The Systemic Risk Council

Robert de V. Frierson
Secretary
Board of Governors of the Federal Reserve System
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SUBMITTED VIA ELECTRONIC MAIL

March 2, 2015

Re: Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies (Docket No. R-1505, RIN 7100 AE-16)

Dear Mr. Frierson:

The Systemic Risk Council (the Council or we)[1] welcomes the opportunity to express its strong support for the implementation of a risk-based capital surcharge (the GSIB surcharge) for U.S. bank holding companies identified as global systemically important banking organizations (GSIBs), as recently proposed by the Board of Governors of the Federal Reserve System (the Board).[2] The Proposed Rule builds on a foundation laid by the Group of Twenty Finance Ministers and Central Bank Governors and the Financial Stability Board (FSB) to address the systemic and moral hazard risks associated with GSIBs.[3]

The Council believes that a well-calibrated GSIB surcharge will assist regulators and GSIBs to lean into the headwinds of systemic risk *ex ante*, that is, prior to the onset of periods of financial stress. This, in turn, will contribute to a reduction of the probability of catastrophic GSIB failures. A critical aspect of this calibration is the Proposed Rule's establishment of a direct relationship between the size of the surcharge and the relative difficulty of liquidating or resolving a failed GSIB, and the Council would encourage the Board to give even greater weight to a GSIB's "complexity" in calculating the

[1] The independent, non-partisan Systemic Risk Council (www.systemicriskcouncil.org) was formed by the CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. and global capital markets, with a focus on systemic risk. The statements, documents, and recommendations of the private sector, volunteer Council do not necessarily represent the views of its supporting organizations. The Council works collaboratively to seek agreement on each of its recommendations. This letter fairly reflects the consensus views of the Council but does not bind its individual members.

[2] Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, 79 Fed. Reg. 75473 (Dec. 18, 2014) [henceforth, the Proposed Rule].

[3] *See* Press Release, FSB, *G20 Leaders endorse Financial Stability Board policy framework for addressing systemically important financial institutions* (Nov. 12, 2010), *available at* http://www.financialstabilityboard.org/wp-content/uploads/pr_101111a.pdf?page_moved=1. *See also*, FSB, *Reducing the moral hazard posed by systemically important financial institutions* (Oct. 20, 2010), at 3, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_101111a.pdf?page_moved=1 ("[Global systemically important financial institutions] should have loss absorption capacity beyond the minimum agreed Basel III standards. … Depending on national circumstances, this greater capacity…could be achieved by a combination of a capital surcharge [with other policy options].").

surcharge. Furthermore, by explicitly incorporating into the measurement of systemic risk the additional factor of a GSIB's reliance on short-term wholesale funding—a factor not included in the surcharge framework suggested by the Basel Committee on Banking Supervision (the BCBS)[4]—the Proposed Rule promises to curtail one of the key accelerants of the contagion that engulfed the global financial system during the 2008 financial crisis. Though capital and liquidity regulation have traditionally been addressed separately, we respect the Board's desire to discourage volatile, short-term funding through all tools at its disposal, including capital standards. Finally, by encouraging GSIBs to curtail or eliminate factors and activities contributing to their GSIB status, the GSIB surcharge is likely to reduce the moral hazard arising from the perception that GSIBs are "too big to fail."

1. *Summary of the Proposed Rule*

The Proposed Rule, issued pursuant to the Board's authority under Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act),[5] would "establish a methodology to determine whether a U.S. top-tier bank holding company is a GSIB based on five broad categories that are believed to be good proxies for, and correlated with, systemic importance—size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity."[6] Firms designated as GSIBs pursuant to this methodology would be required to calculate a capital surcharge using two separate methods.[7] The first method is based on the sum of a firm's "systemic indicator scores," reflecting the above five measures of systemic importance.[8] The second method is calculated in the same manner but replaces "substitutability" with a measure of the firm's reliance on short-term wholesale funding.[9] The GSIB surcharge applicable to an individual firm would be the higher of the two surcharges determined in accordance with the above methods.[10] The firm's required capital conservation buffer, consisting of Tier 1 common equity, would then be increased by the amount of the applicable GSIB surcharge.[11]

2. *The Proposed Rule reduces the probability of GSIB failure.*

The Proposed Rule is designed to reduce the expected systemic impact of a GSIB's severe distress or failure to a level approximately equal with that of a large but *non-systemic* bank holding company, where "expected systemic impact" is the product of (i) the "systemic loss given default" of a GSIB and (ii) the probability of such a default.[12]

