Federal Financial Analytics, Inc.

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Secretariat of the Basel Committee on Banking Supervision
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CH-4002
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RE: The regulatory framework: balancing risk sensitivity, simplicity and comparability - discussion paper

Dear Sir or Madam:

In this letter, I provide the views of Federal Financial Analytics, Inc. ("FedFin") on the discussion paper recently released by the Basel Committee on Banking Supervision ("Basel Committee") to reduce the complexity of global capital rules.[1] This letter is solely my view and that of the other partners at FedFin and does not necessarily reflect the view of any of our clients. A list of them (excluding some governmental agencies that have asked for confidentiality) may be found on the firm's website (WWW.FEDFIN.COM). FedFin has received no compensation for providing these views.

Federal Financial Analytics strongly supports the discussion paper's goals of simplicity and comparability. However, we recommend that, instead of laying out definitions for these terms by which to judge the capital rules, the Basel Committee should not only assess its own capital standards for simplicity and/or comparability – complex principles as shall be discussed in more detail below – but also go beyond the capital rules to assess the success of the Basel Committee's efforts to date not only on capital, but also on the broad framework of prudential reforms crafted or proposed in the wake of the crisis.

Reviewing only capital overlooks a critical matter – the interaction of capital with many other rules – and contributes to the risk that the cumulative impact of all of these rules will result not only in a regulatory framework that is far from simple and comparable, but also one that is so unworkable as to create profound incentives for finance to flee to the "shadows."
In our practice, FedFin analyzes major Basel Committee and global prudential standards to advise clients on their strategic impact. Not only is the complexity of each rule on its own

[1] The Basel Committee on Banking Supervision, *The regulatory framework: balancing risk sensitivity, simplicity and comparability - discussion paper* (July 2013), *available at* http://www.bis.org/publ/bcbs258.pdf.

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daunting, but the challenge of identifying appropriate risk-mitigation, product-offering and/or franchise restructurings-actions warranted by the combination of major rules has become the most critical one at every major cross-border financial-services firm. Contradictions and inconsistencies among all these rules (discussed in more detail below) have created a strong incentive not only for traditional regulatory arbitrage – conducting an activity outside the scope of financial regulation – but also for a new form of arbitrage in which regulated firms pick and choose among prudential standards and comply with those least disruptive to their business objectives or desired domiciles, operating in seeming accordance with applicable law and rule despite growing risk. The Financial Stability Board ("FSB") has rightly cited inter-connectedness as a systemic indicator for global banks,[2] but it is also a contributing factor to systemic risk in regulation – i.e., rules so complex on their own and – worse – in aggregate that supervisors focus on compliance detail, not on fundamental strategy within individual financial firms (micro-prudential risk) or growing problems across the financial system (macro-prudential risk).

In 2011, Federal Financial Analytics issued a white paper analyzing the array of regulatory interactions we call "complexity risk."[3] In this letter, we shall update this analysis to support the recommendation that the Basel Committee take a holistic view of simplicity and comparability, not confine these objectives to its review of the capital rules. This recommendation is discussed in detail below, along with several proposals to enhance the simplicity goal through better measurement of regulatory outcomes. We also note the difficulty of actual implementation of standards that are comparable across borders. These additional recommendations include:

- The Basel Committee should focus future work on identifying simple criteria by which it can determine whether its rules are being implemented in both rule and spirit, looking not just at nominal action, but also the extent to which supervisors can and do demand meaningful conformity with best practice. It should do so across the array of prudential rules and within the Joint Forum to assess whether global financial institutions – not just banks – are safer over time periods, using metrics not yet laid out in this discussion paper to define this criterion and measure it from a capital, liquidity, and resolvability perspective. The last of these criteria – resolvability – is the most critical one since it in practice does not matter how little capital a financial institution has if only its shareholders and creditors are put at risk. However, recognizing the critical financial-intermediation function performed by banks, the Basel Committee should supplement the "safer" metric with others that measure improvements in financial inclusion, development of prudent and innovative products, and enhanced business conduct (including better protection

[2] Financial Stability Board, *Global systemically important insurers (G-SIIs) and the policy measures that will apply to them* (July 18, 2013), *available at* http://www.financialstabilityboard.org/publications/r_130718.pdf.
[3] Federal Financial Analytics, *A New Framework for Systemic Financial Regulation: Simple, Transparent, Enforceable and Accountable Rules to Reform Financial Markets* (Nov. 2011), *available at* http://www.fedfin.com/images/stories/client_reports/complexityriskpaper.pdf.

for retail consumers and investors). Given the difficulties of defining "simplicity" and "comparability" evident in this discussion paper, it will be more productive for the Basel Committee instead to define criteria by which it and others can judge the success of reform efforts to date and then identify key areas for improvement.

