



April 27, 2012

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Jennifer J. Johnson, Secretary
Docket No. 1438; RIN 7100-AD-86

Re: Enhanced Prudential Standards and Early Remediation Regulations under Dodd-Frank 165/166

Ladies and Gentlemen:

The Clearing House Association L.L.C. (“**The Clearing House**”), the American Bankers Association (the “**ABA**”), the Financial Services Forum (the “**Forum**”), The Financial Services Roundtable (“**The Roundtable**”) and the Securities Industry and Financial Markets Association (“**SIFMA**” and, together with The Clearing House, the ABA, the Forum and The Roundtable, the “**Associations**”)¹ are writing to comment on the Board of Governors of the Federal Reserve System’s (the “**Federal Reserve**”) notice of proposed rulemaking (the “**NPR**”)² implementing the enhanced prudential standards and early remediation provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”).³

¹ The Associations collectively represent financial institutions accounting for a substantial majority of banking and financial assets in the United States. Descriptions of the Associations are provided immediately following the signature page of this letter.

² 77 Fed. Reg. 594 (Jan. 5, 2012). The introduction and commentary included in the NPR are referred to herein as the “**Preamble**”, and the proposed rules set forth in the NPR are referred to herein as the “**Proposed Rules**”.

³ Pub. L. No. 111-203 (2010)

The Associations and their members support a robust and effective regulatory system, which includes not only appropriately designed rules implementing Sections 165 and 166, but such other fundamental reforms as the Basel Committee on Banking Supervision's ("BCBS") capital and liquidity frameworks announced in December 2010 ("Basel III") and the Federal Reserve's Capital Plan Rule set forth in 12 C.F.R. § 225.8 (the "Capital Plan Rule"). If, however, implementing regulations (including the Proposed Rules) are not properly designed and calibrated to the risks they are designed to address, they raise the potential for damage to the financial system and the broader economy.⁴ Our greatest concern in this regard as to the Proposed Rules relates to the extraordinary overstatement of exposures in the single-counterparty credit limits (the "SCCL") addressed in Subpart D of the Proposed Rules and in *Annex C* to this Comment Letter.⁵

We have set forth in separate annexes to this letter (including its annexes, this "Comment Letter") specific comments and recommendations regarding six of the seven topical areas addressed in the separate subparts of the Proposed Rules, as follows:⁶

- in *Annex A*, comments on Subpart B – Risk-Based Capital Requirements and Leverage Limits (the "Proposed Capital and Leverage Rules");
- in *Annex B*, comments on Subpart C – Liquidity Requirements (the "Proposed Liquidity Rules");
- in *Annex C*, comments on Subpart D – Single-Counterparty Credit Limits (the "Proposed SCCL Rules");
- in *Annex D*, comments on Subpart E – Risk Management (the "Proposed Risk Management Rules");

⁴ A number of other provisions of Dodd-Frank, including the Lincoln Amendment (Section 716), and, most importantly, the Volcker Rule (Section 619), also create concerns about damage to the financial system and economy.

⁵ In *Annex C*, we also address the Proposed SCCL Rules' failure to satisfy basic administrative law standards requiring an agency to provide an appropriate explanation of the reasons for a proposed rule.

⁶ This Comment Letter is focused on the concerns of bank holding companies ("BHCs"), and we do not address the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies. The Associations also are not addressing Subpart H – Debt-to-Equity Limits for Certain Covered Companies. Contemporaneously with our submission of this Comment Letter, we are delivering to the Federal Reserve and other recipients of this Comment Letter copies of previously submitted comment letters, studies and other submissions of the Associations referred to in the Annexes to this Comment Letter and bearing on our recommendations and concerns (collectively, the "Prior Submissions").

- in *Annex E*, comments on Subparts F and G – Supervisory Stress Test Requirements and Company-Run Stress Test Requirements (the “**Proposed Stress Test Rules**”); and
- in *Annex F*, comments on Subpart I – Early Remediation Framework (the “**Proposed Early Remediation Rules**”).

Each Annex includes an executive summary of the Associations’ comments on the subpart addressed in that Annex.⁷

Part I of this Comment Letter addresses seven key areas of concern, including our fundamental concerns with the Proposed SCCL Rules, and Part II summarizes certain of our key recommendations and concerns with respect to each subpart other than the Proposed SCCL Rules.

I. Key Concerns

- A. The Associations support a robust regulatory regime and acknowledge the need to correct for past regulatory deficiencies and gaps. Some parts of the Proposed Rules, however, do more harm than good, potentially contributing to systemic risk rather than mitigating it and having an adverse impact on banking institutions’ customers and the broader economy.**

Legislators, regulators and banks have been largely aligned in their views of the core supervisory and management problems that contributed to the onset and escalation of the financial crisis:

- insufficient capital (in terms of both quantity and quality) at some institutions;
- insufficient liquidity at some institutions;
- Boards of Directors and management teams at some institutions that were late to recognize the scope of the crisis and failed to react and adjust with the speed required; and
- the absence of credible resolution regimes for large financial institutions.

The Associations have consistently supported significant and fundamental changes to the regulatory regime in order to establish a regulatory framework that both *protects* the financial system against potential systemic meltdowns of the type faced in the recent crisis and *enables* the financial system to play its necessary role in fostering economic and job growth.

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Capitalized terms used in this letter and not otherwise defined are used with the meanings assigned to them in the attached Annexes. References in the Annexes to “**the Comment Letter**” mean this letter.

In the context of these dual objectives, the prudential regulatory framework should recognize that regulation has costs and limits. We understand that the legislative and regulatory responses to the severity of the financial crisis must be sufficiently comprehensive and robust to protect against a reoccurrence. At the same time, however, we are concerned that, in some crucial respects, regulatory reforms (including the Proposed Rules) are so imbalanced as to do more harm than good. The Proposed Rules cannot eliminate economic cycles or all risk, nor should they attempt to do so. It is critically important that decision makers (including the Federal Reserve and other agencies) promulgate rules required or permitted under Dodd-Frank that achieve a reasonable degree of regulatory balance by, among other things, informing their rulemakings with quantitative analysis where relevant and a holistic understanding of the consequences of their implementation.

The Associations submit that banks can perform their role in the economy only by taking controlled risks. The principal functions of banks include performing credit intermediation through the assumption of credit risk, properly controlled and limited and accurately measured, in relation to their borrowers and counterparties and providing maturity transformation for customers (that is, providing longer term loans to customers and accepting shorter-term deposits from customers), and managing the related risk. If the prudential regulatory framework inhibits these risk-taking functions of banks, the still nascent economic recovery may likely be stalled and future economic growth will be curtailed by a reduced availability of credit. We are also concerned that excessive limitations on the ability of U.S. banks to take controlled risks will reduce the role of the United States as a leader in the global financial system.

We also submit that the final rule should take into account the substantial progress that has already been made in terms of regulatory enhancement. A recent and graphic example is the performance of the largest U.S. banks under the Federal Reserve's comprehensive capital adequacy review ("**CCAR 2012**").⁸ These banks demonstrated strong capital even under a scenario involving extremely adverse macro-economic assumptions and the Federal Reserve's conservative application of those assumptions (in terms of both depth of losses and front-end loading of those losses).

Our concerns with respect to regulatory imbalance focus on three principal aspects of the Proposed Rules:

First, as discussed in Part I.C and of most importance, the Proposed SCCL Rules would needlessly reduce liquidity in the financial system and thereby dampen economic activity. The Proposed SCCL Rules' imposition of:

⁸ Stress testing is important. But so too is learning lessons from that testing – for example, whether proposals to increase capital requirements sharply above the levels just validated under CCAR 2012 risk having higher costs than benefits. Moreover, as discussed in detail throughout this Comment Letter, certain aspects of the rules implementing Sections 165 and 166, if adopted as proposed, are likely to have a destabilizing impact and increase systemic risks.

- unrealistic and one-dimensional measures of exposure, such as the current exposure method (“**CEM**”) for derivatives and the “add-on” approach used in securities lending and repurchase transactions (“**repo and securities lending transactions**”), drastically exaggerating actual exposures,
- the notional shifting requirement when utilizing credit protection or acting as a market maker in credit protection contexts, and
- the reduction of the credit limit to 10% for major covered companies (defined as those having consolidated total assets of \$500 billion or more),

taken together with other aspects of the Proposed SCCL Rules, would result in the need for extraordinary adjustments of relationships among market participants that are unnecessary, unwise, potentially destabilizing and, in certain instances, unsupported by the statute or by Congressional intent. Moreover, the reduction of the credit limit to 10% cannot be implemented absent a determination that the statutory test mandated by Dodd-Frank for a variation from the 25% statutory standard has been met – *i.e.*, “would be necessary to mitigate risks to the financial stability of the United States.”⁹

Second, the capital surcharge contemplated by the Preamble’s discussion of the Proposed Capital and Leverage Rules (i) is not required by Dodd-Frank Section 165’s “more stringent” requirement, (ii) is premature, (iii) if based on the BCBS’s G-SIB Surcharge (as is apparently intended), is fundamentally flawed in its methodology, and (iv) could result in such excessive capital levels that it harms the position of regulated banking organizations with investors and has an adverse impact on their customers and the broader economy.

Third, the Proposed Early Remediation Rules (i) include automatic triggers for falling into Level 2 and Level 3 remediation that are overly sensitive and rigid and, thus, threaten to impose significant regulatory constraints on firms that are not warranted by the firm’s actual condition, and (ii) subject a firm to the entire panoply of early remediation restrictions and requirements as a result of reaching a single “triggering event”, irrespective of whether such restrictions and requirements are related to the triggering event that caused the firm to be placed into the regime or, in the particular situation, would actually aid the company’s recovery.

⁹ Section 165(e)(2) of Dodd-Frank (emphasis added).

- B. It is exceedingly important that the Proposed Rules be analyzed holistically, not only with respect to the interplay among their subparts but also with other reforms, both in the United States and abroad. We urge the Federal Reserve and the other U.S. banking agencies to consider and address the interplay among reforms in the context of considering individual reforms.**

The full potential combined impact of financial services regulatory reforms, including the Proposed Rules, Basel III (both capital and liquidity), Title II of Dodd-Frank, proposed margin requirements for swaps (Section 731 of Dodd-Frank) and the Volcker Rule (and related regulations currently under consideration by the Federal Reserve, Office of the Comptroller of the Currency (“OCC”), Federal Deposit Insurance Corporation (“FDIC”), Securities and Exchange Commission (“SEC”) and Commodity Futures Trading Commission (“CFTC”)), has not yet been comprehensively analyzed and, to our knowledge, no one in the regulatory or academic communities has asserted that it has. Public sector officials, including Federal Reserve Chairman Bernanke, have acknowledged that the aggregate impact of the current financial services regulatory reforms in the United States has not yet been fully analyzed (at least as of last summer).¹⁰ Others in the regulatory community, including SEC Commissioner Troy Paredes and then Acting Comptroller of the Currency John Walsh, have expressed concern on this issue.¹¹ The reality is that the cumulative effects of the Proposed Rules and other

¹⁰ See, e.g., Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke’s Speech on the U.S. Economic Outlook (June 7, 2011) (*transcript available at <http://video.cnbc.com/gallery/?video=3000026289>*).

