The Clearing House
At the Center of Banking Since 1853

August 1, 2012

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

Re: A Framework for Dealing with Domestic Systemically Important Banks

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (the "Basel Committee") June 2012 consultative document, *A framework for dealing with domestic systemically important banks* (the "Consultative Document").

The Clearing House has consistently voiced strong support for ongoing regulatory reform efforts that aim to make financial systems safer and more robust. Nevertheless, we have reservations regarding the implementation and calibration of a capital surcharge for domestically systemic important banks ("D-SIBs") as described in the Consultative Document and how such a surcharge would impact the broader economy. 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. We believe that the negative externalities associated with banks perceived as too big to fail can be effectively addressed without the imposition of a punitive add-on capital surcharge for D-SIBs as contemplated in the Consultative Document.

[1] 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 U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

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I. <u>Domestic regulators should have significant discretion to apply the D-SIB framework in light of the other prudential measures and reforms designed to limit systemic risk.</u>

The Clearing House supports the notion contained in the Consultative Document that any D-SIB framework, including the assessment and application of policy tools, should allow for significant national discretion, and we agree with the Basel Committee's rationale that any such framework should be constructed in a way to allow for national regulators to take account of the structural characteristics of the relevant domestic financial system and economy when considering whether to establish a D-SIB regime.[2]

As the Consultative Document recognizes, the imposition of a significant capital surcharge on D-SIBs explicitly rests on the assumption that such a surcharge is necessary to address the potential negative externatilities to the domestic financial system and economy that could result from the failure of a bank.[3] For this reason, The Clearing House supports the view, reflected in the Consultative Document, that more intensive supervision and regulation, as well as the existence of effective resolution regimes (including recovery and resolution plans), can reduce the potential for banks to pose a systemic risk to domestic financial systems and economies.[4]

In this regard, recent reforms - including increases in the minimum Common Equity Tier 1 ("CET1") ratio and the implementation of a 250 basis point capital conservation buffer under the new standards contained in the Basel Committee's fundamental reforms to the capital and liquidity frameworks announced in December 2010 ("Basel III"),[5] as well as the implementation of effective recovery and resolution regimes and other heightened prudential standards in a number of countries - have already led to substantial increases in the amount of capital held by D-SIBs and have or will substantially address the potential for a bank's failure to have systemic implications for national financial systems and economics.

As stated in The Clearing House's letter to the Board of Governors of the Federal Reserve System dated April 27, 2012,[6] the heightened capital requirements under Basel III alone will require U.S. banks to increase the amount of CET1 capital they hold by *over 100%*

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[2] *See* ¶ 4-7 of the Consultative Document.

[3] *See* id. Since the existence of effective resolution regimes, including recovery and resolution plans, can substantially reduce or eliminate the potential for the failure of a bank to create systemic risk, The Clearing House believes the existence and strength of such regimes should be expressly recognized as a factor under Principle 2 that a national authority should consider in determining whether, or how, to implement any D-SIB surcharge.

[4] *See* ¶ 7 and 42 of the Consultative Document.

[5] *See Basel III: International framework for liquidity risk measurement, standards, and monitoring* and *Basel III: A global regulatory framework for more resilient banks and banking systems* at http://www.bis.org/bcbs/basel3.htm?ql=1.

[6] Available at http://www.theclearinghouse.org/index.html?f=073837.

from the amount held at December 31, 2007.[7] In addition, as a result of the imposition of Basel III's quantitative, qualitative and risk-weighting requirements, the 7% minimum CET1 ratio under Basel III is equivalent to a 14% Tier 1-capital ratio under the pre-crisis Basel I rules for U.S. banks. If the global systemically important banks ("G-SIB") surcharge is also imposed,[8] it would result in the U.S. banking system holding the equivalent of 16% Tier 1 capital in Basel I terms, or 400% the Tier 1 capital required before the crisis in order to be "adequately capitalized"(namely, 4%).[9]

Moreover, substantial reform efforts have been made in several countries to end too big to fail and implement effective recovery and resolution regimes. The United States, for example, has adopted a comprehensive and effective resolution regime and "living will" requirements that end too big to fail.[10] Other significant regulatory reforms that have been introduced by the Basel Committee and domestic regulators address a variety of concerns relating to capital adequacy, liquidity risk, loss absorbency, market risk, counterparty risk, stress testing and capital planning. Many of these measures have already required banks to make (or implement plans to make) modifications to their capital structures, balance sheet composition, liquidity and operational risk functions, clearing arrangements, and disclosures.