It is implicit in the very definition of "GSIB" that the systemic loss given default of the world's largest, most interconnected financial firms is substantially higher than that of a large but non-systemic bank holding company. Consequently, the Proposed Rule aims to calibrate the GSIB surcharges such that the probability of an individual GSIB's severe distress or failure is dramatically reduced.[13] This feature alone, in our view, warrants adoption of the Proposed Rule. As Board Governor Daniel K. Tarullo, citing a BCBS economic impact analysis of capital surcharges, stated in recent remarks, the GSIB

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[4] Proposed Rule, *supra* n. 2, at 75477.
[5] Public Law 111-203, 124 Stat. 1376, 1423 (July 21, 2010) (codified at 12 U.S.C. § 5365 (2012)).
[6] Proposed Rule, *supra* n. 2, at 75475.
[7] *Id*.
[8] *Id*.
[9] *Id*.
[10] *Id*. In most cases, the second method would produce a higher total score than the first method and thus would serve as the basis for the actual GSIB surcharge applied. *Id*., at 75480.
[11] *Id*., at 75475.
[12] *Id*.
[13] *Id*.

surcharges "should provide substantial net economic benefits by reducing the risks of destabilizing failures of very large banking organizations."[14] The Council wholeheartedly agrees with Governor Tarullo's assessment. We further observe that the GSIB surcharges not only promise to deliver substantial net economic benefits but also represent a significant step toward resolving the so-called "too-big-to-fail" conundrum that has bedeviled financial regulators since the onset of the 2008 financial crisis.

3. *The Proposed Rule creates incentives for GSIBs to restructure their operations and internalize the costs associated with their systemic risk.*

Since the GSIB surcharges are designed to increase in direct proportion to the magnitude of an individual GSIB's systemic indicator score, another likely effect of the Proposed Rule will be to create incentives for GSIBs to "reduce [their] risk of failure, internalize the negative externalities [they pose], and correct for competitive distortions created by the perception that [they] may be too big to fail."[15] As Governor Tarullo indicated in the aforementioned speech, "during the transition period for implementation of the [GSIB surcharges]…, the affected firms will presumably be considering whether they wish to reduce or alter the range, amount, or types of their activities so as to place themselves in a lower 'risk bucket,' with a concomitantly lower capital surcharge."[16]

The benefits of the Proposed Rule will thus not be limited to making GSIBs more resistant to failure by increasing the amount of loss-absorbing capital on their balance sheets and placing additional investor capital at risk before government mechanisms may be called upon. It will likely also induce GSIBs to restructure their operations in ways that further mitigate the risk of failure as well as eliminate competitive distortions.

4. *The systemic indicator scores assigned to GSIBs partially reflect the complexity of resolving a GSIB in the event of its failure, a factor that the Council believes deserves greater statistical weight in the scores.*

Reducing the difficulty of liquidating or resolving systemically important financial institutions, including GSIBs, is one of the primary objectives of post-2008 financial reform.[17] The Council has recently commented on one such effort, namely, the FSB's consultative document on the importance of "total loss-absorbing capacity" in resolving a complex holding company structure.[18]

The systemic indicator scores calculated under the Proposed Rule take into account an institution's degree of "complexity." As the Board notes:

> The global systemic impact of a banking organization's failure or distress is positively correlated to that organization's business, operational, and structural complexity. Generally, the more complex a banking organization is, the greater the expense and time necessary to resolve

[14] Gov. Daniel K. Tarullo, *Advancing Macroprudential Policy Objectives* (Jan. 30, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm [henceforth, the Tarullo Speech].
[15] Proposed Rule, *supra* n. 2, at 75475.
[16] Tarullo Speech, *supra* n. 14.
[17] The importance of this subject is highlighted by the actions taken by the Board and the Federal Deposit Insurance Corporation (FDIC) to criticize the second round of resolution plans filed by eleven of the largest banking organizations operating in the United States pursuant to Section 165(d) of the Dodd-Frank Act. *See* Joint Press Release, *Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers: Firms Required to Address Shortcomings in 2015 Submissions* (Aug. 5, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm.
[18] *See* Comment Letter of the Council to the FSB (Feb. 2, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/The-Systemic-Risk-Council-on-TLAC.pdf.