¹¹ Commissioner Paredes commented in a September 2010 speech: “This builds to a straightforward but important point – that is, we need to use the regulatory authority Dodd-Frank has conferred upon us cautiously, carefully evaluating the intended benefits of our actions while giving due regard to the potential undesirable consequences of our regulatory steps. This should include assessing the cumulative impact of the entire package of new regulatory demands to anticipate the overall effect of the regulatory regime when viewed as a combined whole.” (Remarks before the Security Traders Association 77th Annual Conference and Business Meeting (Sept. 24, 2010), *available at <http://www.sec.gov/news/speech/2010/spch092410tap.htm>*)

Then Acting Comptroller Walsh commented in a January 2012 speech: “Dodd-Frank...mak[es] very significant changes in the way business is done by financial institutions. There are so many moving parts that it is very hard to judge how these many approaches will interact, or what their cumulative effect will be.” (Remarks before the Centre for the Study of Financial Innovation (June 21, 2011), *available at <http://www.occ.treas.gov/news-issuances/speeches/2011/pub-speech-2011-78.pdf>*) Then Acting Comptroller Walsh also commented in a June 2011 speech: “Nonetheless, it is also an undeniable quality of human nature that, in the frenzy of the moment, we can overreact in response to crisis. Describing this as a swinging pendulum may be a tired cliché, but it’s worth asking ourselves: where is that pendulum right now? One of our OCC supervisors created the wonderful malapropism of ‘trying to keep the pendulum in the middle of the road,’ but that is surely not where we are today. To put it plainly, my view is that we are in danger of trying to squeeze too much risk and complexity out of banking as we institute reforms to address problems and abuses stemming from the last crisis.” (Remarks at the American

rulemakings and reforms, which are often individually complex and when considered together amount to an incredibly complex mosaic, are almost certain to have unintended consequences and potential economic costs, and are likely in some cases to create the potential for actually increasing instead of decreasing systemic risks.

There are three specific aspects of this sweeping NPR that warrant reemphasizing the need for a holistic analysis of regulatory reforms, including the Proposed Rules:

First, a holistic analysis in the context of any particular regulatory reform has two foci – namely, (i) what other reforms are targeted to the same objective and, hence, should be taken into account by rulemakers in fashioning a particular set of rules (and in estimating the impact of those rules), and (ii) apart from the particular objective of a rule or set of rules, what are the impacts of combined rulemakings on customers for banking services and the economy more broadly. The Federal Reserve acknowledges the first component, noting in the Preamble that Dodd-Frank takes a “multi-prong approach” to “mitigating the threat to financial stability posed by systemically important financial companies,” and then goes on to cite, among others, Title II’s orderly liquidation authority, the Financial Stability Oversight Council (“**FSOC**”), and regulation of over-the-counter derivatives, other core financial markets and financial market utilities.¹² The Federal Reserve does not, however, acknowledge in the Preamble the other component – analyzing holistically the impacts of combined rulemakings on customers and the economy more broadly.

We believe the risk of severe consequences arising out of the Proposed Rules and other regulatory reforms, taken together, is more than negligible, which should argue persuasively for a thoughtful, holistic approach. At some point on the regulatory reform spectrum, macroprudential efforts to reduce systemic risk in the banking system will tip over into a reduction of credit availability and stall economic recovery. As we have consistently maintained in commenting on proposed reforms (including in this Comment Letter), the Associations’ position is not that regulatory reform is unnecessary (indeed, we unequivocally recognize its need), but rather that it should be sufficiently balanced to avoid both the indirect risk of bank failure adversely impacting the economy and the direct risk of the rules themselves adversely impacting the economy.

Second, any analysis of the impact of a proposed rulemaking, even more so in the context of broad reforms, is incomplete without a cost/benefit analysis. The Associations note with disappointment that the NPR reflects little or no attempt by the Federal Reserve in many of the Proposed Rules, including in particular the Proposed SCCL Rules, to weigh the enormous costs to the covered companies and U.S. financial markets associated with the proposals against the likely benefits

Securitization Forum Annual Conference (Jan. 24, 2012), available at <http://www.occ.gov/news-issuances/speeches/2012/pub-speech-2012-11.pdf>

¹² 77 Fed. Reg. at 595.

of the proposals for the goal of U.S. financial stability.¹³ Nor does the NPR indicate that the Federal Reserve made any effort to consider whether the benefits and goals of the proposals could be achieved and unnecessary costs avoided through other less burdensome regulatory alternatives. For example, before proposing the Proposed SCCL Rules, the Federal Reserve did not conduct a quantitative impact study (“QIS”) to assess the actual impact on the covered companies or financial markets of the new requirements for measurement of credit exposure on derivatives and repo and securities lending transactions, the reduction of the statutory credit limit to 10%, or the coverage of individuals and high-quality sovereigns. The NPR also does not indicate that the Federal Reserve gave any consideration to whether the intended benefits of financial stability under the Proposed SCCL Rules could be achieved, and the significant costs associated with developing and maintaining completely new tracking, reporting and compliance mechanisms avoided, by aligning the SCCL requirements with existing risk management systems and utilizing long-established lending limit definitions and concepts.

The Proposed Rules thus contravene U.S. government policy requiring an analysis and “reasoned determination” regarding the costs and benefits of a proposed rule, including the “costs of cumulative regulations”, and the consideration of less burdensome alternatives.¹⁴ These are principles the Federal Reserve has stated it endeavors to abide by in developing and adopting regulatory protocols, including specifically those required under Dodd-Frank.¹⁵ Indeed, contrary to the Federal Reserve’s statement of policy, the Federal Reserve did not solicit comment in the NPR regarding the costs and benefits of the proposed approaches.

The Associations urge the Federal Reserve to conduct a QIS of the Proposed Rules, or, at the very least, the Proposed SCCL Rules, as promptly as practical and release the QIS results for public comment. If the QIS cannot be completed prior to publication of final rules, the Federal Reserve should subsequently request comment on whether the QIS results require modifications of the final rules. The QIS should be completed well in advance of the scheduled effective date of the Proposed SCCL Rules so that any necessary modifications can be made before banks must initiate their implementation programs.¹⁶

¹³ Costs associated with regulatory compliance are a significant issue for U.S. banks. See, e.g., Dan Fitzpatrick and Robin Sidel, *Costs Hobble Banks’ Profits*, *The Wall Street Journal* (Apr. 12, 2012).

¹⁴ Executive Order 13563, January 18, 2011. Executive Order 13579, July 11, 2011, states that independent regulatory agencies, such as the Federal Reserve, should comply with the cost benefit analysis and regulatory burden reduction requirements of Executive Order 13563.

¹⁵ Letter from Federal Reserve Chairman Ben Bernanke to Mr. Cass R. Sunstein, Office of Information and Regulatory Affairs, dated Nov. 8, 2011.

¹⁶ Alternatively, one or more of the Associations could conduct a QIS, in which case we would request a similar approach to timing.

Third, the United States has taken a more comprehensive approach than any other country to address regulatory reform. Although some countries have taken steps to address components of topics covered by Dodd-Frank, no country has adopted restrictions comparable to the Volcker Rule or adopted legislation or regulations having the scope of Dodd-Frank.¹⁷ There can be no question but that substantive regulation has competitive consequences. It is essential that the Federal Reserve and other U.S. regulatory agencies, in proposing regulations, consider and analyze both the individual aspects and combined impact of proposed rules that may place U.S. banks at an unwarranted competitive disadvantage compared to those countries that have not implemented a comparable approach. Two principal respects in which the United States has moved more aggressively than other countries are:

- Covered companies' capital adequacy is measured under a very stringent stress test standard (namely, *5% Tier 1 common ratio*, calculated based on a severely stressed scenario, utilizing very conservative assumptions and projected over nine quarters) that may place covered companies at a competitive disadvantage to their international competitors, the capital adequacy of which is not analyzed under such severely adverse scenarios.
- The Proposed SCCL Rules would place covered companies under a very restrictive regime, which is not ultimately risk-based and is an approach not utilized by any other country. The result will be to drive a variety of key bank products to the non-U.S. competitors of U.S. banks which are not subject to comparable rules.

C. The Proposed SCCL Rules are so fundamentally flawed that they would have an adverse impact not only on regulated banking organizations but also on their customers and the broader economy, as noted above. The NPR also fails to satisfy basic administrative law standards.

The Proposed SCCL Rules would mandate methodologies that markedly depart from well-established and sensible risk management practices, drastically exaggerating actual exposures, and, if adopted as proposed, would require massive unwinding of existing transactions and reduce liquidity in key markets (perhaps severely). The arbitrary reduction of the credit limit for major covered companies (defined as having \$500 billion or more of total consolidated assets) and the mandated use of one-dimensional, risk-insensitive measures of exposure will needlessly cause significant harm to U.S. financial institutions, their customers and the U.S. economy.

¹⁷ At a recent Senate hearing, a panel of witnesses consisting of senior representatives from several Federal agencies, including among others Martin Gruenberg, John Walsh, Dan Tarullo and Elisse Walter, was asked whether it could identify three countries that had passed a comprehensive set of regulations comparable to Dodd-Frank. No one on the panel identified a single country. *See Hearing on Orderly Liquidation, Derivatives and the Volcker Rule Before the Senate Banking, Housing and Urban Affairs, 112th Congress (2012).*

The Associations and their members support and have long embraced enterprise-wide measurement and regulation of risk exposures. Indeed, beyond statutorily-mandated bank lending limits, BHCs have established limits and monitored exposure in accordance with these enterprise-wide limits for many years. In implementing Section 165, however, the Federal Reserve has chosen to depart arbitrarily and radically from the approach taken by BHCs notwithstanding the Federal Reserve's review during the examination process of individual BHCs' approaches.

In order to assess the effects of the Proposed SCCL Rules on banking organizations and on the derivatives market more broadly, The Clearing House commissioned a QIS ("**The Clearing House SCCL Study**"), which has drawn on data provided by 13 banking organizations, including several banking organizations that are not members of The Clearing House. That study is currently being completed and will be delivered to the Federal Reserve and other U.S. banking agencies, as well as to the FSOC, upon its completion during the coming weeks. Preliminary results indicate that for the 13 organizations surveyed, if the Proposed SCCL Rules were adopted as proposed:¹⁸

- there would be in the aggregate 100 exposures to 29 unique counterparties in excess of the applicable credit limit;¹⁹
- the average counterparty exposure for those excesses would be 248% of the applicable credit limit;²⁰ and
- the counterparty exposures that would exceed the credit limit include exposures to seven highly-rated non-U.S. sovereigns and two CCPs.

The consequences of unwinding or terminating transactions to eliminate the extraordinary amount of excess exposures that would result if the Proposed SCCL Rules were adopted as

¹⁸ This data is based on our interpretation of how exposures would be calculated under the Proposed SCCL Rules. As a result, the numbers may be higher or lower if our interpretation is incorrect. In addition, some underlying data is based on approximations because certain data was not available at this time in the necessary form. Key assumptions and approximations include the following: (i) shifting to protection providers has not been capped at the amount of protection required to hedge net exposure to the reference name; (ii) exposure for protection providers has been netted within reference names for each netting set with the protection provider; (iii) collateral haircuts have not been fully applied; and (iv) the control definition has not been fully applied.

¹⁹ If no allowance is made for short-term breaches of the credit limit (as discussed in Part III.C.2 of *Annex C*), covered companies inevitably will have to manage to a lower limit (e.g., 80% of the limit that would otherwise apply). Using 80% of the limit that would otherwise apply as the threshold, there would be 120 exposures in excess of that threshold.

²⁰ This average represents a "count-weighted" average (i.e., a straight average of the percentage for each of the 100 incidents of exposures in excess of the applicable credit limit).

proposed, as well as the consequences in future crises of constraining the ability of covered companies to provide liquidity to each other as well as to other market participants, cannot be fully known at this time, but the risks would obviously be substantial and potentially destabilizing.

As discussed in *Annex C*, the large number of exposures in excess of the credit limit are the result of a number of serious flaws in the Proposed SCCL Rules. The three principal flaws of the calculation methodology are: (i) use of CEM for derivatives and the add-on for repo and securities lending transactions; (ii) the requirement to shift the face amount of an exposure from a reference name to an eligible protection provider; and (iii) the 10% credit limit for major covered companies. Implementation of final rules with these provisions will likely create significant dislocations in financial markets and materially constrain liquidity in key markets.

The Federal Reserve's approach appears to be grounded in concerns that we believe are, in some important respects, unwarranted and, in all respects, can be addressed through alternative macroprudential rules without the severe and potentially adverse consequences resulting from the Proposed SCCL Rules.