- Success metrics – not a search for "simple" standards – better reflect the complexity of global finance. As evident by the difficulties of crafting a "simple" leverage rule for on- and off-balance sheet assets,[4] cross-border banking organizations undertake complex activities (e.g., securities financing) that play a vital economic role that do not lend themselves to crude numerical ratios. Resolvability is thus a more appropriate metric, although better clarity within and across rules will improve not only industry compliance, but also supervisory enforcement.

- The Basel Committee should emphasize simplicity over comparability. Comparability will prove elusive because national accounting, legal, and many other essential standards cannot be harmonized, despite the urging of global regulators that this be done. Peer reviews such as those global regulators now conduct are a more appropriate way to assess comparability, as review standards can seek to normalize evaluation criteria taking specific national conditions into account in a manner difficult to do in rule without violating the goal of simplicity. An undue emphasis on "comparability" will also lead to homogeneous rulemaking that could lead to "herding" behavior by regulated institutions and resulting micro- and macro-prudential risk.

These recommendations are offered not because we do not share the Basel Committee's goal of enhanced simplicity and comparability. That this would be valuable goes without saying. However, the complexity of the discussion paper shows how difficult it may be to implement these goals, even if the Basel Committee confines its purview to the capital rules. For example, page three of the discussion paper has 31 sentences in four paragraphs that define "simplicity." In paragraph 9 the paper states: "Simplicity... has two dimensions: the simplicity of the capital standard itself and the simplicity of the capital calculation process." In paragraph 11, the discussion paper states that:

A capital calculation process is simple if it requires:

> "Simple inputs: "a simple standard does not require a large number of inputs and avoids reliance on inputs not captured within the normal accounting or risk management systems of banks (i.e., the inputs are subject to internal or external validation so the data called for is more readily accessible, better understood, and more reliable). Simple

[4] Basel Committee on Banking Supervision, *Revised Basel III leverage ratio framework and disclosure requirements* (June 2013), *available at* http://www.bis.org/publ/bcbs251.pdf.

> calculations: a simple standard can be calculated without the need for the use of highly advanced mathematical and statistical concepts, avoids iterative calculations, and can be easily verified by external parties such as supervisors or auditors."

As this text makes clear, the Committee has set itself a very worthy goal, but may find it difficult to implement even if the simplicity and comparability objectives are confined to regulatory capital.

I. Complexity Risk Occurs Across Rules, Not Just in Capital Standards

As noted, Federal Financial Analytics in 2011 focused on complexity risk, detailing how it occurs across the spectrum of prudential rules aimed at banks. As demonstrated therein, this creates unintended consequences and perverse incentives – e.g., shortages in high-quality assets that pose shadow and systemic risk, a concern recently and rightly highlighted by other committees under the aegis of the Bank for International Settlements.[5] The 2011 FedFin paper recommended several actions, most notably:

- supervisors should construct rules that take into account all the others in effect or pending completion, not in the current "silos" of working groups charged with only one specific responsibility;
- overall supervisory judgments of individual institutions and/or sectors should be made public not only to enhance market discipline, but also to hold accountable lax or conflicted supervisors; and
- supervision should prioritize the implementation and enforcement of risk-tolerance policies established by boards of directors (or equivalent bodies) and senior management, leaving detailed compliance with regulatory technicalities to junior examiners and industry personnel.

Since this 2011 paper, FedFin has updated the complexity-risk landscape with a far more detailed assessment of the interaction and potential unintended consequences of a more complete array of prudential and resolution rules, focusing also on inter-affiliate and activity requirements (e.g., ring-fencing, the "Volcker Rule," asset securitization risk retention).[6] Examples of possible perverse results included a focus on shadow banking, with the paper identifying which rules have the greatest potential to migrate potential systemic risk outside the banking system.

