



August 26, 2011

By electronic submission to baselcommittee@bis.org

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

Re: Comment on Consultative Document on “Global systemically important banks: Assessment methodology and the additional loss absorbency requirement”

To the Basel Committee:

The Global Financial Markets Association (GFMA),¹ an international financial trade association, includes banks that are the largest participants in national and global banking and financial markets. GFMA therefore appreciates this opportunity to comment on the Consultative Document issued on July 19, 2011, by the Basel Committee on Banking Supervision (“Basel Committee”) entitled “Global systemically important banks: Assessment methodology and the additional loss absorbency requirement.” This proposal, which has also been endorsed by the Financial Stability Board (“FSB”), would impose a surcharge of Common Equity Tier 1 capital on global systemically important banks (“G-SIBs”). While GFMA strongly supports the goal of the Basel Committee and the FSB to promote financial stability, we have very serious concerns with the proposed surcharge, as discussed below.

Accordingly, GFMA believes that the current proposal should be fundamentally revised and re-proposed. Any re-proposal should demonstrate that the benefits exceed the costs of reduced economic growth; expressly take into account new recovery and resolution regimes as well as other reforms that

¹ The Global Financial Markets Association (GFMA) joins together some of the world’s largest financial trade associations to develop strategies for global policy issues in the financial markets, and promote coordinated advocacy efforts. The member trade associations count the world’s largest financial markets participants as their members. GFMA currently has three members: the Association for Financial Markets in Europe (AFME), the Asia Securities Industry & Financial Markets Association (ASIFMA), and, in North America, the Securities Industry and Financial Markets Association (SIFMA).

materially reduce systemic risk; contain a transparent and empirically supported methodology; and enable a G-SIB to take action to reduce its systemic importance.

I. Overview of proposal and the GFMA’s concerns

For the banks to which it would apply, the proposed G-SIB capital surcharge would be in addition to the approximately four-fold increase in minimum Common Equity Tier 1 capital already required by the Basel III agreement. The stated purpose of the surcharge is to address “negative externalities” posed by G-SIBs that the Basel Committee believes current regulatory policies do not fully address. Consultative Document, p.1 (¶ 2). That is, in the absence of effective orderly resolution regimes, global systemic importance is to be measured in terms of the estimated impact that a failure of a G-SIB could have on the global financial system and wider economy – “a global, system-wide, loss-given-default (LGD) concept.” Consultative Document, p.4 (¶ 14).

The methodology for determining this estimated impact is intended to be a transparent and relatively simple “indicator-based measurement approach” that produces relative scores for banks based only on the following indicators: size, interconnectedness, the lack of substitutability for services provided, cross-jurisdictional activity, and complexity. Other factors that might affect a bank’s negative externalities or risk to the financial system, such as the degree to which it can be resolved in an orderly manner, are not to be considered.²

A bank’s score will determine both whether it qualifies as a G-SIB, and if so, the degree of its global systemic importance: the higher the score the G-SIB receives, the higher the surcharge it will be required to meet, with initial surcharges ranging from 1 to 2.5% of risk-weighted assets. This range of proposed surcharge amounts is based on the Basel Committee’s empirical analysis that is very briefly summarized in Appendix 2 to the Consultative Document, which appears to rely primarily on the so-called “expected impact” approach. The proposal further requires that any surcharge be composed exclusively of Common Equity Tier 1 capital – contingent common equity, even if fully loss absorbing, would not qualify.

While the Consultative Document acknowledges that the proposed surcharge is likely to have a negative impact on economic growth, the Basel

² While in theory the proposal provides for the possibility of discretionary adjustments to the scores based on supervisory factors, in practice the hurdles for doing so would make such supervisory overrides extremely rare.

Committee evidently believes that the benefit to financial stability will outweigh this cost. The Committee's impact analysis is not included in the Consultative Document, however, and will not be publicly released until September, after the public comment period on the Consultative Document has ended.

GFMA has the following fundamental concerns with this proposed G-SIB surcharge regime:

- **Benefits of surcharge are not demonstrated to exceed costs of reduced economic growth.** The Consultative Document does not demonstrate that the marginal safety benefits of the capital surcharge, coming as it would on top of the recent substantial increase in common equity required by Basel III, would clearly offset the cost in reduced economic growth. Indeed, the Committee's cost-benefit analysis will not even be made public until *after* the close of the public comment period, which violates fundamental principles of fairness and common sense, especially regarding a proposal of this magnitude. GFMA therefore renews our request that the comment period be extended until after the Committee's cost-benefit analysis has been made public so that all parties can appropriately review and comment on that analysis.
- **The amount of the proposed surcharge is not justified.** The very summary analysis provided to support the amount of the surcharge – based primarily on the so-called “expected impact approach” – includes little empirical support, and lacks transparency. It does not support a surcharge, especially of the magnitude proposed.
- **The “cliff effect” of the proposed surcharge is also not justified and should be adjusted.** As proposed, any reduction in a G-SIB's capital below the extra amount required by the proposed buffer would result in immediate and substantial restrictions on capital distributions. GFMA suggests an alternative approach that would be more flexible and reduce the cliff effect of breaching the buffer. As described below, this alternative would provide regulatory discretion to avoid immediate imposition of distribution restrictions (to better enable recovery during stress events) and set the G-SIB buffer as a separate measure on top of the capital conservation buffer.
- **There should be clear and well defined offsets for improvements in orderly resolution regimes.** The essential stated purpose for the surcharge is to offset the impact on the financial system caused by the inability to effect an orderly resolution of a G-SIB – so-called “negative externalities.” Therefore, the establishment of orderly resolution regimes for G-SIBs should expressly be included as a mitigating factor in determining the amount of the surcharge. Indeed, improvements in orderly resolution regimes address the concern about negative externalities of a G-SIB failure without the moral hazard implications

of a G-SIB surcharge. Similarly, material progress on other regulatory steps to reduce systemic risk should offset the surcharge as well.

