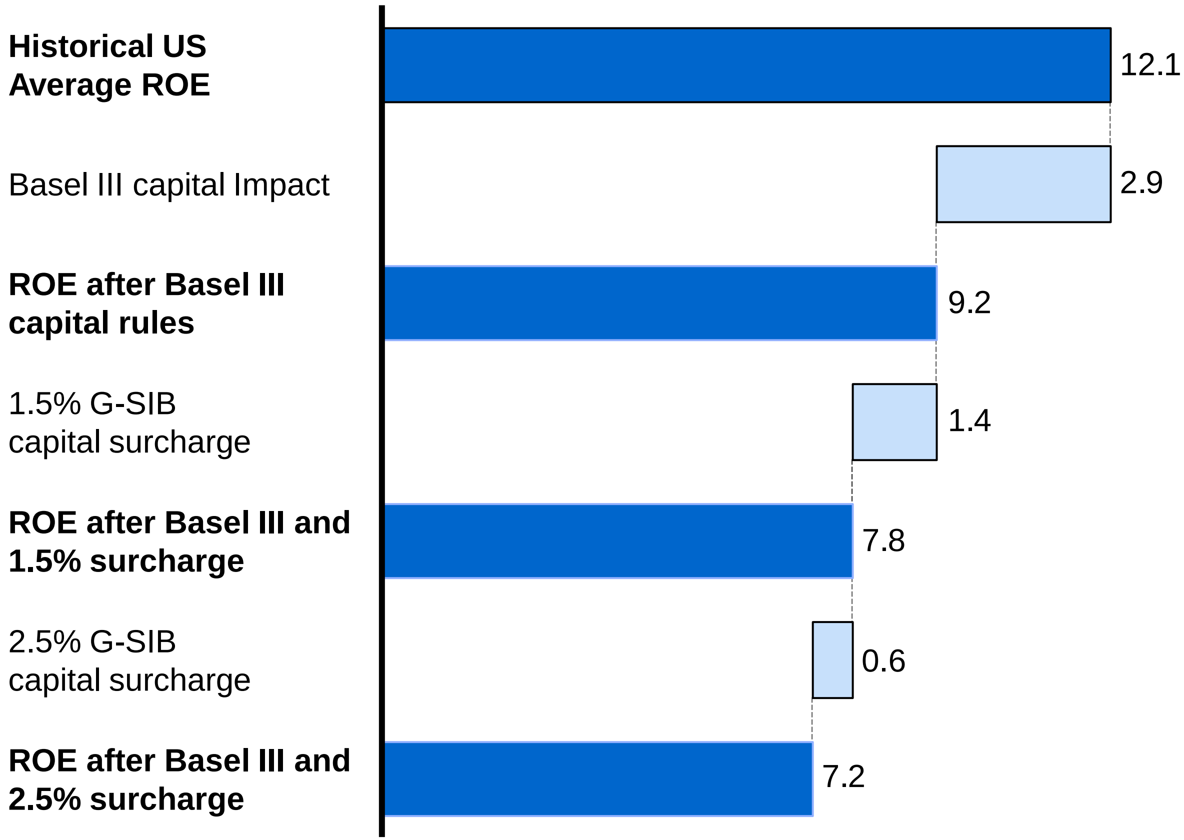


Bins chosen to have approximately equal number of banks per bin for all Basel III CET1 / Basel III RWA ratios > 4.5
SOURCE: Company 10Ks, regulatory filings

Contents

Unmitigated, Basel III capital requirements would reduce RoE by 290 bps and a 2.5% G-SIB surcharge would reduce ROE by a further 200 bps

Unmitigated ROE impact of Basel III capital proposals, as of Q4 2010[1]
Percentage points



- Key **question as to where the incidence** of regulatory changes **will fall**; i.e.,
  - **On customers**, through higher loan pricing and fees
  - **On banks**, through cost reduction (e.g., non-compensation, compensation consolidation among small banks)
  - **On shareholders**
- Analysis does not consider likely business model changes
- Even in an environment where banks are better capitalized and more liquid, the reduction in return on equity will likely be greater than the reduction in cost of equity

1 Not including ROE impacts of the LCR and NSFR