> it. Costly resolutions can have negative cascading effects in the markets, including disorderly unwinding of positions, fire sales of assets, disruption of services to customers, and increased uncertainty in the markets.[19]

As proposed, the systemic indicator scores would include three separate indicators of complexity: (i) notional amount of OTC derivatives; (ii) Level 3 assets; and (iii) trading and AFS securities as of December 31 of a given year.[20] An additional dimension of a GSIB's complexity is its internal complexity. Internal complexity may include the number and variety of a GSIB's activities as well as the operational, managerial, and risk-related interconnections associated with such activities. Another aspect of internal complexity is the coherence of a GSIB's corporate structure. The senior management of a GSIB that is too big and too complex to manage may simply be unaware of or fail to appreciate the nature and scope of these risks. Similarly, excessive complexity can cloud the view of supervisory authorities seeking to cabin such risks. Complexity therefore increases a GSIB's probability of default and the systemic cost thereof and also makes the GSIB more difficult to resolve post-default. Given the nexus between a GSIB's complexity and the risks it poses to the financial system, we encourage the Board to give the complexity factor greater statistical weight in calculating the systemic indicator score and to include additional considerations in its measure of complexity, including its demonstrated ease of recovery or resolution under its own resolution plan. We believe that the GSIB surcharge should be inversely proportional to the difficulty of resolving an institution. A GSIB that fails to develop a credible plan for its recovery or resolution should confront a substantially higher surcharge. On the other hand, GSIBs that develop plans credibly promising swift and orderly recovery or resolution without recourse to public funds should be accorded a lower GSIB surcharge. Such a measure would reinforce incentives for GSIBs to develop viable resolution plans and complement the incentives outlined above relating to the risk of failure and competitive distortions.

5. *The Proposed Rule appropriately focuses on the significant contribution of a GSIB's reliance on short-term wholesale funding to its systemic risk.*

The Council applauds the Board's focus on the contribution of short-term wholesale funding to the generation and transmission of systemic liquidity risk, the effects of which were amply demonstrated by the 2008 financial crisis. Such funding is uniquely vulnerable to contagious runs in periods of financial stress, and, if the regulatory community draws any lessons from the experience of 2008, chief among them should be that reducing the financial system's exposure to the threat of a rapid loss of liquidity in short-term wholesale funding markets is of paramount importance to financial stability. We note, however, that the current risk-based capital rules continue to encourage short-term funding between banking organizations by treating such lending as extremely low risk. Thus, to some extent, this aspect of the proposed GSIB surcharge is necessary in order to counter incentives created by the underlying framework for risk weighting assets. While we support the Board's proposal to impose a higher surcharge for those GSIBs that heavily rely on short-term funding, we encourage the Board to continue to examine and address counterproductive incentives in the risk-based capital rules, by, for instance, placing much greater emphasis on a banking organization's leverage ratio.

6. *The Board should "show its work" in designing and calibrating the GSIB surcharges in order to build broad support for the Proposed Rule*.

One of the most innovative features of the Proposed Rule is the systemic indicator score, which seeks to quantify the respective contributions of various factors to a GSIB's systemic importance. Based on

[19] Proposed Rule, *supra* n. 2, at 75486.
[20] *Id*.

these scores, GSIBs and other financial institutions will be ranked against their peers, and the GSIB surcharges will be assessed accordingly to achieve the corresponding reductions in the probability of default discussed above. Given the absence of precedent as to how GSIBs will manage their capital conservation buffers, with or without a GSIB surcharge component, during periods of systemic or idiosyncratic stress, we believe that it would be appropriate for the Board to "show its work" under the Proposed Rule to a greater degree.[21] A more fulsome explanation of how the Board arrived at the specific calibration of the various systemic indicator score factors would go a long way toward demonstrating the need for a GSIB surcharge and the benefits thereof. As long as the GSIB surcharge is "just a number," understood only by a handful of specialists, it will be subject to attack as being ill-conceived, unduly burdensome, and a barrier to economic recovery. The Council believes that greater transparency regarding the Proposed Rule's methodology should bolster the Board's claims in the eyes of the public that the Proposed Rule will be effective in eliminating the "too-big-to-fail" problem and contribute to sustained prosperity.

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Respectfully submitted,

Sheila Bair, Chair
On behalf of the Systemic Risk Council
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[21] Similarly, the Board in the Proposed Rule cited the persistence of the perception that some bank holding companies are "too big to fail" as a reason for the adoption of the Proposed Rule without acknowledging recent debates as to whether and under what circumstances large bank holding companies continue to enjoy a "too big to fail" advantage. Proposed Rule, *supra* n. 2, at 75474; *See, e.g.*, United States Government Accountability Office, *Large Bank Holding Companies: Expectations of Government Support*, GAO 14-621 (July 31, 2014), *available at* http://www.gao.gov/assets/670/665162.pdf.

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* Affiliations are for identification purposes only. Council members participate as individuals, and this letter reflects their own views and not those of the organizations with which they are affiliated.