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[5] Committee on the Global Financial System, *Asset encumbrance, financial reform and the demand for collateral assets* (May 2013), *available at* http://www.bis.org/publ/cgfs49.pdf.

[6] Federal Financial Analytics, STRATEGIC REGULATORY LANDSCAPE: Regulatory Intent versus Policy and Market Risk in the Financial-Services Industry Capital, Liquidity, Risk Management and Related Prudential Requirements (OCT. 2012), available at http://www.fedfin.com/images/stories/client_reports/Regulatory%20Landscape.pdf.

The FSB is of course well aware of the extent to which systemic risk may be posed outside regulated banks, with global regulators recently making progress not only on the FSB's shadow-banking "workstreams,"[7] but also on systemic standards for large insurance companies[8] and resolution protocols proposed for insurance, financial-market infrastructure, and firms that hold client assets.[9] However, none of these initiatives is complete, nor are efforts to curtail the risks posed by money-market funds ("MMFs") significantly advanced in the U.S. or other nations despite ongoing work by the European Commission and the International Organization of Securities Commissions ("IOSCO").

Based on this, we submit that efforts to enhance simplicity and comparability in the capital rules – while laudable – will have little meaningful impact on the safety and soundness of global finance. Instead, we urge the Basel Committee to build on the good work in this discussion paper to join with the International Association of Insurance Supervisors and IOSCO within the Joint Forum to prioritize prudential rules and resolvability concerns in a framework that assesses the cross-cutting impact of each prioritized standard in light of the others. Once this matrix has been completed and unintended consequences or perverse effects identified, the Basel Committee should craft a list of near-term final actions, making each as simple and comparable as possible on its own and in concert with other prudential and resolution priorities.

II. The Committee Should Focus on Success Metrics, Not Search for "Simplicity" and "Comparability"

A. Judging Safety and Soundness, Not Progress Issuing Rules

One important benefit of the prioritization and inter-connectedness matrix described above is that it will permit the Basel Committee, as well as other global supervisors, better to assess the success of all their very hard work. To date, this is at best uncertain despite the five or more years that have passed since the financial crisis brought the global economic system frighteningly close to the brink. Regulators may well track success on the basis of the rules now finalized by each agency within the Joint Forum, but a bookshelf does not make for a safer financial system.

The International Monetary Fund ("IMF") has made a major contribution to assessing safety and soundness through its Financial Sector Assessment Program ("FSAP"). Based on factors that apply across nations and are tailored to reflect national conditions, the IMF puts teams on the ground for rigorous, careful assessment of actual adherence to best practice, assessed in light of

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[7] G-20, *Leaders Declaration* (Sep. 6, 2013), *available at* http://www.g20.org/load/782795034.
[8] IAIS, *Final G-SII Policy Measures* (July 18, 2013), *available at* http://www.iaisweb.org/view/element_href.cfm?src=1/19150.pdf.
[9] FSB, *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (August 12, 2013), *available at* http://www.financialstabilityboard.org/publications/r_130812a.pdf.

supervisory practice and – most importantly – results. The Basel Committee should review FSAPs, assess how current they are, and determine the degree to which key nations are reviewed by the IMF in a sufficiently timely, thorough and comparable fashion. Based on this, a public measurement released annually of actual global financial system safety and soundness can be constructed that would show:

- aggregate global progress towards meeting Basel Committee rules and best-practice expectations;
- trouble spots by nation;
- trouble spots by risk parameter (e.g., capital, liquidity, resolvability); and
- the extent to which financial intermediation and/or market infrastructure functions are shifting to "shadow" entities by nation and across the globe. It is understood that the IMF's FSAPs do not now include this last analytical point, but we believe FSB work in this sector permits it quickly to be constructed and added as a Basel measurement criterion.

B. Additional Success Metrics

While critical, safety and soundness are not the only metrics by which regulation can and should be judged. We urge the Basel Committee also to construct and make public success metrics judging the extent to which global regulatory practice enhances protection for retail consumers and investors and the extent to which national practice promotes financial inclusion, as that goal is defined by the Group of Twenty.[10] Additional metrics on other criteria may well also be of use, but the Basel Committee should start with these, complete work on them, and then progress to others as deemed of value.