Specifically, the usage of the one-dimensional CEM is apparently a reflection of the Federal Reserve's skepticism as to the accuracy of internal model methods ("IMMs") in times of market distress. Although we recognize that models are not infallible, the thorough review of these models during the examination process should significantly mitigate this risk. Likewise, the automatic risk-shifting appears to reflect a concern that banks' judgments as to when risk-shifting is appropriate are flawed, or even that banks will seek to evade single-counterparty credit limits absent this requirement. Although, once again, judgments are not infallible, arbitrary formulae such as mandated risk-shifting are inherently inaccurate and the examination process would deal with evasion. With respect to both calculation of exposure and risk-shifting, we recognize the need, from a supervisory and prudential perspective, to have a better understanding and appreciation of the scope of transactions between and among covered companies and other participants in financial markets. It should be possible, however, to address this concern through the reporting already required by Section 165(d)(2) of Dodd-Frank.

The arbitrarily determined 10% credit limit on "major covered companies" is not explained or otherwise articulated in the NPR, so it is impossible to provide informed comments. Nonetheless, we are concerned that this limit, and the potential consequences of the Proposed SCCL Rules more generally, reflect a view of the negative impact of interconnectivity that we believe is conceptually flawed. As discussed in *Annex C*, the financial contagion that occurred in the financial crisis was not principally a function of interconnectivity risk *per se* but of similarity risk.²¹ Notwithstanding our views regarding interconnectivity risk, we recognize that the absence of a definitive analysis of the

²¹ By "similarity risk" we mean risk arising out of the similarity in the risk exposures among institutions (e.g., concentrations of exposures by multiple institutions to subprime lending), with the consequence that institutions with these exposures incurred periods of financial stress at the same time, not because of their exposures to each other, but because of their exposure to the same type or source of risk.

systemic nature of the recent financial crisis requires a meaningful response. Accordingly, the Associations have undertaken a thorough effort to develop alternatives that address the Federal Reserve's concerns, particularly model fallibility in stressed conditions, but that would not place financial markets at risk or constrain liquidity in key markets.

Specifically, our key recommendations are as follows:

- Alternatives to CEM. Requiring all covered companies to use CEM to calculate derivative exposure will result in an inaccurate and substantial overstatement of such exposure in relation to the risk posed by the exposure with potentially severe consequences for liquidity of the derivative markets. The Associations propose two approaches for measuring exposure that would be available to covered companies as an alternative to CEM. The alternatives are designed to address concerns with IMMs and capture the effect of future market volatility, but still provide meaningful and realistic measures of exposure by addressing the most significant flaw of CEM, which is its failure to take into account collateral and legally enforceable netting in the calculation of potential future exposure.
 - The first approach is a stressed IMM ("**Stressed IMM Approach**"), which could be effected in one of two ways: (1) the covered company would calculate the exposure under its IMM and then subject the result of that calculation to a multiplier specified by the Federal Reserve in order to provide an additional buffer against excessive credit exposure, or (2) the Federal Reserve could assign both (i) the confidence level that would be used by the covered company to calculate its estimate of potential future exposure under its IMM and (ii) the period of stress to be used in calibrating the IMM to either a historical lookback period or a set of market implied data, or specify criteria for selection of such period of stress.
 - The second approach would require a covered company to use a replacement cost, calculated in accordance with regulatory capital rules, for derivative transactions under specific stress scenarios specified by the Federal Reserve as the measure of exposure ("**Supervisory Stress Approach**"), similar to the approach recently used by the Federal Reserve for CCAR 2012.
- Optional exposure-shifting by protection buyer. The requirement that covered companies that buy eligible protection shift the face amount of an exposure from the reference name to the eligible protection provider results in a gross overstatement of the exposure covered companies have to eligible protection providers by ignoring the reduced likelihood that the covered company will experience a loss because both the counterparty and the protection provider would have to fail ("**double default**"). The likely consequences of this shifting requirement are a significant reduction in the availability of protection products, higher costs, and the perverse effect of transforming a risk mitigant into a risk exaggeration. This requirement should be eliminated, and the final rules should permit a covered company to make its own good faith

determination, subject to written policies and procedures (which would be subject to review during the examination process), regarding whether to shift an exposure from an underlying obligor to an eligible credit protection provider when the covered company purchases credit protection.

- Alternatives for repo and securities lending transactions. The proposed add-on that would be applied to a covered company's exposure in a repo or securities lending transaction and the haircut applied to the collateral securing such transactions result in a significant overstatement of exposure and the risk associated with it. This approach also fails to take into account the relationship between the securities transferred/lent and the type of collateral securing the transaction, as well as the risk-mitigating attributes of the portfolio as a whole. To address these concerns, the Associations propose that covered companies be permitted to use a simple Value at Risk ("VaR") method to calculate net credit exposure for repo and securities lending transactions. A covered company would not need separate and distinct approval by the Federal Reserve for this purpose if the covered company has already received approval to use a VaR method for regulatory capital compliance purposes. If the Federal Reserve determines that a more standardized approach is necessary, it could prescribe inputs and assumptions for the models. At a minimum, a different set of haircuts should be developed to be applied to repo and securities lending transactions that take into account the cash or securities on loan and the particular collateral securing the transactions.
- Do not reduce the 25% credit limit. The 25% statutory credit limit should not be reduced for any covered companies. The Federal Reserve has provided no basis to determine that imposing the dramatically lower and arbitrary 10% credit limit on certain major covered companies would even help mitigate risks to U.S. financial stability, much less be "necessary", as required by the statutory standard.²²
- Exempt CCPs. Exposures to central counterparties ("CCPs") should be exempted from the credit limit, at least initially. Imposing a limit on a covered company's transactions with a CCP ignores the special regulatory scrutiny and regime to which CCPs are subject and will impede progress towards the goal of centralized clearing mandated by Dodd-Frank. Whether limits on a covered company's transactions with a CCP should be imposed, and the mechanics of any such limitation (including which exposures should be included in the aggregate exposure calculation and how

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As discussed in Part II.D of *Annex C*, courts have addressed on a number of occasions the meaning of the word "necessary" in statutory contexts. Courts have, in situations similar to those here, construed the term to mean "indispensable", and have always defined the term as something akin to "required", as opposed to merely "useful". If the Federal Reserve wishes to adopt for some group of covered companies a less than 25% credit limit relying on the "necessary to mitigate" language in Section 165(e)(2) of Dodd-Frank, it must undertake an analysis of the interplay between percentage credit limits and size and demonstrate their nexus to the statute's "necessary to mitigate" test.

those exposures are calculated), should be addressed as part of the larger exercise, both in the United States and abroad, of framing the regulatory regime applicable to CCPs.

- Do not apply the credit limit to high-quality non-U.S. sovereigns. Exposures to high-quality non-U.S. sovereign obligations should not be covered by the credit limit. Our recommendation is designed to ensure that covered companies will be able to continue to accept such high-quality obligations as collateral, and avoid distorting the market for, and reducing the liquidity of, these obligations. Importantly, Dodd-Frank does not require that non-U.S. sovereign obligations be subject to the credit limit because sovereigns are not companies under any accepted definition of that term.²³ Nor does the NPR indicate that the Federal Reserve conducted any analysis, as required by U.S. governmental policy, of the benefits of treating all non-U.S. sovereigns as companies against the potentially significant resulting costs and damage to covered companies and financial markets. Moreover, coverage of non-U.S. sovereigns, the obligations of which have similar levels of liquidity and creditworthiness as those of the United States, which the Federal Reserve did not subject to the credit limit (presumably because of its risk profile), is unsustainable under the Administrative Procedure Act (“APA”),²⁴ particularly given the absence of any explanation or basis for differentiation.
- Individuals should not be covered as counterparties. Exposures to individuals should not be covered by the Proposed SCCL Rules, as in no respect can the definition of “company” under the statute be read to cover individuals, nor would such coverage be consistent with Congressional intent and the purpose of Section 165(e) to address interconnectivity risk “among large financial companies.”²⁵ Credit transactions by a covered company with individuals plainly do not present systemic interconnectivity concerns. Moreover, the Federal Reserve has not provided any basis or explanation for covering individuals as counterparties under the rule, and the NPR provides no indication that the Federal Reserve considered the very severe burdens that would be placed upon covered companies to monitor and calculate daily their exposures to millions of individual customers. Given the extreme unlikelihood that exposure to an individual would ever approach the credit limit or pose systemic interconnectivity issues, we submit that under no conceivable calculus can the burdens placed upon institutions by such a requirement be justified.
- Use financial reporting consolidation as “control” definition. The Proposed SCCL Rules adopt a broad definition of “control”. This broad definition creates an aggregation of exposures that is inconsistent with financial reality and accurate risk-evaluation and goes beyond the

²³ Under the Bank Holding Company Act, the Federal Reserve has explicitly excluded sovereigns from the definition of “company”. 12 U.S.C. 1841(b). Banca Commerciale Italiano, 68 Fed. Res. Bull. 423 (1982); Letter dated August 19, 1988 from William W. Wiles to Patricia S. Skigen.

²⁴ 5 U.S.C. 551, *et seq.*

²⁵ 77 Fed. Reg. at 612.

requirements of the statute or its intent. The proposed definition of “control” would require that a covered company include all affiliates of a counterparty in calculating its aggregate exposure to that counterparty no matter how tenuous or remote the affiliation and regardless of the existence of any actual obligation or responsibility of the “individual company” for the affiliate or likelihood of support. As just one example, if a general partnership or managing member interest is treated as a voting security using a Bank Holding Company-type definition, exposure to all of the controlled portfolio companies of all the private equity funds with the same general partner (or similar fund advisor with an equity stake) and exposure to the funds themselves could potentially be aggregated.²⁶ The definition of “control” should be revised to include only those situations where a company is consolidated for financial reporting purposes. Using this definition of “control” will help avoid aggregation of exposures that do not reflect actual risk. It would also address compliance problems raised by the Proposed SCCL Rules, which would require access to information that is generally not available to a covered company.

- Limit compliance burden. The burden associated with requiring a covered company to calculate compliance for each and every counterparty on a daily basis cannot be justified by any supervisory or systemic benefit. As long as a covered company’s policies and procedures are sufficient to prevent an exposure from approaching a specified percentage of the credit limit, there is no reason to require daily monitoring or any reporting of exposures that fall well below the credit limit.
- Provide a more reasonable effective date. The Proposed SCCL Rules have fundamental flaws and no delay in implementation of rules implementing Section 165(e) will address those flaws. At a minimum, however, given the complexity of calculating counterparty exposures under these rules, even if revised to address the flaws, we believe the Federal Reserve should exercise its authority to extend the transition period for the full two years. This extended effective date will provide needed time to shift credit relationships without causing market shocks. In addition, an extended transition period will provide covered companies with more time to develop enhanced systems to comply with the Proposed SCCL Rules.

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This represents one additional example of the presumably unintended consequence of a number of the proposed regulatory reforms of driving business from the regulated banking industry to the largely unregulated shadow banking sector.