- **The lack of transparency in the test undercuts its usefulness both to G-SIBs to reduce risk and to markets to monitor risk-taking.** The proposal falls short of its own goal of transparently setting forth its methodology. As a result, a G-SIB would be unable to calculate its surcharge amount, and therefore could not effectively calibrate the amount by which changes in its conduct would decrease its surcharge amount. In addition, without additional transparency, markets would be less able to discipline G-SIBs for the amount of systemic risk they choose to take.
- **Clear problems with the indicator-based measurement approach should be addressed.** One such problem is the likely correlation between criteria, such as the over-counting of “size” by failing to recognize that many of the proposed indicators and sub-indicators correlate with size. Other problems include the distortions created by grading G-SIBs based only on *relative* scores; the failure to take into account diversification benefits; and the inclusion of factors in the “substitutability” indicator that are not clear proxies for systemic risk.
- **Going concern contingent capital should be allowed as part of the surcharge.** Contingent securities that meet the recent guidance from the BIS should be allowed to count toward any surcharge.³ These instruments absorb loss in the scenarios that are relevant for the safety of G-SIBs, and are recognized as high-quality capital for both national regimes and for Tier 1 capital. They also provide a large, alternative source of capital supply from a different set of investors. This will help achieve the overall objective of strengthening bank capital at a reasonable cost and will reduce the pressure on institutions to meet these targets through asset reduction, which can plainly have adverse economic effects.

Each of these concerns is discussed in more detail below.

³ See GHOS press release of 13 January 2011 available at <http://www.bis.org/press/p110113.htm>; see also Consultative Document, Annex 3.

II. The marginal safety benefit of the proposed capital surcharge – beyond the benefits of the increased capital requirements of Basel III – have not been shown to clearly exceed its cost of reduced economic growth.

GFMA agrees with the conclusion that higher capital requirements can make banks safer by “reduc[ing] the probability of failure of G-SIBs by increasing their going-concern loss absorbency.” Consultative Document, p.2 (¶ 5). But it is also well recognized, including by the Basel Committee, that higher capital requirements reduce credit availability and intermediation, which in turn reduce economic activity and growth. At some point increased capital requirements reach the limits of their utility, and the diminishing marginal benefits of increased safety are outweighed by the costs of reduced economic growth. This safety-growth trade-off is real, yet the Consultative Document fails to make the case that the marginal benefits of the proposed surcharge – coming as it does on top of the substantial capital increase required by Basel III – will offset its wider costs to the economy. GFMA believes that robust analysis of this fundamental trade-off is critical, especially during this time of exceptionally fragile global economic conditions.

Common equity capital requirements have already increased dramatically. In the wake of the financial crisis, both policymakers and the industry agreed that common equity capital levels were too low in financial institutions, increasing their probability of failure and substantially decreasing confidence in the financial system – results that substantially increased financial instability, leading to the financial crisis and economic contraction. As a result, Basel III dramatically increased minimum common equity capital requirements in three ways: by more than tripling the required ratio of common equity to risk-weighted assets; by significantly reducing the types of capital that would count as common equity; and by significantly increasing the risk-weights for certain types of assets (especially trading assets that are most associated with systemic risk that are held almost exclusively by the largest banks). The net effect was to more than quadruple the required level of common equity for most large banks, which have since raised enormous amounts of capital to begin complying with the new rules. Indeed, large banks have raised more than \$500 billion in common equity from non-governmental sources since the beginning of 2008.⁴ As confidence in the

⁴ *US Board of Governors of the Federal Reserve System, Comprehensive Capital Analysis And Review: Objectives and Overview* (March 18, 2011) (more than \$300 billion for large US banks) available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110318a1.pdf>; Bloomberg L.P. “Writedowns vs. Capital Raised,” September 1, 2007 to August 18, 2011 (2011) (Bloomberg Database) (more than \$200 billion for large European banks).

adequacy of bank capital has returned, however, the prospect of additional common equity capital requirements on top of the Basel III mandated levels has raised serious questions about the safety-growth trade-off. Moreover, the new minimum requirements only represent a lower bound to the capital banks will have to hold. Depending on their jurisdiction, banks will face additional buffers (such as those related to prompt corrective action or stress-testing rules).