Significantly, in the United States, the interplay of the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR") stress testing requirements and the capital plan rule set forth in 12 C.F.R. § 225.8 (the "Capital Plan Rule") operates as a surcharge on institutions with greater than $50 billion in consolidated assets and already requires covered companies to comply with a more stringent capital regime than is required of non-covered companies. For instance, the most recent stress test for covered companies applied a capital standard that is far more rigorous than the published capital requirements for U.S. banking organizations (or, for that matter, the capital requirements that exist, with very limited exceptions, anywhere else in the world) – a minimum 5% Tier 1 common equity ratio over nine quarters under severely stressed conditions and conservatively calculated. These results provide the ultimate refutation of the need for even more capital. To require certain U.S. banks, for example, to hold extra capital, through the operation of a separate and additional D-SIB surcharge, beyond what

[7] For further information regarding how much additional common equity banks will need to hold relative to pre-crisis levels, as well as the data on which this estimate is based, see slides 9 and 13 of The Clearing House study entitled "*How Much Capital Is Enough? Capital Levels and G-SIB Capital Surcharges*" (the "G-SIB Surcharge Study") available at http://www.theclearinghouse.org/index.html?f=073503.

[8] See *Global systemically important banks: assessment methodology and the additional loss absorbency requirement* at http://www.bis.org/publ/bcbs207.pdf.

[9] *See* slide 6 of the G-SIB Surcharge Study.

[10] Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") creates a new resolution authority, called the Orderly Liquidation Authority ("OLA"), for systemically important financial institutions which gives supervisors an array of tools to resolve a large bank and mitigate systemic risk. The Federal Reserve Board and the Federal Deposit Insurance Corporation also have adopted rules that require banking organizations with $50 billion or more in total assets to prepare and submit credible recovery and resolution plans.

would be required for the bank to withstand (and continue to act as a financial intermediary through) a financial collapse in Europe and a domestic depression (the model of the Federal Reserve's macroeconomic assumptions) would be undeniably excessive and unnecessary in light of the discretion the Consultative Document gives national regulators to implement the principles underlying heighted capital requirements for D-SIBs.

We are concerned that a D-SIB surcharge, in combination with other recent reforms that increase the amount of effective CET1, would add little marginal utility to addressing the potential for negative externalities created by banks perceived as too big to fail. In view of the measures already underway to reduce the systemic risk of financial institutions such as OLA, CCAR and the additional enhanced prudential standards required under Section 165 of the Dodd-Frank Act, we strongly believe that financial institutions are holding sufficient capital to ensure the safety and soundness of the U.S. financial system. Accordingly, we fully support the principle that local supervisors be given national discretion as to the application of the D-SIB framework after considering local reforms. We believe that a policy which inherently ignores the existence of alternative tools and is simply based on the principle that size alone creates prudential concerns is short-sighted and inappropriate. It is our hope that national regulators will consider the Consultative Document in a transparent, comprehensive, empirically-supported and validated manner that justifies the establishment and potential magnitude of any applicable surcharge in light of the presence of effective and credible recovery and resolution regimes and other legislation and regulation designed to reduce systemic risk and moral hazard costs.

II. The D-SIB Surcharge calibration methodologies should be transparent and available for public review and comment.

There are uncertainties in the appropriate calibration for a D-SIB surchage. First, banks subject to any potential surcharge require transparency surrounding its assessment and calculation such that it is possible for a bank to calculate its potential surcharge and engage in effective capital planning, as well as determine what steps it could take to reduce its surcharge. In addition, without transparency, uncertainty is created for each potential D-SIB, which may adversely affect the availability of capital to them.

Second, because there could be competitive inequities between D-SIBs and other banks not subject to the surcharge, it is important that the methodology for any surcharge be rationalized. Otherwise, small statistical differences could have dramatically different effects on banks with essentially similar risk profiles.