- D. Numerous aspects of the Proposed Rules, along with regulatory reform measures more broadly, appear premised on the “big is bad” belief that size inherently is a major indicator of and contributor to systemic risk, and assume that (i) “too big to fail” has not been addressed and cannot be solved and (ii) forcing institutions to reduce their size will reduce systemic risk without creating any loss of services or harm to customers or the domestic or international financial systems or economies. In our view, neither the belief nor the assumptions are correct.**

Although some academics, legislators and even members of the Federal Reserve System have called for large banks to be broken up, this was not the decision that Congress made in Dodd-Frank.²⁷ Section 165 calls for enhanced prudential supervision of larger banks rather than their break-up. Nonetheless, the Federal Reserve appears to suggest that, contrary to Congress’ determination, it has set a course to use Section 165 to achieve indirectly what it was not authorized to address directly – that is, precipitate a reduction in the size of large banks through size-based regulation.²⁸ The Preamble asserts that the Proposed Rules “would provide incentives for covered companies to reduce their systemic footprint . . .”²⁹ Two aspects of the Proposed Rules go directly to this point – (i) the Proposed SCCL Rules’ 10% credit limit for major covered companies and (ii) the G-SIB Surcharge, as well as many of the indicators in the BCBS’s G-SIB Surcharge (which the Preamble indicates may be the basis for a surcharge on covered companies or a subset of covered companies) that correlate with, and largely appear to be proxies for, size.³⁰ We submit that an approach grounded in a “too big” or “big is bad”

²⁷ In April 2010, Senators Sherrod Brown and Ted Kaufman offered an amendment to the Senate’s financial regulatory reform bill that, if enacted, would have had the effect of forcing some large U.S. banking organizations to downsize. That amendment was soundly rejected on the Senate floor by a bipartisan majority of senators. The vote was 33 to 61. (S. AMDT. 3733 to S. 3217, 111th Cong. (2010); 156 CONG. REC. S3352 (daily ed. May 6, 2010) (Roll Call Vote No. 136 Leg.)) Also, in May 2010, Senators Maria Cantwell, Russ Feingold, Tom Harkin, John McCain and Bernie Sanders offered an amendment to the same bill that would have reinstated the Glass-Steagall Act, which through its prohibition on the affiliation of commercial banks and investment banks, likely would have had the effect of forcing some large U.S. banking organizations to downsize. The Senate never debated or called the amendment for a vote. (156 Cong. Rec. S3793, 3808-09 (daily ed. May 17, 2010) (text of Senate Amendment No. 3884 to Amendment No. 3739 to S. 3217))

²⁸ This is an even more radical approach than suggested by two recent Federal Reserve application decisions that appear to interpret the new “financial stability factor” in Sections 3 and 4 of the Bank Holding Company Act as an inhibition to future growth by the largest banks. See Federal Reserve System, *Order Approving Acquisition of a State Member Bank* (Dec. 23, 2011) (approving an application by The PNC Financial Services Group, Inc. and PNC Bancorp, Inc. to acquire RBC Bank (USA)); Federal Reserve System, *Order Approving Acquisition of a Savings Association and Nonbanking Subsidiaries* (Feb. 14, 2012) (approving an application by Capital One Financial Corporation to acquire ING Bank, fsb).

²⁹ 77 Fed. Reg. at 596.

³⁰ We note, specifically, the provision in the BCBS proposal that threatens G-SIBs with a higher surcharge (including the 3.5% “empty bucket”) if they grow by acquisition.

concept is not only contrary to Congress' intent but is misguided and detrimental to a sound, strong banking system and a strong economy for at least four reasons.

First, it is important for the American and global economies that there be banks of all sizes, including at least some banks of significant size. The variety allows the banking industry to serve customers from the very smallest firms to the largest, including multinational companies, with convenience that matches the needs of our customers, innovation that all types of banks can provide, and financings to bolster economic growth and job creation by meeting the demands of customers of all sizes.³¹ Banks must mirror the economic system they are designed to serve. In the 21st century, companies served by international banks compete in a global economic system, exporting finished products, importing raw materials and components, and establishing substantial operations abroad. Therefore, they need banks that are competitive around the world and are able to meet quickly and efficiently a wide range of financial needs, from treasury services to overnight funding to trade finance to currency hedging. It is unrealistic to believe that these needs can be entirely met by small banks or by hedge funds or other members of the shadow banking system. There are many facets of an institution, not just size, that determine its effectiveness, productivity, risk and contribution to its customers and communities.

Second, the empirical record contradicts the argument that size alone correlates to risk. Between January 1, 2008 and March 31, 2012, the FDIC placed into receivership 430 banks having aggregate consolidated assets of approximately \$682 billion. Of those receiverships, all but one of the banks had less than \$50 billion of total consolidated assets. Likewise, two of the countries with the most concentrated banking systems, Canada and Australia, fared better during the crisis than almost any other country.

Third, although the Associations recognize that in many (but not necessarily all) cases, the failure of a large bank is more likely to result in national systemic risk than the failure of a smaller bank, we submit that this issue should be addressed by an effective and credible resolution regime for large institutions. We believe that such a regime has been created by the orderly liquidation authority of Title II of Dodd-Frank, which is supplemented by the living will requirements and other Dodd-Frank provisions.

As mentioned above, the Federal Reserve notes in the Preamble that Dodd-Frank takes a multi-prong approach to mitigating the threat to financial stability posed by systemically important financial companies, including the orderly liquidation authority in Title II of Dodd-Frank.³² The Proposed

³¹ The Clearing House has addressed these considerations in a study previously provided to the Federal Reserve and the other U.S. banking agencies, titled "*Understanding the Economics of Large Banks*," available on its website at <http://www.theclearinghouse.org/index.html?f=073071>.

³² 77 Fed. Reg. at 595.

Rules' substantive provisions, however, with their focus on size and restrictions designed to encourage reduction in size, fail to give credibility to Title II.³³

Fourth, the Associations agree that taxpayers should never again be required to bail out a financial institution and that "too big to fail" is an unacceptable policy. This issue is, however, addressed directly by Title II, which provides that stockholders are wiped out, management replaced and creditors held responsible for any losses suffered in the failure of a systemically important institution, and indirectly by several other provisions of Dodd-Frank and Basel III. In addition, unlike the Bankruptcy Code's Chapter XI reorganization arrangement, Title II provides no option to a government-controlled liquidation. In addition, Dodd-Frank amended Section 13(3) of the Federal Reserve Act to eliminate the potential for single-company special financing.

- E. With respect to the Proposed Stress Test Rules, it is crucial that (i) the design of the models used as part of the stress test process be transparent and subject to an appropriate public consultative process prior to implementation, (ii) the CCAR 2012 disclosure template generally be used for disclosure of the results of both supervisory and company-run stress tests, at least for covered companies with consolidated assets of \$50 billion or more, and (iii) disclosures are not provided, or required to be provided, in any circumstances under base case scenarios.**

The macro-economic assumptions of the supervisory stress scenarios required by Section 165(i) of Dodd-Frank and Proposed Stress Test Rules are but one component of the stress test process. Equally important are the models, methodologies, techniques and underlying assumptions the Federal Reserve will use to calculate each covered company's stress test and capital plan results. In the wake of the CCAR 2012 experience, the Associations believe that the design of the models, techniques and underlying assumptions to be used as part of the stress test process should be transparent and subject to an appropriate public consultation and input well before adoption and implementation for purposes of the Proposed Stress Test Rules and, as a practical matter, the Capital Plan Rule. In particular, we strongly urge the Federal Reserve to provide detailed explanations of methodologies, models, techniques and underlying assumptions the Federal Reserve will use for purposes of the required supervisory stress test. This would help to ensure that covered companies have sufficient information to analyze meaningfully the supervisory stress test results, thereby reducing the potential "black box" aspects of the supervisory stress test and allowing firms to engage in the very type of forward-looking capital planning that the Federal Reserve seeks to promote. In addition, transparency in the models and methodologies will assist banks' ability to access the public capital markets in a timely

³³ *The Economist* simulated the failure of a \$1 trillion BHC at its Buttonwood Gathering on October 27, 2011. Notably, *not* among the options considered for dealing with the failure by the participants in the simulation (who included Larry Summers, John Dugan and Rodgin Cohen) was a government-sponsored bail out, because such bail outs are prohibited under Dodd-Frank. The Economist, *Fright Simulator: How to Deal with a Collapsing Bank under the Dodd-Frank Rules* (Nov. 12, 2011), available at <http://www.economist.com/node/21538164>.

and efficient manner by avoiding prolonged “blackout” periods for equity offerings. We do not believe it is appropriate for covered companies’ capital planning and distribution decisions to be governed by models and methodologies that have never been subject to appropriate prior review and input. Aspects of CCAR 2012 stress testing methodology related information published heretofore by the Federal Reserve have been useful and instructive. The models themselves, however, continue to be described only in fairly general terms, with important methodological particulars being left open or vague. It is this continued lack of meaningful detail and specificity that furthers the problematic supervisory stress testing “black box”.

In addition, given the mandated “summary” disclosure of company-run stress test results, without an understanding of the models and underlying assumptions used by the Federal Reserve, covered companies will find it challenging to explain differences in their own stress test results and those run by the Federal Reserve. The largely inexplicable disclosure of these differences would only serve to heighten the “black box” effect and lead to market confusion concerning annual stress test results.

We strongly disagree with suggestions that transparency into the supervisory models and their underlying assumptions would enable banks to “game” the system or otherwise lead to turning the capital planning and stress testing processes into mechanical compliance exercises. The Associations believe that the company-run stress test process is the proper supervisory forum for ensuring that the Capital Plan Rule and the Proposed Stress Test Rules encourage and result in enhanced risk management and capital planning processes by covered companies. It is simply unfair to ask a bank to pass a test – and manage towards the standards of that test – if the parameters are largely unknown or otherwise opaque. Doing so is functionally similar to establishing a minimum risk-based capital ratio, but then not publishing the rules explaining how banks are to calculate their risk-based assets for complying with the ratio.

We do commend the Federal Reserve for implementing the CCAR 2012 disclosure regime in a manner which was appropriately balanced by providing useful information to market participants while simultaneously ensuring that disclosure of stress test results does not result in effectively providing earnings guidance concerning base case scenarios or other information that would enable reverse-engineering of base case or quarter-by-quarter results. Thus, the Associations strongly urge that the Federal banking agencies generally adopt the template used in reporting the CCAR 2012 results for purposes of publication of both the results of supervisory stress tests conducted by the Federal Reserve and the annual and semi-annual stress tests conducted by covered companies with consolidated assets of \$50 billion or more – e.g., publication of the results of only the “severely adverse” supervisory scenario for the annual supervisory and company-run stress tests and the company-generated “severely adverse” scenario for the mid-year company-run stress test, as applicable. This would be in accordance with the respective provisions of Sections 165(i)(1) and (2), which call for publication of only a “summary of the results” of the stress tests required thereunder. Under no circumstances should the Federal Reserve disclose, or should covered companies be required to disclose, base case stress test results.

Finally, in order to ameliorate the negative effects of what in reality is a variable or floating minimum capital requirement created by the interaction of the Proposed Stress Test Rules and the Capital Plan Rule, the Federal Reserve and the other banking agencies should adopt a uniform approach for identifying supervisory stress scenarios (which would apply absent exigent circumstances) so that changes from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be.

- F. The Proposed Risk Management Rules and the governance provisions of the Proposed Liquidity Rules (i) are so detailed and prescriptive as to risk impeding directors' proper discharge of their oversight duties and (ii) in several areas blur the distinction between the proper oversight role of the Board of Directors and management's responsibility for day-to-day operations.**

The Associations unreservedly support more robust risk management and largely support the governance provisions in the Proposed Rules. We are concerned, however, that addressing such a complex subject with the granularity and rigidity brought to the topic by the Proposed Rules raises the risk that managing to compliance with rules will actually impede effective managing of the liquidity and other risks the Proposed Rules are designed to address. As discussed in detail in The Clearing House's recently published "*Guiding Principles for Enhancing Banking Organization Corporate Governance*," it is essential that (i) the distinction between the roles of the Board of Directors and management be preserved and (ii) there be recognition that a one-size-fits-all approach will inherently fail to account for the wide variety of circumstances that exist among individual institutions.³⁴ The Proposed Risk Management Rules and the governance provisions of the Proposed Liquidity Rules would require the Board of Directors (or committee or subcommittee thereof) to become involved – to an unprecedented degree – in granular, management level matters that risk impeding directors' proper discharge of their oversight duties. We discuss our specific concerns in this regard in *Annex B* and *Annex D*.