As was learned, very much the hard way in the United States, rules that focus on keeping banks safe can put consumers at so much risk that their distress creates macroeconomic shocks that reverberate even to "fortress" balance sheets. However, national retail-customer protection schemes vary widely in goal as well as practice. For example:

- The United States continues to rely largely on disclosure, supplemented by rule and/or enforcement orders now largely under the purview of the newly-created Bureau of Consumer Financial Protection.
- The United Kingdom focuses on prescriptive standards designed to ensure that financial institutions offer the "best" product, doing so through rules being constructed by the newly-established Financial Conduct Authority.

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[10] G-20, *Leaders Declaration* (Sep. 6, 2013), *available at* http://www.g20.org/load/782795034.

- The People's Republic of China has few protections for ordinary bank customers and investors.

- Japan relies largely on longstanding social custom and a high degree of national literacy to protect ordinary financial-industry consumers.

Each of these different approaches has divergent outcomes, but a "light-touch" approach may well provide customer protection akin to a heavy-tough, prescriptive one when the results of the U.K. and Japanese approaches are compared. The Basel Committee would make a major contribution to customer protection and financial-market innovation by determining outcome measures for consumer -protection regulation.

Financial inclusion is, as noted, a goal of the Group of Twenty heads of state, although it has not yet been recognized within the framework of prudential regulation as a major concern. Because the underlying, critical purpose of banking and financial services is to promote economic growth, financial inclusion is a key metric of successful regulation. If only very large corporations are well served in wholesale finance, small- and medium-size enterprises ("SMEs") will not flourish and serve national needs, including technological innovation. If only wealthy retail customers are served by banks, poverty will remain endemic and low- and moderate-income customers will be at undue risk in the hands of "shadow" short-term loan providers, remittance-transfer agents, and similar providers. And, if financial systems cannot meet SME or lower-income needs, nations may seek to do so through governmental organizations, creating potential systemic risks as was all too evident in the United States with Fannie Mae and Freddie Mac.

The World Bank has done excellent work in the area of financial inclusion. Given the extent to which issues here apply across banking, securities, and insurance products, the Basel Committee may wish to construct a success metric within the Joint Forum, rather than undertake it on its own. However, as with the safety-and-soundness and consumer-protection metrics, one judging financial inclusion would help to illuminate whether the Basel Committee's years of extremely hard work are having their desired outcome.

III. "Simplicity" is Complex in Practice to Achieve and Could Pose New Risk

As noted above, the Basel Committee's own proposed definition of "simplicity" is complex. The paper rightly observes that risk-based capital should be made more simple and comparable, perhaps by using a leverage standard. However, it then goes on to say that leverage could be imposed with or without risk-based capital and that overall bank capital requirements should be refined through as many as seven new metrics and after consideration of numerous additional ways to measure leverage.[11] One idea – use of a new ratio to come up with "income volatility" on which leverage would then be based is extremely complex and may well obviate the

[11] The Basel Committee on Banking Supervision, *The regulatory framework: balancing risk sensitivity, simplicity and comparability - discussion paper* ¶ 54-56 (July 2013), *available at* http://www.bis.org/publ/bcbs258.pdf.

comparability objective. Further, the discussion paper lays out a wholly new issue: capital rules aimed at other policy objectives, not just promoting bank solvency.[12] Again, this may well be worthy, but it will prove far from either simple or comparable to achieve.

While it proposes all of these possibly simple solutions to the complexity of the risk-based capital rules, the discussion paper also states that:

> "[T]he complexity of the current framework reflects the way banking has evolved during the past few decades. As it has grown more complex, so has the regulatory framework in response. This being the case, future remedies for complexity may ultimately lie in tackling the fundamental causes of banking complexity – which the simplification of the Basel rules can go only so far in addressing."[13]