The link between higher capital and lower growth. In adjusting capital requirements, the potential trade-off between safety and growth is well recognized, with increased capital requirements resulting in reduced credit availability. Indeed, a very recent paper by a senior official at the Bank of England referred favorably to the use of capital and other prudential requirements as a macroeconomic tool to increase or decrease credit growth in the economy.⁵ Moreover, the Basel Committee has itself recognized this trade-off. For example, Basel III's countercyclical capital buffer is fundamentally premised on the concept that higher required capital is a macroeconomic tool that will reduce credit availability and economic growth in overheated national economies.⁶ More to the point, the Consultative Document itself sets forth a provisional estimate, based on earlier work done by the Committee's Macroeconomic Assessment Group (MAG) in the context of Basel III, that the proposed surcharge would dampen growth during its phase-in period. Consultative Document Section III.B.

Further analysis and public comment is required. While the provisional estimate shows only a modest reduction in growth,⁷ that estimate is not empirically supported because the MAG's full analysis of the projected

⁵ "Risk Off," Speech by Andrew G. Haldane, Executive Director, Financial Stability and Member of the Financial Policy Committee, Bank of England (August 18, 2011) (suggesting use of capital and other prudential requirements as macroeconomic tool to increase or decrease credit growth in the economy) available at <http://www.bankofengland.co.uk/publications/speeches/2011/speech513.pdf>.

⁶ See Consultative Document, *Countercyclical capital buffer proposal* (July 2010), p. 13 ("it is important that whichever authority is chosen [to administer the buffer], the choice of buffer add-on is taken after an assessment of as much of the relevant prevailing supervisory and macroeconomic information as possible, bearing in mind that the operation of the buffer requires information from both of these sources and that it will have implications for the conduct of monetary and fiscal policies, as well as banking supervision.") available at <http://www.bis.org/publ/bcbs172.pdf>.

⁷ Based on the MAG's earlier work, "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. For a four year implementation period, the range of impacts is 0.17 to 3.17 basis point per year on average over the transition." Consultative Document, p.16 (¶ 78). The Document acknowledges that this amount could be higher or lower depending on several factors. *Id.*, n.24.

impact of the surcharge will not be completed and published until September – ***after the public comment period has expired with respect to the Consultative Document.*** Given the critical importance of this issue, GFMA strongly believes that the Basel Committee should have the benefit of robust public comment on the potential impact of the proposed surcharge ***before*** finalizing its views. Indeed, fundamental principles of procedural fairness require the opportunity for public comment on an issue of this magnitude. Accordingly, we hereby renew our request made earlier this month to extend the public comment period on the Consultative Document to allow for public input on the potential economic impact of the proposed surcharge.

GFMA makes this request based on the conviction that the risk to growth from the surcharge is likely to be significant, not modest – that capital beyond the amount required by Basel III would significantly diminish investor appetite for bank equity, which in turn would require banks to abandon more capital intensive businesses, increase prices to earn a sufficient return on equity, or reduce the size of their balance sheets. These are all actions that would plainly and negatively affect economic activity during a period of economic fragility that is likely to persist for some time, even without the further headwinds of higher capital requirements.⁸

Moreover, we do not believe that any reduction in lending or intermediation activities at G-SIBs caused by the surcharge will be offset by an increase in such activities at smaller institutions not subjected to the additional capital requirement. The scale of financial activities provided by global banks to global companies – from huge debt or equity underwritings or loan syndications provided on short notice, to large customized derivative transactions that help manage risk, to substantial cross-border and multi-currency loans – will simply not be easy to replicate by smaller firms. Even to serve smaller companies, small banks would need to raise substantial amounts of equity to provide loans at pricing comparable to those provided by larger banks. While both large and small institutions experience economies of scope and scale, smaller institutions cannot easily serve as perfect substitutes for the exit of larger firms.⁹

⁸ Failure to adequately consider the costs of the proposal may also doom its implementation in jurisdictions where the proposal will be administratively implemented through an agency rule-making and, thereafter, subject to judicial review. See *Business Roundtable et al. v. Securities and Exchange Commission*, No. 10-1305 (D.C. Cir. July 22, 2011) (striking down SEC rule due to failure to adequately consider the costs associated with the rule proposed).

⁹ See “Who Said Large Banks Don’t Experience Scale Economies? Evidence from a Risk-Return-Driven Cost Function,” Research Department, Federal Reserve Bank of Philadelphia, by Hughes and Mester (July 2011) available at <http://www.philadelphiafed.org/research-and-data/publications/working-papers/2011/wp11-27.pdf>; see also C. Calomiris, *In the World of Banks*, (...continued)

Finally, some have suggested that the delay of any surcharge until 2019 will mitigate adverse affects. But if the reaction to the Basel III requirements is any guide, markets and banks themselves will not respect this intended gradual transition. Indeed, current regulatory restrictions on dividends and capital repurchases have effectively accelerated the phase-in of the Basel III requirements, and these restrictions would likely have the same accelerating effect with respect to any surcharge. All of these factors will pressure banks to gravitate to the new standards immediately, at exactly the same time that the financial system is adjusting to all the other regulatory impacts, further exacerbating pressure on the fragile economic recovery.

III. The proposed amount of the surcharge is not justified.

The proposed amount of the surcharge is intended to quantify the impact of a G-SIB's failure on the financial system based on the "negative externalities" that such a failure is projected to cost. In this context, the proposed surcharge is calibrated for currently identified G-SIBs as an additional amount of Common Equity Tier 1 capital ranging from 1 to 2.5% of risk-weighted assets, with an "initially empty bucket" of 3.5% at the top.