- G. For small, midsize and regional banks, implementation of regulations under Sections 165 and 166 should avoid creating a "cliff effect" by providing for a transition period after the institution has crossed the applicable asset threshold.**

Dodd-Frank creates an unprecedented number of new regulations, and threatens regulatory expansion as targeted regulatory requirements intended for larger, more complex institutions are applied to smaller, and in many instances, low-risk traditional banking operations. Prudential supervision as envisioned in the Proposed Rules creates regulations and supervisory expectations applicable to the largest and most complex banks, but applies these same rules to all covered financial institutions, disregarding the significant differences in business model, complexity, risk, compliance resources, and potential systemic importance.

³⁴ The Associations have long advocated this point. See Letter from the ABA to Governor Susan S. Bies, dated April 28, 2005.

Moreover, compliance expectations for institutions over \$50 billion in assets should not be applied to institutions under \$50 billion in assets as *de facto* best practices or in anticipation that at some point in time in the future the institution may cross the arbitrary \$50 billion threshold. To address this concern in part the Associations recommend that the Federal Reserve develop transition rules that would permit an institution up to one additional year following the four-quarter period contemplated by the Proposed Rules after it crosses the \$50 billion or, if applicable, \$10 billion asset threshold, to phase in full compliance with the new requirements for that asset size. This is particularly true and necessary for the stress testing, liquidity and single counterparty concentration provisions, due to the significant investments in systems and resources needed.

II. Certain Key Recommendations and Concerns Addressed in Topical Annexes³⁵

Proposed Capital and Leverage Rules (Annex A). The Associations and their members support a robust capital regime. Nonetheless, we strongly believe that it would be premature to impose a significant capital surcharge on covered companies, or a subset of covered companies, based on the framework established by the BCBS applicable to G-SIBs (or any other framework), and that such a surcharge is not required to satisfy Dodd-Frank's mandate for "more stringent" capital standards, for the following reasons:

- The Federal Reserve's application of its existing Capital Plan Rule, as the interface between that rule and the Proposed Stress Test Rules, in and of itself satisfies Dodd-Frank's "more stringent" capital standard. The most recent stress test for covered companies applied a capital standard that is far more stringent than the published capital requirements for U.S. banking organizations (or, for that matter, the capital requirements that exist, with very limited exceptions, anywhere else in the world) – a minimum 5% Tier 1 common ratio over nine quarters under severely stressed conditions and conservatively calculated. BHCs with \$50 billion or more in total consolidated assets already are, and covered companies will be, required to maintain capital ratios substantially above those required of non-covered companies as a result of the interplay between this stress testing and the Capital Plan Rule. Indeed, the recent stress test results provide the ultimate refutation of the need for even more capital. To require U.S. banks to hold capital *beyond* what would be required for the bank to withstand – and continue to act as a financial intermediary through – a financial collapse in Europe and a depression in the United States (the model of the Federal Reserve's macro-economic assumptions) would be undeniably excessive.
- The 7% minimum Common Equity Tier 1 ("CET1") ratio under Basel III is equivalent to a 14% Tier 1 capital ratio under the pre-crisis Basel I rules for the United States. No large financial

³⁵ We addressed the Proposed SCCL Rules – both our key concerns and recommendations – in Part I because of both their serious flaws and systemic implications, and a more extensive discussion of the Proposed SCCL Rules is set forth in *Annex C*. Accordingly, we are not addressing the Proposed SCCL Rules in this Part II.

institution that met a 7% CET1 ratio (using the Basel III methodology) at the onset of the crisis suffered serious financial distress.³⁶

- The negative impact of a capital surcharge on the investment attractiveness of covered companies' equity securities is readily demonstrated. A covered company with a return on equity of 12% would have its returns on equity ("ROE") slashed to about 9% by a 250 basis point surcharge. Even a 100 basis point surcharge would reduce a 12% ROE to about 10.5%, thereby reducing the firm's ability to attract capital.
- There are fundamental flaws in the design and indicator-based methodology of the G-SIB Surcharge, including the following:
 - Significant uncertainties regarding the measurement of systemic importance and the calibration of a significant surcharge on large banks, which undermine the credibility of the design and indicator-based methodology of the G-SIB Surcharge;
 - Lack of transparency surrounding the assessment and calculation of the proposed surcharge that frustrates bank management's ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held;
 - The failure to acknowledge the development, in certain countries, of credible recovery and resolution regimes, including Title II of Dodd-Frank and the living will requirements, although the G-SIB Surcharge is premised upon the consequence of a G-SIB failure; and
 - Numerous other flaws that, among other things, may create perverse incentives to increase instead of decrease risk and provide an inaccurate view of systemic importance. For example, the value of underwritten transactions or of assets under custody (at least in the United States) is not indicative of systemic importance in terms of substitutability.³⁷

Proposed Liquidity Rules (Annex B). The Associations endorse the liquidity risk management tools addressed in the Proposed Liquidity Rules and believe the core principles embedded within the Proposed Liquidity Rules reflect actual risk and are consistent with current enhanced

³⁶ See footnote 17 of *Annex A* for our definition of "serious financial distress".

³⁷ As in other areas (including The Clearing House SCCL Study noted above), the Associations have attempted to analyze proposals with hard analysis and data. In the case of possible surcharges, this has included The Clearing House Surcharge Study described in *Annex A* and included in the Prior Submissions, initially prepared in connection with the BCBS's proposal for its G-SIB Surcharge.

liquidity-risk management practices of many banks. The Associations, however, have significant concerns with certain aspects of the Proposed Liquidity Rules. These include:

- The Proposed Liquidity Rules' governance provisions address liquidity risk management with such granularity and rigidity as to raise the risk that Boards of Directors and managements will be forced to manage to compliance with rules to an extent that will impede managing the liquidity risk the rules are designed to address. We strongly urge the Federal Reserve to consider an approach more in line with the strategic and oversight responsibility of the Board of Directors.
- In several areas, the Proposed Liquidity Rules' risk governance provisions blur the distinction between the proper oversight rule of the Board of Directors and management's responsibility for day-to-day operations. We believe these provisions should be adjusted so that the focus of the Board of Directors or risk committee, insofar as liquidity risk is concerned, is on the oversight of liquidity risks, including approval of risk management policies developed and recommended by management.
- We appreciate that the Proposed Liquidity Rules address a number of the Associations' concerns with the Basel III methodology, including (i) permitting U.S. government-sponsored entity securities (most importantly, Fannie Mae and Freddie Mac debt and mortgage-backed securities) to be included in "highly liquid assets" without the artificial Level 1 ("L1")/Level 2 ("L2") distinction in Basel III's liquidity coverage ratio ("LCR"); and (ii) permitting covered companies to develop their own run-off factors and assumed drawn-down rates, provided that they rely on reasonably high-quality data and information to produce creditable outcomes. The Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts to revise the Basel III liquidity framework's approach to the quantitative analysis of liquidity risk, implemented through its LCR (and, depending upon the review to which it will be subject during the observation period provided for in Basel III, potentially the net stable funding ratio ("NSFR")), to an approach more aligned with the Proposed Liquidity Rules.

Proposed Risk Management Rules (Annex D). The Associations' concerns and recommendations with respect to the Proposed Risk Management Rules include:

- As is the case with the risk governance provisions of the Proposed Liquidity Rules, the Proposed Risk Management Rules blur the distinction between the proper oversight role of the Board of Directors and management's responsibility for day-to-day operations in several areas. The Proposed Risk Management Rules should consistently preserve the distinction between a Board of Director's oversight role and management's operational role. Otherwise, boards and board committees will be overwhelmed with duties that impair their ability to provide independent and objective supervision to the company. The risk management committee should approve and oversee risk management policies developed and recommended by management.

- Effective risk management requires the oversight of the board and the involvement of various board committees. The final rules should explicitly acknowledge the Board of Directors' authority to allocate the oversight of certain, specific risk management responsibilities to appropriate board committees, such as an audit, credit or finance committee.
- The definition of "risk management expertise" should be replaced with a definition patterned after the SEC's definition of an "audit committee financial expert."³⁸ Moreover, the Associations believe that an effective risk committee can benefit from members with diverse backgrounds, including senior operational and managerial roles with nonbanking firms, who could provide useful insights into operational risks and reputation risks. We recommend that only one member of the risk committee be required to have "risk management expertise" as that term is appropriately defined.
- Dual reporting by the chief risk officer to the risk committee should not be mandated, nor should the chief risk officer be required to report directly to the chief executive officer. Although we believe the chief risk officer should have clear access to, and regular meetings or contact with, the risk committee and chief executive officer, no single corporate governance model is appropriate for all organizations, and dual reporting would impair effective risk management by complicating the relationship between management and the board.

Proposed Stress Test Rules (Annex E). The Associations believe that credible and robust stress tests can be invaluable tools for capital planning, provide important information to regulators and market participants and serve to enhance the stability of the financial system as a whole, but have several concerns (which have been intensified by the process for the 2012 stress tests) and recommendations with respect to the Proposed Stress Test Rules. These include:

- The design of the supervisory models, techniques and underlying assumptions to be used as part of the stress test process should be transparent and subject to appropriate public consultation and input *before* adoption and implementation for purposes of the Proposed Stress Test Rules. In particular, the Associations strongly urge the Federal Reserve to provide full and detailed explanations of methodologies, models, techniques and underlying assumptions the Federal Reserve will use for purposes of the required supervisory stress test well in advance of implementation. This would help to ensure that covered companies have sufficient information to analyze meaningfully and reconcile the supervisory stress test results, thereby reducing the potential "black box" aspects of the supervisory stress test. There is the potential for error in developing models, whether they are developed by the public or private sector, and a consultative process would help reduce those errors. Furthermore, we strongly disagree with any suggestion that transparency into the supervisory models and their underlying assumptions would somehow enable banks to "game" the system or otherwise lead to turning the capital

³⁸ The SEC defines "audit committee financial expert" in Item 407(d)(5) of Regulation S-K. We discuss that definition in Part III.D of *Annex D*.

planning and stress testing processes into mechanical compliance exercises. The Associations believe that the company-run stress test process is the proper supervisory forum for ensuring that the Capital Plan Rule and the Proposed Stress Test Rules encourage and result in enhanced risk management and capital planning processes. It is simply unfair to ask banks to pass a test the parameters of which are largely unknown or otherwise opaque.

- The Federal banking agencies should work collectively to minimize effectively the duplicative burden of the multiple and overlapping stress test requirements of the Proposed Stress Test Rules and the OCC's and FDIC's respective stress test rules, including by consistently using the same supervisory stress test scenarios and models for purposes of the supervisory and the company-run stress tests and formulating common inter-agency information requirements.
- The CCAR 2012 disclosure template should generally be used for disclosure of both supervisory and company-run stress tests under Section 165(i) of Dodd-Frank and the Federal banking agencies' respective proposed stress test rules, at least for covered companies with consolidated assets of \$50 billion or more.
- Under no circumstances should the Federal Reserve disclose, or should covered companies be required to disclose, base case stress test results or other information that could be used effectively to reverse-engineer earnings guidance or other quarter-by-quarter results under either the supervisory or company-run stress test requirements of the Proposed Stress Test Rules.
- Under the Capital Plan Rule, covered companies are required to demonstrate to the Federal Reserve their ability to maintain capital above existing minimum capital ratios and above a Tier 1 common ratio of 5% under both expected and stressed conditions or else face limitations on capital distributions such as dividends and share buy-backs. Because the amount of required capital will depend on the severity of the stress scenarios, the interplay of the Capital Plan Rule and the Proposed Stress Test Rules makes it challenging for covered companies to engage in prudent medium-to-long term capital planning as a practical matter. In order to ameliorate the negative effects of what in reality is a variable or floating minimum capital requirement, the Federal Reserve and the other banking agencies should adopt a uniform approach for identifying supervisory stress scenarios (which would apply absent exigent circumstances) so that changes from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be. An example would be consistent severity and minimum probability of occurrence benchmarks.