IV. Of Basel's Two Goals, Simplicity – Not Comparability – is Preferable

Although simplicity is very hard to achieve in practice, it remains the more achievable of the two goals laid out in this discussion paper. The discussion draft suggests that the Committee recognizes the challenge of comparability, which in large part results from widely-divergent national standards in critical areas like financial-industry structure, accounting practice, and policy objectives. Federal Financial Analytics has also provided a white paper on this issue, in 2012 detailing major differences between the statutory and policy frameworks in the U.S., European Union, Japan and other nations that complicate and, perhaps, flummox, cross-border regulation.[14] Since then, disputes over matters such as harmonized resolution protocols, margin requirements, and central derivatives clearing have shown how difficult it can be to implement policies agreed upon by the Group of Twenty, let alone more contentious ones such as the pending Federal Reserve proposal to regulate foreign banking organizations.[15]

The discussion draft suggests a possible solution – giving the Basel Committee authority to dictate its standards to member nations.[16] However, it seems extremely unlikely that member nations will agree to cede discretion to an unelected body such as the Basel Committee. The U.S. has yet to agree to many treaties, often considered non-controversial, agreed upon by the

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[12] Ibid, § 3
[13] Ibid, ¶ 77

[14] Federal Financial Analytics, *Operational Impediments to Effective Financial Regulation* (Oct. 2012), *available at* http://www.fedfin.com/images/stories/client_reports/operational%20impediments%20to%20effective%20financial%20regulation.pdf
[15] FRB, *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies* (Dec. 28, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf.
[16] The Basel Committee on Banking Supervision, *The regulatory framework: balancing risk sensitivity, simplicity and comparability - discussion paper* ¶ 67 (July 2013), *available at* http://www.bis.org/publ/bcbs258.pdf.

United Nations, while the European Union's ability to craft cross-border rules that supersede national prerogative is well known. For the Basel Committee to obtain comparable power seems unlikely.

Indeed, even if nations were to cede what many consider sovereignty and allow Basel to set key rules, the Committee's ability to do so is uncertain. A major challenge for both simple and comparable rules is the incomplete state of academic understanding of the causes of the financial crisis and the cures most likely to succeed. In a recent paper,[17] we have assessed the varying academic and governmental work that attempts to define a "systemically-important financial institution" ("SIFI"). Although both the FSB and several nations have issued SIFI methodologies, it remains to be seen if the selected criteria will be adopted across borders and/or prove useful predictors of actual systemic-risk potential.

The comparability goal is also hampered by the complex definition proposed for it in this discussion paper. It argues that regulatory frameworks deliver "perfect comparability" -- a high and likely unachievable objective -- if they meet the following criteria:

> "Comparability between banks: two banks with portfolios having identical risk profiles apply the framework's rules and arrive at the same amount of risk-weighted assets and two banks with different risk profiles should produce risk numbers that are different proportionally to the differences in risk.
> Comparability over time: a bank's risk-weighted assets do not change over time if the underlying risks remain unchanged, and change proportionally when risks do change.
> Comparable information: any differences in risk-weighted assets across banks, jurisdictions and over time can be understood and explained."[18]

Conclusion

Simplicity and comparability are worthy objectives, but the Basel Committee is unlikely to achieve either of them due to the combination of all of the other rules that govern banks, the inherent complexity of financial-services firms and the markets in which they operate, and the difficulty of actually requiring cross-border adherence to measurable, meaningful, and clear standards sufficient to address both micro- and macro-prudential risk. It is for this reason we recommend a goal that may seem more ambitious, but one we think is actually easier for the Basel Committee to accomplish: put the capital rules – risk-based and leverage – into the

[17] Federal Financial Analytics, *Are U.S. SIFIs Still TBTF? An Assessment of the New Resolution Regime for Systemically-Important Financial Institutions* (Oct. 22, 2012), available at http://www.fedfin.com/images/stories/client_reports/assessment%20of%20resolution%20regime%20for%20sifis.pdf

[18] The Basel Committee on Banking Supervision, *The regulatory framework: balancing risk sensitivity, simplicity and comparability - discussion paper* ¶ 13 (July 2013), *available at* http://www.bis.org/publ/bcbs258.pdf.

broader context of prudential regulation, develop success metrics across the array of critical rules, and make clear to institutions and national regulators how well best practice is in fact being achieved.

We would be pleased to answer any questions and provide additional information to support the Basel Committee's critical work.

Sincerely,

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