Neither the range of proposed amounts, nor the determination of the thresholds, is justified or supported by the Consultative Document. That is, the only support is the brief, three-page justification for the proposed amount of the surcharge in Annex 2 of the Consultative Document – based primarily on the so-called "expected impact" approach. There, the calibration of the proposed surcharge schedule lacks transparency, and the empirical analysis behind the key assumptions is so imprecise that the calibration should not be thought of as anything more than an unsupported policy judgment.

The expected impact approach is designed to determine the amount of extra capital that would be required to equate the expected impact of failure of a SIB and a non-SIB. At its core it is based on data from a set of 73 banks from 14 countries. The G-SIB scoring mechanism has been applied to the data on those 73 banks, and 28 have been judgmentally determined to be in the set of global systemically important banks. The amount of extra capital required of the 28 banks identified as G-SIBs is determined by comparing the highest scoring G-SIB to the bank just below the G-SIB cutoff, called the reference bank. The maximum additional capital requirement is determined to be 2.5%.

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Bigger Can Be Better, Wall St. J. (Oct. 19, 2009) available at <http://online.wsj.com/article/SB10001424052748704500604574483222678425130.html>.

Each of these assumptions that contributes to the determination of the schedule is supported by empirical analysis that is only alluded to, but never documented, in the Consultative Document. The G-SIB score is not empirically derived, but reflects the judgments of the Committee concerning the correct indicators and the weights attached, so the determination of the score is inherently opaque. The critical capital ratio below which it is assumed that banks fail is based on the Basel Committee’s “Calibrating regulatory minimum capital requirements” paper¹⁰ – but even that work acknowledged that there is no single model that can produce the right answer. And the key assumption in determining the size of the surcharge – the multiplier – is intended to reflect the societal impact of a G-SIB relative to the reference bank – yet the determination of the size of that multiplier is not transparent; instead, it is merely stated without explanation that the highest scoring G-SIB will have an impact on society that is 3 to 5 time greater than the reference bank. There is absolutely no underlying support for this assertion.

In short, the Consultative Document fails to provide an adequate empirical basis for imposing such a large surcharge on G-SIBs. This failure prevents informed comment on the proposal.

IV. The “cliff effect” of the proposed surcharge is also not justified and should be adjusted.

By combining the G-SIB surcharge with the capital conservation buffer, large banks may face immediate restrictions of 40% on distributions at capital levels as high as 9.5% (or higher if the countercyclical buffer applies), which is therefore likely to be perceived as a hard floor. This will cause those banks to hold an additional internal buffer above the minimum, with attendant adverse economic effects. Furthermore, during stress events, such restrictions could hinder recovery plans.

To mitigate these effects, GFMA believes a more flexible approach is warranted in any re-proposal. This would be achieved partly by allowing regulatory discretion in the application of the buffer in stress situations, and partly by redesigning the G-SIB buffer so that it acts as a separate band above the capital conservation buffer. If a G-SIB’s capital declined into the upper half of the G-SIB buffer, there would be no automatic restrictions on capital distributions; instead, such a decline would act as an early warning for regulators and management to introduce recovery actions. If it declined into the lower half of the buffer, a 20% discretionary restriction on capital distributions would apply to

¹⁰ See BCBS, *Calibrating minimum capital requirements and capital buffers: a top-down approach* (Oct. 2010) available at <http://www.bis.org/publ/bcbs180.pdf>.

moderate the cliff effects of the 40% restriction, which would not apply until capital declined further into the capital conservation buffer. This modified approach would also help level the playing field between large and small banks during stress situations.

V. Significant progress on orderly resolution regimes should reduce or eliminate any surcharge – as should significant progress on other regulatory steps to reduce systemic risk.

As previously discussed, the key purpose of the proposed surcharge is to offset, in the absence of effective orderly resolution regimes, the expected impact that a failure of a G-SIB could have on the global financial system. The corollary to this principle is that measures that reduce the estimated impact of such a failure should correspondingly reduce the amount of the surcharge. By definition, regulatory measures that facilitate the orderly resolution of a G-SIB – such as the FSB’s recent proposals on recovery and resolution – “will serve to reduce the impact of a G-SIB’s failure.” Consultative Document, p.2 (¶ 8).

Yet not only does the proposal fail to take orderly resolution into account in the initial test determining the surcharge, but it also prohibits supervisors from considering this factor in exercising supervisory discretion to adjust the results of the test. Consultative Document, p.11 (¶ 56) (“Views on the quality of the policy/resolution framework within a jurisdiction should not play a role in this G-SIB identification process.”).

This makes no sense. Critical steps have been taken to reduce the likelihood of a large bank failure, and other measures have been taken in the United States and Europe to lessen the impact on the financial system should a failure occur. National jurisdictions and international standard setters have not yet fully fleshed out acceptable methods for resolving G-SIBs. But they are making real progress, and to the extent they do, any surcharge should be reduced.