Proposed Early Remediation Rules (*Annex F*). The Associations support the overall objective of Section 166 of Dodd-Frank of minimizing the probability that a covered company will become insolvent and the potential harm arising from such an insolvency. As we discuss in detail in *Annex F*, however, we are concerned that the sensitivity and rigidity of the automatic triggers and the failure of the mandated remediation measures to be calibrated to the nature of the applicable triggering event increase the risk that entry into the early remediation regime by a firm will precipitate its further

deterioration rather than address its deficiencies and enhance its financial condition. To address these concerns, our recommendations with respect to the Proposed Early Remediation Rules include:

- The use of automatic triggers as contemplated by the Proposed Early Remediation Rules creates the risk that certain triggers, if misapplied or misused, could have the procyclical effect of exacerbating funding or market pressures at the affected covered company. The Associations believe a more appropriate approach would be for the Federal Reserve to make early remediation decisions based on discretionary supervisory judgments, in light of all the facts and circumstances, taking into consideration non-determinative quantitative and qualitative factors. Related to this point, the Federal Reserve should not preclude flexibility to tailor remediation actions so that they appropriately address the issues requiring remediation. Once the determination is made that remediation is required, it is consistent with Section 166 for the Federal Reserve to choose one or more of several potential remediation actions.
- All notices, determinations and regulatory actions taken in the early remediation regime should be treated as non-public confidential supervisory information.
- The Associations believe that stress tests, the results of which are a function of the severity of hypothetical scenarios, should not be a trigger for early remediation; if they are to be used as a trigger, they should not trigger remediation requirements higher than Level 1. The supervisory stress tests as contemplated by the Proposed Stress Test Rules are based on hypothetical scenarios over a nine-quarter period, and therefore the outcome of the stress tests depends upon the severity of the scenarios as well as the Federal Reserve's calculation models. This creates a meaningful risk that remediation could be triggered by outlier results that have little basis in reality. Level 1 early remediation would allow the Federal Reserve to monitor a firm on the basis of failing to meet the requirements of the stress test, rather than mandating actions based on hypothetical assumptions. Moreover, covered companies that did not meet the required capital ratio under the severely adverse scenario under the supervisory stress tests would continue to be subject to meaningful and binding restrictions under the Capital Plan Rule, including the prohibition on making any capital distributions until a revised capital plan was submitted and received a no-objection from the Federal Reserve. Our concerns are exacerbated by the fact that market participants may be able to predict or discover early remediation actions against specific firms by scrutinizing stress test disclosures. The publicly observable nature of many of the automatic triggers may actually impair the ability of a firm to take appropriate restorative capital actions because market participants may assume the firm will inevitably fall into the early remediation regime prior to reaching an actual trigger.
- To the extent mandatory triggers are retained, the Associations have specific concerns with the triggers, including:
 - The prices of market indicators, such as credit default swaps and equity securities, are susceptible to manipulation, and movements in their prices may be otherwise unrelated to underlying financial or management weakness. In

particular, triggering a credit default swap-based indicator could quickly exacerbate liquidity stresses.

- Companies subject to the early remediation regime should be promptly released from applicable restrictions and requirements when restored to appropriate managerial or financial health.
- Immaterial non-compliance with the risk management, risk committee and liquidity requirements should not result in early remediation.³⁹ Materiality thresholds should be built into the triggers.

* * *

In conclusion, the Associations appreciate the substantial efforts of the Federal Reserve in developing the Proposed Rules. We are deeply concerned, however, that, in a number of key areas, implementation of the Proposed Rules could have serious adverse consequences that would increase risks to financial institutions, the markets, customers and the economy, notwithstanding that the objectives sought to be achieved are worthwhile. In this Comment Letter, we have attempted to identify those areas and propose recommendations that accomplish the objectives without incurring those consequences.

³⁹ Non-compliance should also not trigger unrelated remediation actions. For example, a deficiency in meeting the risk committee requirements under the Proposed Risk Management Rules could by itself result in restrictions on distributions, even though that may do nothing to address the underlying risk management issue.

April 27, 2012

If you have any questions or need further information, please contact (i) at The Clearing House, Paul Saltzman, its President and General Counsel (e-mail – paul.saltzman@theclearinghouse.org, telephone number – (212) 613-0318); (ii) at the ABA, Wayne A. Abernathy, its Executive Vice President, Financial Institutions and Regulatory Affairs (e-mail – wabernat@aba.com, telephone number – (202) 663-5222); (iii) at the Forum, Robert S. Nichols, its President and CEO (e-mail – rob.nichols@financialservicesforum.org), telephone number – (202) 457-8765); (iv) at The Roundtable, Richard M. Whiting, its Executive Director and General Counsel (e-mail – Rich@fsround.org, telephone number – (202) 589-2413); and (v) at SIFMA, Kenneth E. Bentsen, Jr., its Executive Vice President, Public Policy and Advocacy (e-mail – kbentsen@sifma.org, telephone number – (202) 962-7400).

Respectfully submitted,



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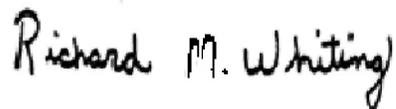


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The Clearing House Association

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

American Bankers Association

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13 trillion banking industry and its two million employees. Learn more at www.aba.com.

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The Financial Services Forum is a non-partisan financial and economic policy organization comprising the CEOs of 20 of the largest and most diversified financial services institutions doing business in the United States. The purpose of the Forum is to pursue policies that encourage savings and investment, promote an open and competitive global marketplace, and ensure the opportunity of people everywhere to participate fully and productively in the 21st-century global economy.

The Financial Services Roundtable

The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine and account directly for \$92.7 trillion in managed assets, \$1.1 trillion in revenue, and 2.3 million jobs.

Securities Industry and Financial Markets Association

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

Proposed Capital and Leverage Rules (Subpart B) – Risk-Based Capital Requirements and Leverage Limits¹

The Federal Reserve indicated in the Preamble that it will address Dodd-Frank’s requirement² that it establish risk-based capital and leverage standards for covered companies that are more stringent than the standards applicable to nonbank financial companies and BHCs that do not present similar risks “with a two-part effort.”³ The Proposed Capital and Leverage Rules take only a limited first step by applying the Federal Reserve’s Capital Plan Rule, added to Regulation Y effective December 30, 2011,⁴ to all covered companies (including nonbank covered companies) as well as to the BHCs with \$50 billion or more in consolidated assets to which it currently applies. The Federal Reserve indicated that the second step in the two-part effort would be to implement a quantitative risk-based capital surcharge for covered companies or a subset of covered companies, based on the framework established by the BCBS applicable to global systemically important banks (“**G-SIBs**”, and the BCBS’s proposed surcharge, the “**G-SIB Surcharge**”).⁵

The Associations commented at length on the BCBS’s G-SIB Surcharge proposal, addressing concerns with the basic concept, fundamental reservations with its underlying assumptions and significant concerns with flaws in its indicator-based methodology. Those comment letters, copies of which were provided to the Federal Reserve, included:

- a letter, dated August 26, 2011, from The Clearing House and the Institute of International Bankers (the “**Prior TCH/IIB Surcharge Letter**”);
- a letter, dated August 26, 2011, from the ABA; and
- a letter, dated August 26, 2011, from the Global Financial Markets Association, of which SIFMA is a member.

For ease of reference, copies of those letters (the “**Prior Surcharge Letters**”) are included in the Prior Submissions.

The BCBS adopted final G-SIB Surcharge provisions (the “**G-SIB Final Rules Text**”) substantially as initially proposed. When the BCBS released its G-SIB Final Rules Text, it also released a cover note (the “**Cover Note**”) that discussed some of the comments submitted to the BCBS on the G-SIB Surcharge proposal and generally dismissed the comments, often in a conclusory fashion with little

¹ Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

² Section 165(b)(1)(A)(i) of Dodd-Frank.

³ 77 Fed. Reg. at 598.

⁴ 12 C.F.R. § 225.8.

⁵ See BCBS, *Global Systemically Banks: Assessment Methodology and the Additional Loss Absorbency Requirement – Rules Text* (November 2011).

Proposed Capital and Leverage Rules

explanation.⁶ We urge the Federal Reserve, as it considers possible implementation of a surcharge applicable to covered companies or a subset of covered companies, to consider the concerns raised in the Prior Surcharge Letters. The Associations' comments in the Prior Surcharge Letters on the BCBS's G-SIB proposal, with limited exceptions, apply to the G-SIB Final Rules Text as well. Further, beyond our fundamental concern regarding any surcharge effectively based on size, our specific reservations regarding the BCBS's G-SIB Surcharge apply with equal force to any similar capital surcharge that the Federal Reserve may consider for covered companies or a subset of covered companies if based on the BCBS's G-SIB Surcharge.

As discussed in Part I.D of the Comment Letter in the context of the Proposed Rules as a whole (and in the Prior Surcharge Letters in the specific context of the BCBS's G-SIB Surcharge proposal), we do not agree with the simplistic view that size alone creates prudential concerns or, more broadly, that large banks are inherently problematic and do not provide important economic and other benefits or that it is not feasible to end "too big to fail." The Federal Reserve's proposal eventually to impose a surcharge on certain covered companies that builds on the G-SIB Final Rules Text, and the Proposed Rules more generally, has an apparent bias toward acceptance of those assumptions. Because these assumptions are untested, and may very well be profoundly inaccurate, we urge the Federal Reserve to proceed cautiously, particularly in the context of the Proposed Capital and Leverage Rules and the Federal Reserve's evaluation of how Dodd-Frank's "more stringent" requirement should be interpreted. As applied to risk-based capital requirements and leverage limits, we believe this requirement is sufficiently flexible to permit the Federal Reserve to consider a range of approaches, discussed further below, and does not require implementation of a surcharge.

Part I of this Annex summarizes our comments; Part II addresses our view as to the application of Dodd-Frank's "more stringent" requirement in the context of risk-based capital and leverage requirements; Part III addresses our fundamental reservations regarding the assumptions underlying a capital surcharge for entities deemed to be systemically important (whether these entities are G-SIBs or non-G-SIB covered companies); Part IV addresses our fundamental reservations regarding the design and indicator-based methodology of the G-SIB Surcharge; and Part V addresses certain specific questions raised by the Federal Reserve.

I. Executive Summary

The "more stringent" test in Section 165 of Dodd-Frank does not require a capital surcharge on covered companies (Part II). The Associations strongly believe that the Proposed Capital

⁶ The U.S. banking agencies have suggested that, while (as required by law) they will publish for comment "a concrete proposal for implementation of a quantitative risk-based capital surcharge for covered companies, or a subset thereof, based on the BCBS approach" (using the Federal Reserve's words in the Preamble (77 Fed. Reg. at 604)), they feel bound to the agreement reached through the BCBS process. We continue to believe that the G-SIB Surcharge is deeply flawed and should be re-addressed by the regulatory community, both the U.S. banking agencies and their international counterparts. Moreover, consistent with the suggestion of prejudgment in the above-quoted language from the Preamble, U.S. banks are already being required to demonstrate a path to compliance with Basel III in their submissions under the Capital Plan Rule even before the U.S. banking agencies have published proposed rules for comment. We urge the Federal Reserve and the other agencies not to prejudge the application of the G-SIB Surcharge or other aspects of Basel III to covered companies (or banks more generally) and to give full consideration to comments submitted by the Associations and other commenters.

Proposed Capital and Leverage Rules

and Leverage Rules' application of the Capital Plan Rule to covered companies, combined with the stress testing regime applied as part of CCAR 2012 as it will be further developed by the Proposed Stress Test Rules (whether adopted as proposed or after giving effect to our comments in *Annex E* concerning those rules), satisfies Dodd-Frank's "more stringent" capital standard. Because of these rules, BHCs with \$50 billion or more in total consolidated assets already are, and covered companies will be, required to maintain capital ratios considerably above those required of non-covered companies. Non-covered companies are not subject to a regulatory requirement that they project forward capital ratios for any period, let alone under stressed, as opposed to baseline, conditions for at least nine quarters.