As a general matter, we believe that a bank should be able to undertake capital planning in accordance with capital regulations and know the impact of its actions on its required capital. Bank management must be able to make fundamental business decisions on an informed basis. As such, we fully support the principle that national assessment methodologies be made transparent. We would also add that national supervisors should (i) make publicly available

substantive supporting empirical analysis showing how the various indicators and the implied capital surcharge on the activities measured by those indicators are linked to a reduction in probability of default of a D-SIB and (ii) allow ample opportunity for meaningful public review and comment of assessment methodologies and calibration of Higher Loss Absorbency ("HLA") requirements.[11]

We also recommend that issues like acquisitions of institutions in financial distress, which could be beneficial to the broader economy especially in times of economic weakness, be considered when constructing a methodology. Rules should allow for temporary exemptions for this type of activity by the national regulator if the acquisition is in the best interest of domestic financial stability.

III. <u>Size is disproportionately weighted in determining the impact of a D-SIB's failure on the domestic economy.</u>

There is significant overlap between the size category, on the one hand, and the interconnectedness, substitutability/financial institution infrastructure and complexity categories, on the other (*i.e.*, Principle 5 in the Consultative Document). In the case of the largest banks, the size of a bank tends to correlate positively with 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).[12] Consequently, size has a signficiant impact on all of the catetgories of factors identified in the Consultative Document and may become largely determinative of whether or not a bank is designated as a D-SIB. This emphasis on size is especially problematic given that size, by itself, is a poor proxy for systemic importance, as a bank's business model and group structure and complexity are important considerations in this determination.[13]

The Clearing House believes that 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.

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[11] As defined in ¶ 10 of the Consultative Document.

[12] While the Consultative Document does not include factors pertaining to size, interconnectedness, substitutability/financial institution infrastructure and complexity, the Basel Committee's release *Global systemically important banks: assessment methodology and the additional loss absorbency requirement* (November 2011) at http://www.bis.org/publ/bcbs207.htm on which the D-SIB methodology is based, lists these specific factors.

[13] 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.

Indeed, as The Clearing House has consistently stated, there are essential benefits attributable to larger banks that will be reduced and potentially lost if a significant surcharge is imposed on large banks, encouraging, or effectively requiring, these banks to reduce their size.[14] The results of The Clearing House's study show that the benefits attributable to larger banks divide into three broad categories: the unique scope of products and services provided by large banks that cannot be credibly provided by other institutions, economies of scale and the promotion of innovation in the banking industry.[15]

Given the substantial overlap between the size category and the indicators of the other categories, the fact that size by itself is a poor indicator of systemic importance and the benefits that large banks provide to the economy, this indicator points to a structural flaw in the proposed D-SIB assessment factors and an over-reliance on size as an indicator of systemic importance. As a result, The Clearing House supports the principle that national authorities have discretion to include country-specific factors and apply weights to factors as they deem appropriate, but would have concerns should local authorities apply a methodology that simply followed the G-SIB approach which places too much emphasis on size.

IV. **The additional capital required by the D-SIB surcharge may have unfavorable consequences on the broader economy.**

We believe that an additional capital surcharge likely will impose additional costs on D-SIB customers and impair economic growth. Higher capital requirements may lead to decreased availability of credit as banks 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 that they hold, leaving banks with little choice but to reduce lending. These actions may reduce job growth and potentially harm the currently fragile broader economy. Moreover, the cumulative effects of these complex rules could have economic costs and other unintended consequences that are not readily apparent.

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[14] *See* The Clearing House's letter dated August 26, 2011, to the Basel Committee on Banking Supervision available at: http://www.theclearinghouse.org/index.html?f=072754.

[15] *See* The Clearing House's Scaled to Serve analysis available at: http://www.theclearinghouse.org/index.html?f=074122.

We thank you for considering the comments provided in this letter. If you have any questions or are in need of any further information, please contact me at (212) 612-9211 (email: brett.waxman@theclearinghouse.org) or Michelle Hubertus at (212) 613-9804 (email: michelle.hubertus@theclearinghouse.org)

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