GFMA supports the Consultative Document on Effective Resolution of Systemically Important Financial Institutions published by the FSB on July 19, 2011. Indeed, GFMA’s comments on that document, which are set forth separately, strongly support the proposition that authorities in all relevant jurisdictions should have or obtain the capacity to resolve G-SIBs without systemic disruption and without exposing the taxpayer to the risk of loss, all within a reasonable timeframe. Taxpayer-funded bailouts have been chosen in the past by some national authorities, including during the recent global financial crisis, because they were considered the lesser of two evils compared to a severe destabilization or collapse of the financial system and the potential long-term harm to the wider economy in terms of higher unemployment and lower output. Initiatives have been taken by various nations and international bodies with the

aim of reducing systemic risk and enhancing resolvability. If implemented and administered properly, these initiatives have the potential to create a credible alternative to taxpayer-funded bailouts, a goal that GFMA has long promoted and supported.

US orderly resolution regime. In this connection, in the United States, the largest financial institutions must draft recovery and resolution plans (also known as “living wills”), and each must detail the actions it would take to survive a crisis and its plan for liquidation, sale, or recapitalization in an insolvency scenario. Supervisors oversee this process. Under the Dodd-Frank Act, each large firm also must submit a recovery and resolution plan under the Bankruptcy Code. And in the event resolution under the Bankruptcy Code proves unworkable, the Federal Deposit Insurance Corporation (FDIC) has authority to resolve a financial services holding company in much the same way it has resolved banks. Should it become receiver for a financial company, the FDIC is permitted to provide liquidity support to enable an orderly liquidation or recapitalization, with any losses borne by surviving companies. GFMA has been providing substantial input to US regulators as they flesh out the details of this new regime to make orderly resolution a truly viable option for large financial institutions.

European orderly resolution regime. The European Commission is also currently considering a legal framework for cross-border bank recovery and resolution¹¹ that is consistent with the recommendations of the FSB.¹² These proposals would, if enacted, establish a common set of resolution tools across Member States consisting of sale, bridge banks, asset separation, and debt write-down that would establish an unprecedented ability of the authorities to resolve G-SIBs. Other elements of the proposals anticipate the creation of group-wide resolution plans under the oversight of a single resolution authority in the parent institution’s home Member State, in cooperation with the other relevant Member States. The overriding objective of these and other measures is to ensure that banks can be resolved in ways that minimize the risks of contagion and ensure the continuity of essential financial services while avoiding imposing a burden on taxpayers.

¹¹ European Commission, Internal Market and Services DG, Technical details of a possible EU framework for bank recovery and resolution, 6 January 2011 *available at* http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

¹² FSB Consultative Document, *Effective Resolution of Systemically Important Financial Institutions* (July 2011) *available at* http://www.financialstabilityboard.org/publications/r_110719.pdf.

These proposals follow the pattern set in the UK by the Banking Act 2009, which put in place a permanent special resolution regime with tools to protect financial stability by effectively resolving failing banks. More recently, the UK FSA has published a consultation paper¹³ that covers the requirement for certain financial firms to prepare and maintain Recovery and Resolution Plans. These plans seek both to reduce the likelihood of failure by requiring banks to identify options in order to achieve recovery, and to ensure that banks have plans in place to wind down in the event of failure. As the FSA points out, a clearly stated aim of the resolution plans is to enhance cooperation and crisis management planning for globally systemically important financial institutions with international regulators.

Taken together, the work underway both on the international and national level to introduce consistent and comprehensive recovery and resolution regimes across multiple jurisdictions will significantly reduce both the probability and financial impact of G-SIB failures. Indeed, successfully arming regulators with effective new authority to orderly resolve large, complex financial institutions will profoundly improve the safety of the financial system.

In short, this real progress being made in different jurisdictions in facilitating orderly resolution of G-SIBs should expressly be taken into account in mitigating the amount of any surcharge – not just in the supervisory override, but in the indicator-based measurement test itself. Such an offset for significant progress on orderly resolution is entirely consistent with the fundamental purpose of the surcharge. It would also provide a powerful incentive to jurisdictions and large institutions around the world to develop viable orderly resolution regimes – a goal strongly supported by both the Basel Committee and the FSB. Of course, the assessment of any such offset should be done under clear, objective, and transparent criteria that are consistently implemented across jurisdictions.

In making this point, we do not believe that offsets to the surcharge should be allowed **only** after all major jurisdictions have adopted, in coordination with one another, demonstrably effective resolution regimes for G-SIBs. That would be setting the bar too high, and would not appropriately reflect tangible steps taken by individual jurisdictions that will materially reduce systemic risk. Accordingly, GFMA believes that a reduction in the surcharge would be appropriate whenever the home jurisdiction of a G-SIB establishes by binding legislation or regulation an orderly resolution regime for systemically important financial institutions that the Basel Committee or the FSB believes will materially reduce risk to the system in the event of a G-SIB failure. Moreover, if a group of

¹³ Recovery and Resolution Plans CP11/16 August 2011 *available at* http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.

jurisdictions establishes an effective cross-border recovery and resolution regime, then it should be considered whether cross-jurisdictional activity among these jurisdictions would remain a factor in determining systemic importance.