The assumptions underlying any significant capital surcharge on covered companies are flawed (Part III). The Associations have fundamental reservations regarding the assumptions underlying the imposition of a significant capital surcharge on large banks, such as the G-SIB Surcharge. These assumptions appear to include: (i) capital-focused regulatory reforms that have already occurred or will occur as part of Basel III's implementation are not, in the absence of a surcharge like the G-SIB Surcharge, sufficient to address the role of inadequate capital as a contributor to systemic risk; and (ii) more capital is always better. Further, two critical assumptions underlying recent regulatory reform efforts more broadly, including the G-SIB Surcharge, appear to be that (i) these regulatory reforms, both nationally and internationally, have failed to address the systemic risks posed by large banks and meaningfully reduce the probability of their failure and (ii) large banks are inherently problematic and do not provide important economic and other benefits. For the reasons discussed in Part III, the Associations believe that these underlying assumptions are deeply flawed.

The BCBS's G-SIB Surcharge methodology is flawed (Part IV). The Associations strongly believe that the G-SIB Surcharge has fundamental flaws in design and with respect to its indicator-based methodology in particular. These include the following:

- There are significant uncertainties regarding the measurement of systemic importance and the calibration of a significant surcharge on large banks, undermining the credibility of the design and indicator-based methodology of the G-SIB Final Rules Text.
- There is a lack of transparency surrounding the assessment and calculation of the proposed surcharge that undermines the ability of a bank to determine its surcharge or determine what steps to take to reduce its surcharge. This lack of transparency frustrates bank managements' ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held.
- The G-SIB Final Rules Text discourages banks from diversifying their assets across jurisdictions and business lines.
- The G-SIB Final Rules Text inherently encourages banks to concentrate their activities in business lines that are not penalized under the indicator-based methodology, thereby amplifying the potential for systemic disruptions if those business lines turn out to be a primary source of problems in a subsequent financial crisis.
- Numerous specific aspects of the G-SIB Final Rules Text's indicator-based methodology are flawed, as discussed in Part IV.C.

Proposed Capital and Leverage Rules

As such, the Associations strongly believe that it would be premature to impose a significant capital surcharge on covered companies, or a subset of covered companies (or, for that matter, any group of banking organizations in the United States or internationally). At a minimum, any potentially viable capital surcharge regime should enable covered companies subject to the surcharge to evaluate their structure and operations and proactively determine the potential magnitude of the applicable surcharge on an on-going basis in order to manage and/or mitigate its potential impact; provide for the reduction of the surcharge as institutions reduce their systemic importance in the aggregate; take into account the regulatory environment in which covered companies operate, including the presence of effective and credible recovery and resolution regimes and other legislation and regulation designed to reduce systemic risk and moral hazard costs; reflect a more balanced and accurate view of systemic importance; not encourage increased risk-taking; and eliminate the other flaws of the proposed methodology set forth in the G-SIB Final Rules Text.

II. The Federal Reserve’s application of its existing Capital Plan Rule, as the interplay between that rule and stress testing will be enhanced by the Proposed Stress Test Rules, in and of itself imposes a “more stringent” capital standard on covered companies.

Section 165 of Dodd-Frank requires that the prudential standards established under that section for covered companies, including risk-based capital requirements and leverage limits, be “more stringent than the standards and requirements” applicable to other financial institutions.⁷ The statutory language does not mandate that the “more stringent” requirement be met with a capital surcharge or across-the-board higher capital ratios, as representatives of the U.S. banking agencies have acknowledged, albeit in the context of smaller covered companies.⁸ We respectfully submit that the Proposed Capital and Leverage Rules’ application of the Capital Plan Rule to covered companies, combined with the stress testing regime applied as part of CCAR 2012 as it will be further developed by the Proposed Stress Test Rules (whether adopted as proposed or after giving effect to our comments in *Annex E*), meets the more stringent requirement in and of themselves.

The Capital Plan Rule, which applies to all BHCs with consolidated assets of \$50 billion or more, specifies that a BHC’s capital plan must include a discussion of how the BHC will, “under expected and stressful conditions,” maintain capital above minimum regulatory requirements and above a Tier 1 common ratio of 5%,⁹ provides that the Federal Reserve will consider the BHC’s ability to meet that standard in reviewing its capital plan¹⁰ and specifies that the Federal Reserve will object to the capital plan if the BHC “has not demonstrated an ability” to maintain capital above those standards “on a pro

⁷ Section 165(a)(1)(A) of Dodd-Frank.

⁸ See, e.g., the testimony of Governor Tarullo before the Senate Banking Committee in December 2011, where he commented that “[n]o decision has yet been made as to whether the more stringent capital to be applied to large U.S. banking firms that are not on the eventual list of global systemic banks will be in the form of a quantitative surcharge.” *Continued Oversight of the Implementation of the Wall Street Reform Act: Hearing Before the S. Banking Comm.*, 111th Cong. (Dec. 6, 2011) (statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

⁹ 12 C.F.R. § 225.8(d)(2)(ii)(A).

¹⁰ 12 C.F.R. § 225.8(e)(1)(i)(C).

Proposed Capital and Leverage Rules

forma basis under expected and stressful conditions throughout the planning horizon.”¹¹ The relevant time horizon, specified both in the Capital Plan Rule and the Proposed Stress Test Rules (both for supervisory and company-run stress scenarios), is at least nine quarters. It has been our members’ experience that these stress tests serve as a governor on not only capital actions but on approvals for a variety of initiatives.

The Proposed Stress Test Rules do not indicate whether the stress scenario to be applied by the Federal Reserve in evaluating covered companies’ capital plans will be the “adverse” or “severely adverse” scenario contemplated by the rules; the Federal Reserve applied a scenario that is described as “severely adverse” to the CCAR 2012 process. Irrespective of which scenario applies, the unavoidable arithmetic consequence is that BHCs with \$50 billion or more in total consolidated assets already are, and covered companies will be, required by regulation to maintain capital ratios above those required of non-covered companies. Non-covered companies are not subject to a regulatory requirement that they project forward capital ratios for any period, let alone under stressed or severely stressed, as opposed to baseline, conditions for at least nine quarters. We are not suggesting that non-covered companies will in fact maintain capital ratios targeted only to regulatory *minima*. Prudent management and supervision in any event will result in even non-covered companies establishing targeted capital levels that are above regulatory *minima*, and even the existing regulatory standards for “well capitalized” status and consequences for falling below “well capitalized” status¹² effectively require all BHCs and banks (whether or not, in the case of BHCs, they are covered companies) to maintain capital above well-capitalized requirements. Additionally (and depending on how the U.S. banking agencies ultimately choose to apply the Basel III capital framework in the United States), Basel III’s capital conservation buffer as a practical matter becomes part of the minimum capital requirements. Our point is simply this: apart from the requirements that otherwise apply (taking into account not only prudent management and supervision but also the possible application of the Basel III capital framework differently to different BHCs and banks based on size and other criteria), the interplay of the Capital Plan Rule and the Proposed Stress Test Rules will require covered companies to comply with a more stringent capital regime than is required of non-covered companies.

¹¹ 12 C.F.R. § 225.8(e)(2)(ii)(C).

¹² For example, if the financial holding company or its depository institution subsidiary ceases to be “well-capitalized”, a financial holding company must execute an agreement with the Federal Reserve explaining the actions the company will take to correct areas of noncompliance and providing a schedule within which each action will be taken. 12 C.F.R. § 225.83(c); Section 606 of Dodd-Frank. Until the Federal Reserve determines that a company has remedied the deficiencies that led to the loss of “well-capitalized” status, the Federal Reserve, among other potential supervisory actions, may impose limitations on the conduct and activities of the company. *Id.* § 225.83(d). If the company does not remedy the deficiencies within 180 days, the Federal Reserve may order the company to divest ownership or control of any depository institution owned or controlled by the company. *Id.* § 225.83(e). Further, under the prompt corrective action regime, a depository institution that is merely “adequately capitalized” (as opposed to “well capitalized”) can on safety and soundness grounds be subjected to activity limitations and restrictions (including limitations on distributions) as though it were “undercapitalized”. 12 U.S.C. § 1831o(g)(1)(B).

Proposed Capital and Leverage Rules

III. The assumptions underlying a punitive capital surcharge, such as the G-SIB Surcharge, are flawed.

The assumptions that underlie proposals to impose significant capital surcharges on large banks, such as the G-SIB Surcharge, generally appear to be:

- capital-focused regulatory reforms that have already occurred or will occur as part of Basel III's implementation are not, without a surcharge like the G-SIB Surcharge, sufficient to address the role of inadequate capital as a contributor to systemic risk; and
- more capital is always better.

Further, as discussed in the Comment Letter, two critical assumptions underlying the Proposed Rules (including the Proposed Capital and Leverage Rules as well as regulatory reform more generally) include:

- regulatory reforms, both nationally and internationally, have failed to address the systemic risks posed by large banks and meaningfully reduce the probability of their failure; and
- large banks are inherently problematic and do not provide important economic benefits.

We discuss these assumptions and their implications in the Comment Letter because they apply broadly to the Proposed Rules, not only the Proposed Capital and Leverage Rules.

The Associations and our members are joined with the Federal Reserve and other national and international regulators in a common endeavor – to address the weaknesses (both supervisory and management) that became apparent during the financial crisis. We seek to assist the Federal Reserve and other regulators in addressing the supervisory aspects of this endeavor, not to resist proper enhancements to regulation and supervision. We also believe, however, it is critically important that the multitude of on-going reforms achieve a regulatory balance that does not unnecessarily harm the financial system and the economy, customers that are the consumers and users of banking services, or banking organizations themselves. The regulatory community's focus on size as a prudential concern, whether in the context of regulating capital requirements or the other aims covered by Section 165 of Dodd-Frank and the Proposed Rules, must be tempered by (i) progress that has been made to end "too big to fail" in the United States as well as (ii) an understanding of the benefits attributable to larger institutions (and the consequences of losing those benefits).

The Associations continue to believe that the assumptions underlying the G-SIB Surcharge (or a similar surcharge that may be proposed under Section 165(b) of Dodd-Frank) are deeply flawed, as discussed in the Prior Surcharge Letters. Accordingly, we urge the Federal Reserve to proceed cautiously in considering application of a capital surcharge to covered companies or some subset of covered companies, particularly in view of the fact that Section 165's "more stringent" standard is sufficiently flexible to permit the Federal Reserve to satisfy its requirements without a surcharge and, as indicated above, we believe has already been met. Even apart from Section 165 of Dodd-Frank and the Proposed Capital and Leverage Rules, measures already taken by large banking organizations to improve the robustness of their capital, partly in response to the anticipated implementation of Basel III, have substantially addressed the role of inadequate capital as a contributor to large bank failures posing systemic risks by reducing their probability of failure.

Proposed Capital and Leverage Rules

Over the past two years, significant regulatory reforms have been introduced both by the BCBS and by regulators in the United States to address a wide variety of regulatory concerns, including capital adequacy, liquidity risk, market risk, stress testing, capital planning, derivatives reforms (including with respect to the role of central counterparties), and limitations on trading and investment activities that are perceived to be high risk. The final Basel III capital and liquidity frameworks have been the foundation for international efforts to address capital adequacy and liquidity risk; the U.S. banking agencies are moving ahead with the amendments to their market risk capital rules (known as Basel II.5),¹³ the U.S. banking agencies issued in June 2011 proposed joint guidance on stress testing and requested public comments,¹⁴ have adopted the Capital Plan Rule effective December 30, 2011 (and, pursuant to the Capital Plan Rule, recently completed its CCAR 2012 review; and the U.S. banking agencies are in the process of moving forward with regulations to implement the Volcker Rule. Many of these measures will require, or have in practice already required, BHCs that are covered companies to make major changes to their capital structures, balance sheet composition and liquidity and operational risk management functions, calling into question the need to impose an additional capital surcharge at this time.