Finally, for similar reasons, the proposed surcharge should also take into account any other regulatory measures that significantly reduce G-SIB systemic risk. The larger point here relates to the key assumption underlying the entire proposed framework, which is this: if a G-SIB were to fail, it would have a larger negative impact on the economy than a non-G-SIB. The proposal quantifies this differential impact by assuming that the highest-scoring G-SIB will have an economic impact that is 3 to 5 times greater than a non-G-SIB. As mentioned above, the proposal provides no support for this assumption, but more to the point in this context, it also fails to include any express provision for adjusting the assumption if the systemic impact of G-SIBs relative to non-G-SIBs changes. This static approach is inconsistent with the many other initiatives underway to address the risk of G-SIBs, including enhanced liquidity regimes, new regulation that restrict concentrations and large exposures, changes to resolution regimes, recovery and resolution plan requirements, and derivative infrastructure initiatives, just to name a few.

In short, GFMA believes that the calibration of the multiplier should be clearly explained, and that the framework should explicitly provide for a reduction in the multiplier assumption if, as is likely, the systemic risk of G-SIBs relative to non-G-SIBs declines. More broadly, we respectfully request that the proposed formula and methodology for the surcharge be recalibrated based on new facts and circumstances that occur between adoption and implementation.

VI. The Basel Committee should address a number of specific problems with the methodology and risk-weighting factors used to determine G-SIB “scores.”

GFMA believes that there are specific parts of the indicator-based measurement test that need to be adjusted before any proposal is finalized. These include the test’s lack of transparency; distortions created by the use of *relative* scores; the inappropriate inclusion of factors that do not involve systemic risk; the failure to consider benefits of diversification; the lack of coordination of a G-SIB surcharge with possible surcharges imposed on national systemically important banks; and the relationship of the surcharge to the Basel III non-common Tier 1 and Total Capital requirements.

Lack of transparency. The proposal is intended to be simple and transparent so that banks and market participants can readily calculate and understand individual institutions’ scores, with the result that G-SIBs will be rewarded for changing their activities in ways that reduce systemic risk.

Unfortunately, at least as proposed, the Consultative Document fails to achieve this goal. Surcharges are difficult to calculate and impossible to forecast, in part because they rely on data from a subjective sample of 73 banks, and metrics that are difficult to model even for banks subject to the surcharge. For example, a G-SIB cannot determine at any given time its score under the rule and what actions it could undertake to improve its score. This opaqueness complicates institutions' business planning and management activities.

In addition, the test is not defined precisely enough to allow capital markets participants, or even the banks themselves, to determine the G-SIB scores of individual banks. One problem is that some of the indicators cannot be calculated using Basel Committee definitions and published data. The measure of interconnectedness, for example, requires banks to know the securities that are owned by other banks, and the Consultative Document acknowledges that banks will have to use their best estimate to calculate this indicator. Another problem is that many of the other indicators require the identification of quantities corresponding to a point in time, without specification of the exact time or times to be used in the calculation.

Moreover, not only is the method of calculating the indicators not known, but the values of the cut-off scores that determine each G-SIB's additional capital requirement are also not known. A G-SIB (or potential G-SIB) cannot determine what bucket it is in or how close it might be to moving into a higher bucket. Importantly, it also cannot determine how close it is to the 3.5% surcharge, or what potential strategic decisions might move it into that bucket. While the Consultative Document indicates that at least some of these transparency issues will be addressed before implementation, until that occurs it is difficult to provide useful comments on the appropriateness of the methodology.

Also, while the Consultative Document explains why the five categories were chosen, it does not indicate why these categories are considered appropriate to use in a quantitative model; how they correspond to the negative externalities that are the basis for the surcharge; why they are equally weighted; or why the sub-indicators are equally weighted within categories. On the surface, it seems that equal weightings of categories would cause distortions. For example, as discussed below, size appears to be correlated with individual indicators in virtually all of the other categories. The proposal does not discuss whether this correlation was considered and how it was adjusted for, if at all.

In sum, the proposal would make G-SIBs more difficult to understand for investors by introducing volatility and uncertainty in capital and associated profitability projections.

Finally, apart from addressing these fundamental transparency issues, the Basel Committee should ensure that – **before** implementation of any surcharge proposal – there is a truly common international framework for comparable data reporting from G-SIBs headquartered in different countries. Such “apples-to-apples” consistency is critically important to ensuring the integrity of the framework.

Static, relative test provides perverse incentives. Another key concern is that the scores for each bank are derived *on a relative basis* to the other banks in the sample. As a result, it is not clear what happens if the average scores for all the banks change – in either direction. If other policy developments such as the incentives in Basel III capital and liquidity frameworks, the Volcker rule in the US, and the resolution planning process, result in the same *relative* scores, but a lower *average* score for the group, it is not clear how this would be reflected in the capital charges, if at all. Similarly, if average scores rise, it is not clear what if anything happens. It is also not clear how and when the sample of 73 banks will change.

In this sense, the proposed test would not reward risk reduction because it “grades on a curve.” That is, an institution would be rewarded only if it materially decreased its risk *relative to* other G-SIBs. To the extent the entire industry evenly reduces a risk factor measured by the proposal, no G-SIB’s score is reduced. As a result, the proposal as written does not provide any incentive to achieve major, industry-wide risk reduction.

Moreover, well managed banks would be disadvantaged with rising scores if, by virtue of their safety and soundness, they maintain or grow their market shares during periods when the industry shrinks. Additionally, if such well capitalized and managed institutions should engage in loan growth or stabilizing acquisitions during times of distress, they would be penalized for doing so.

Accordingly, the nature of the charge – relativistic – does not provide incentives to lower the riskiness of the G-SIB population as a whole or within individual buckets.

Overweighting of “size”. The proposed surcharge methodology fails to account for potential correlation between the indicators. For example, the size of an institution strongly correlates with the interconnectedness, substitutability, cross-jurisdictional activity, and complexity indicators for the same institution. Size is therefore over-weighted in the determination of a bank’s systemic importance score. Such a result is at odds with the FSB’s own acknowledgment that the relevance of size depends on other factors, including a bank’s business

model, group structure, and complexity.¹⁴ Accordingly, because size alone is a poor indicator of systemic importance, its over-weighting in the indicator-based measurement test is inappropriate.

Certain included factors do not increase systemic risk. Certain key metrics in the proposal are not accurate measures of systemic importance or of negative externalities that would be caused by a G-SIB's failure. These include:

- *Inclusion of underwriting activity in the “substitutability” metric.* The underwriting market is highly competitive and the withdrawal of one or several competitors would have little overall effect on that market.
- *Inclusion of custody activities in the “substitutability” metric.* The custody business is low-risk and severable from an institution's other businesses. It is also a business that naturally benefits from increased scale.
- *Incorporation of derivatives in the “complexity” metric on a gross notional basis.* This is inappropriate, because most derivatives activities are done under netting agreements and therefore their gross notional amounts are not an accurate measure of the institution's systemic risk.
- *Inclusion of the Wholesale Funding Ratio as an indicator.* This factor does not take into account the *term* of a bank's funding, which is an essential facet of its contribution to systemic risk. Since the Committee is most concerned with the heightened risk of very short-term funding, the calculation should be adjusted to include only funding with tenors of less than one year.
- *Accuracy of cross-jurisdictional claims and liabilities as part of the cross-jurisdictional activity indicator.* Certain cross-jurisdictional claims and liabilities erroneously comprise such items as local claims in local currency, but exclude liabilities of entities domiciled in the bank's home country (even if these liabilities originate in another country). In addition, the determination of “country of exposure” is based on the country where a counterparty is officially registered, as opposed to the jurisdiction in which it operates. We do not believe that these are appropriate measures of cross-border risk.

Diversification benefits ignored. The proposal gives no credit to business and geographic diversification. For instance, the proposal ignores the

¹⁴ 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.financialstabilityboard.org/publications/r_091107c.pdf.

fact that a firm with a number of variably correlated businesses is structurally less risky than a monoline of similar size. Indeed, during the financial crisis, problems tended to be much more acute at firms with monoline business models, while diversified firms were in many cases able to offset significant losses from one line of business with gains from others.

Relationship to N-SIB charges. Currently, there is no guidance on how the G-SIB and the N-SIB regimes will work together. Many institutions subject to the G-SIB surcharge may also be deemed N-SIBs. As a result, there needs to be clarification, before finalization of the proposal, of how the G-SIB surcharge regime will work with the N-SIB regime – including, for example, that G-SIB surcharges will be considered only on a consolidated basis under the home country supervisor’s leadership – to ensure that there is a level playing field for international banks.

Relationship to Basel III’s non-common Tier 1 and Total Capital requirements. GFMA assumes that the additional common equity raised to meet any surcharge will count towards the requirements for non-common Tier 1 capital and Total Capital that are in addition to the Common Equity Tier 1 capital required for the minimum requirement, the Capital Conservation Buffer, and the Counter-Cyclical Buffer (if any). However, the relationship between the surcharge and other requirements is not clear in the Consultative Document. GFMA therefore respectfully requests that the Committee clarify this relationship when it finalizes the proposal.

VII. Properly structured going concern contingent capital should be allowed as part of the surcharge.

The Consultative Document acknowledges (§ 89) that the “Group of Governors and Heads of Supervision and the Basel Committee will continue to review contingent capital, and support the use of contingent capital to meet higher national loss absorbency requirements than the global requirement, as high-trigger contingent capital could help absorb losses on a going concern basis.” Nevertheless, having accepted the principle of the loss absorbent characteristics of high-trigger contingent capital, the proposal then denies the opportunity to use such instruments to meet – partly or wholly – the additional loss absorbency requirements to be imposed on G-SIBs. If high-trigger contingent capital is considered effective for national requirements, then there is no reason why it should not be similarly regarded for global purposes.

Importantly, recognition of high-trigger contingent capital for purposes of the G-SIB surcharge will help to reconcile the tension between increased capital requirements and decreased credit availability. Inclusion of such instruments will allow institutions to raise more capital, using different and deeper investor pools

than would otherwise be available if the surcharge must be met exclusively through Common Equity Tier 1 capital. In this regard, the Consultation Document seems to take the view that the attractive cost and supply aspects of contingent capital somehow means that it is of lower quality; GFMA believes, however, that the lower cost can be easily explained by investor preferences. Contingent capital securities are relatively simple fixed income instruments in most scenarios, and absorb loss only in tail-risk scenarios. In contrast, common equity is subject to gains and losses along the full spectrum of risk scenarios. As a result, the risk-return profile of contingent capital is valued by many investors, especially in the current environment.

Finally, properly structured contingent capital provides high-quality loss absorbency and is, in the most important respects, equivalent to common equity, as the Consultation Document notes in ¶ 85. The Consultative Document lists “pros” and “cons” of contingent capital, but approaches the “cons” with an excess of caution that is in many cases unwarranted, and in some cases contradictory. The design standards for contingent capital set out in the Basel Committee release of January 13, 2011, as well as in Annex 3 of the Consultative Document, address many of the concerns cited in ¶ 87 of the latter, such as those in subsections (c) and (d). Many of the other concerns listed in ¶ 87 can be addressed by simple, common-sense requirements. For instance, the example in subsection (b) can be addressed by phasing out capital treatment toward the final maturity of a qualifying contingent capital security. We would also note that the issue of adverse signaling (subsection (e)) should be offset by the incentive for management to issue capital before the trigger threshold, as management will be aware of signaling impacts. On a net basis, supervisors should find it attractive for bank managers to be incentivized to issue capital early, even if there is some risk that they will not succeed. In short, GFMA believes that the listed “pros” fully offset the listed “cons” with respect to overall instrument quality of properly structured contingent capital.

For these reasons – high quality of loss absorbency, consistency with other regulations, and improved cost and supply dynamics – going concern contingent capital should be allowed to count in the surcharge.

* * *

In conclusion, GFMA believes that the current proposal should be fundamentally reconsidered and re-proposed. Any re-proposal should demonstrate that the benefits exceed the costs of reduced economic growth; expressly take into account new recovery and resolution regimes as well as other reforms that materially reduce systemic risk; contain a transparent and empirically supported methodology; and enable a G-SIB to take action to reduce its systemic

importance. GFMA would welcome the opportunity to meet with members of the Basel Committee to discuss these concerns further.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'T. Ryan', with a long horizontal flourish extending to the right.

T. Timothy Ryan, Jr.
CEO
Global Financial Markets Association

cc: Secretariat of the Financial Stability Board
 Bank for International Settlements
 Centralbahnplatz 2
 CH-4002 Basel
 Switzerland

8 August 2011

Basel Committee on Banking Supervision
C/o Secretariat
Bank for International Settlements
CH-4002 Basel
Switzerland
Sent via email to: baselcommittee@bis.org

RE: Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement

To the Basel Committee on Banking Supervision:

1. The Global Financial Markets Association (GFMA)¹ and its members appreciate the opportunity to comment on the assessment methodology and the additional loss absorbency requirement for global systemically important banks (G-SIBs). GFMA applauds the work being done by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) to achieve an appropriate, workable, and sustainable regime for G-SIBs that promotes financial stability. While we will provide you with detailed comments on the G-SIB surcharge, and related transparency and framework of the assessment methodology at a later date, we wanted to submit some preliminary comments on the importance of soliciting feedback on the economic impact of the surcharge.
2. We strongly believe that in contemplating additional changes, policymakers should consider carefully the aggregate economic impact of both existing and prospective prudential requirements to ensure that the expected benefits which they aim to deliver are not outweighed by an unintended negative effect on the economy. **Consequently, we respectfully urge the BCBS to allow time for us to consider the conclusions of the Macroeconomic Assessment Group's work on the impact of the G-SIB proposals before comments are due on the proposed G-SIB capital surcharge.**
3. There is broad consensus that higher capital requirements are an impediment to economic growth. The BCBS expressly recognized this in Basel III's countercyclical

¹ The Global Financial Markets Association (GFMA) joins together some of the world's largest financial trade associations to develop strategies for global policy issues in the financial markets, and promote coordinated advocacy efforts. The member trade associations count the world's largest financial markets participants as their members. GFMA currently has three members: the Association for Financial Markets in Europe (AFME), the Asia Securities Industry & Financial Markets Association (ASIFMA), and, in North America, the Securities Industry and Financial Markets Association (SIFMA).

capital buffer, which embraces higher capital as a tool to reduce excessive growth. The consultative document also acknowledges that increased capital will reduce growth.²

4. In the wake of the financial crisis, policymakers have accepted Basel III's capital requirements as necessary, along with other reforms, to reduce the probability that banks will fail, and to increase consumer confidence in the banking system. Both of these goals foster long-term growth and stability in a way that it is hoped will offset the likely increased cost and decreased availability of credit resulting from higher capital requirements.
5. There is already considerable uncertainty over the cumulative impact on economic growth resulting from the full implementation of Basel III and other planned regulatory reforms.
6. It is therefore possible that, after taking account of the increased safety and stability generated by these reforms, any additional margin of safety created by a further capital surcharge might well be more than offset by a heightened threat to economic growth especially at a time when the global economy is unusually fragile.
7. Since the BCBS will not release its study of the economic impact of the proposal until *after* the public has been allowed to comment, *we request, at a minimum, that the Committee allow comment on that analysis before deciding whether, and if so how, to finalize the proposal.*

We thank the BCBS for its work on these challenging issues and the opportunity to provide comments.

Respectfully submitted,



T. Timothy Ryan, Jr.
CEO
Global Financial Markets Association

² BCBS- *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement*, July 2011, Page 16.