The heightened capital requirements under Basel III alone will require U.S. banks to increase the amount of CET1 U.S. banks hold by *over 100%* from the amount held at December 31, 2007.¹⁵ In addition, as a result of the imposition of Basel III's quantitative, qualitative and risk-weighting requirements, the 7% minimum CET1 ratio under Basel III is equivalent to a 14% Tier 1-capital ratio under the pre-crisis Basel I rules for U.S. banks. If the G-SIB Surcharge is also imposed, it would result in the U.S. banking system holding the equivalent of 16% Tier 1 capital in Basel I terms, or 400% the Tier 1 capital required before the crisis in order to be "adequately capitalized" (namely, 4%).¹⁶ Moreover, Basel III and related enhancements to the capital framework made under Basel II.5 not only address aggregate capital requirements, but also the specific areas in which excessive risk was thought to be incurred. For example, Basel II.5 dramatically increases – often by 400% or more – the capital charge on trading positions held by large banks.

These increased capital requirements, in and of themselves, significantly reduce the potential for large banks to pose systemic risks and reducing their probability of failure in light of empirical evidence that shows that banks on a worldwide basis that had capital levels greater than the new Basel III effective CET1 minimum did not suffer serious financial distress in the recent crisis.¹⁷ Banks

¹³ These proposed amendments are set forth in joint notices of proposed rulemaking regarding (i) revisions to their market risk capital rules to generally align them with Basel II.5 (76 Fed. Reg. 1890 (Jan. 11, 2011)) and (ii) the incorporation of alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings (76 Fed. Reg. 79380 (Dec. 21, 2011)).

¹⁴ *Proposed Guidance on Stress Testing for Banking Organizations with More Than \$10 billion in Total Consolidated Assets*, 76 Fed. Reg. 35072 (June 15, 2011).

¹⁵ For further information regarding how much additional common equity banks will need to hold relative to pre-crisis levels, as well as the data on which this estimate is based, see slides 9 and 13 of the study conducted on behalf of The Clearing House study entitled "*How Much Capital Is Enough? Capital Levels and G-SIB Capital Surcharges*" (the "**G-SIB Surcharge Study**") included in the Prior Submissions.

¹⁶ See page 6 of the G-SIB Surcharge Study for further information.

¹⁷ Data concerning 123 banks worldwide with more than \$68 trillion in assets in the aggregate were examined in order to analyze the performance of banks during the recent financial crisis. This study

Proposed Capital and Leverage Rules

satisfying this minimum CET1 ratio, therefore, proved not to be the source of systemic risks in 2007-2009.

Given that banks currently satisfying the new Basel III capital standard (on a fully phased-in basis) did not suffer serious financial distress in the recent crisis and the other regulatory reform efforts that have been implemented (e.g., the Capital Plan Rule) or will be implemented (e.g., the Basel III liquidity ratios), there would appear to be little marginal utility in imposing additional significant capital surcharges on covered companies (or a subset of covered companies) that is in addition to the minimum 7% CET1 ratio under Basel III that will in any event apply.

- A. More capital is not always better. Capital surcharges on large banks risk reducing economic and job growth and pushing financial transactions to the shadow banking sector.**
 - 1. Surcharges may lead to decreased availability of credit and increased costs for bank customers.**

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

Some proponents of a surcharge have argued that higher capital requirements will lead investors to accept lower rates of return from banks subject to the requirements, which in turn will help

determined that no institution that entered the 2007—2009 crisis with a CET1 ratio (calculated in accordance with Basel III rules) greater than 7% (that is, 100 basis points lower than the level at which banks are likely to operate after considering the voluntary cushion firms will likely hold to reduce the likelihood that capital levels will fall below the regulatory minimum) experienced serious financial distress – that is, failed, was placed into governmental receivership, was acquired under duress by another financial institution or received a substantial direct government capital investment or bail out. Thus, the Basel III CET1 ratio requirement, by itself, would appear to have been sufficient to prevent serious financial distress at banks throughout the world even through the severe disruptions of the financial crisis. See pages page 3 and 6 and slides 16 through 18 of the G-SIB Surcharge Study for further information regarding, and a description of the methodologies employed in, this study. For purposes of this study, a “substantial direct government capital investment or bail out” is defined as a total government capital investment greater than 30% of the bank’s Tier 1 capital as of December 31, 2007. The 30% threshold generally filters out institutions that accepted TARP funds as mandated during the U.S. government’s response to the financial crisis, but banks that received additional capital injections outside the standard TARP Capital Purchase Program process were treated as having received a “substantial direct government capital investment or bail out” for purposes of this study.

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to offset any decrease in ROE and reduce any negative effects from such a decrease.¹⁸ However, we do not believe that lower leverage will in practice lead investors to accept significantly lower ROE from banking institutions. To the contrary, any decreases in ROE on a percentage basis are likely to far exceed any offsetting benefits in the form of lower cost of equity (“COE”) that might result from investor perception, reflected in the yields they demand on investments, that lower leverage implies investments in bank equity carry less risk.¹⁹

Because the very logic behind the imposition of a significant capital surcharge on large banks rests on the existence of substantial negative externalities and moral hazard, reforms which reduce such problems and otherwise decrease systemic risk – such as Title II of Dodd-Frank and Dodd-Frank’s living will requirements – must be taken into account in order for any proposal to impose such surcharges to be consistent with its foundational premises.²⁰ We strongly believe that this doubling up of approaches – both (i) reforms to end too big to fail and decrease risk taking and systemic risk, which inherently involve substantial additional costs, and (ii) a significant capital surcharge – is not only inappropriate but deeply taints the logic of applying a significant capital surcharge on all or a subset of covered companies.

2. A capital surcharge on covered companies, or a subset of covered companies, will encourage the growth of the significantly less regulated and less transparent shadow banking system and therefore increase systemic risk.

Demand in the economy for the products and services that covered companies subject to a surcharge are no longer willing and able to provide because of the higher costs imposed by a capital

¹⁸ See, e.g., David Miles, Jing Yang and Gilberto Marcheggiano, *Optimal Bank Capital*, Discussion Paper No. 31: Revised and Expanded Version, at 9, 10 (Apr. 2011), available at <http://www.bankofengland.co.uk/publications/Documents/externalmpcpapers/extmpcpaper0031.pdf>; Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig and Paul Pfleiderer, *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive*, at 1, 2 (Mar. 2011), available at <https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf>.

¹⁹ Analyses conducted on behalf of The Clearing House estimate that the cumulative impact of the Basel III minimum capital requirement and G-SIB Surcharge would decrease bank ROE by up to 4.9 percentage points. See slide 20 of the G-SIB Surcharge Study for further information. Under the increased capital requirements of Basel III (even before the imposition of a significant capital surcharge), ROE is estimated to fall by approximately 290 basis points without changes to banks’ business models to mitigate the impact. See *Id.* A G-SIB Surcharge of 2.5% is estimated to reduce bank ROE by an additional 200 basis points, absent business changes to mitigate the impact. See *Id.* Even assuming that lower leverage does in fact lead to decreased COE, it is estimated that ROE will decrease by substantially more than COE, based on the empirical relationship between ROE-COE over time, as well as the significant tax benefits of debt in certain jurisdictions. Regardless of whether the premise regarding some relationship between lower leverage and COE proves correct, the imposition of a G-SIB Surcharge can be expected to further decrease ROE substantially.

²⁰ Nevertheless, and quite paradoxically, the BCBS has indicated that such considerations should not play a role in the G-SIB Surcharge equation. See G-SIB Final Rules Text, ¶ 56 (“Views on the quality of the policy/resolution framework within a jurisdiction should not play a role in this G-SIB identification process . . .”). The very failure to recognize, or otherwise take into account the existence of, such reforms when determining the amount of, and whether to impose, the G-SIB Surcharge is indicative of a fundamental analytical flaw and internal logical inconsistency in the assumptions underlying the G-SIB Surcharge.

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surcharge will not, of course, simply evaporate. The provision of some of these products and services is likely to shift to the less regulated and less transparent “shadow banking” sector.²¹ The G-SIB Final Rules Text amplifies this problem by excluding shadow “banks” from the data used to determine indicator scores and thus banks are assessed without regard to the actual market for the activities, assets, liabilities, derivatives and exposures measured by the indicators. As banks subject to a surcharge gradually reduce the size of or abandon targeted business lines that are in effect taxed by the surcharge, “surviving” banks in the sector that are subject to the surcharge will take on ever larger shares of what business remains in the banking system and, thus, be still more heavily penalized by ever-larger surcharges, which will even further drive business, including traditional credit intermediation, to the shadow banking sector.²² In view of the shadow banking system’s role in lowering credit standards during the last decade,²³ and the absence of regulation and transparency, a migration to that system would have negative implications for the health of the financial system as a whole.²⁴ In addition, the shadow banking system can exhibit volatile and intermittent flows compared with the traditional banking system’s credit intermediation function. This lack of reliability as a source of funding would subject borrowers to marketplace vagaries. Both of these outcomes would actually increase systemic risk – quite the opposite of the ultimate goal of the G-SIB Final Rules Text.

* * *

In view of the empirical evidence suggesting that recent regulatory reform efforts may have significantly reduced the systemic risk and probability of failure of large banks and the potential negative economic and other consequences of applying a surcharge like the G-SIB Surcharge on some or all covered companies, the Associations have strong reservations regarding the assumptions underlying the very concept of the capital surcharge on all or a subset of covered companies, and strongly believe the imposition of such a surcharge at this time would be premature, especially given the currently fragile and volatile world market and economic environment.

²¹ See, e.g., Kate Berry and Jeff Horwitz, *Regs Push MetLife Out of Banking, into Shadow System*, American Banker (July 2011) (discussing MetLife’s decision to sell its bank but to continue writing mortgages). See also Thomas F. Cosimano and Dalia S. Hakura, *Bank Behavior in Response to Basel III: A Cross-Country Analysis*, IMF Working Paper (May 2011), at 6 (noting that even modest increases in lending costs as a result of increased capital requirements on banks “could create significant incentives for regulatory arbitrage and a shift away from traditional banking activity to the ‘shadow-banking sector’”).

²² The G-SIB Final Rules Text posits that smaller banks will take over this business, but this is at best uncertain, especially in view of the scale and investment required in several of the targeted business lines (e.g., clearing and settling payments for customers through payment systems).

²³ See Financial Stability Board, *Shadow Banking: Scoping the Issues: A Background Note of the Financial Stability Board* (April 12, 2011), at 3, available at http://www.financialstabilityboard.org/publications/r_110412a.pdf.

²⁴ Cf. Zoltan Pozsar, Tobias Adrian, Adam Ashcraft and Hayley Boesky, *Federal Reserve Bank of New York Staff Reports: Shadow Banking*, Staff Report No. 458, at 24 (July 2010, Revised February 2012) (questioning whether the economically viable parts of the shadow banking system “will ever be stable through credit cycles in the absence of official credit and liquidity puts”).

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IV. The Associations have fundamental reservations concerning the design of the G-SIB Surcharge and its indicator-based methodology in particular.

The Associations are deeply concerned that both the design and, in particular, the indicator-based methodology of the G-SIB Surcharge is deeply flawed. If the Federal Reserve ultimately determines to proceed with such a surcharge, it should do so only after addressing the flaws in the BCBS's G-SIB Surcharge's methodology.

A. There are significant uncertainties regarding the measurement of systemic importance and the calibration of a significant surcharge on large banks.

Even accepting, for argument's sake, the appropriateness of the G-SIB Surcharge, there are significant uncertainties and open questions concerning the theoretical and policy foundations of a G-SIB Surcharge.²⁵ Depending on the assumptions selected and measurement method chosen, the "systemic importance" of a bank can vary widely. The empirical measurement of systemic importance is in an early stage, and academic commentators pursuing this research regularly caution against directly adopting their work as part of a regulatory framework.²⁶ Further, the full potential combined impact of the current financial services regulatory reforms, including Basel III (both capital and liquidity), the reforms in the NPR and the G-SIB Surcharge, has not yet been comprehensively analyzed.²⁷ As a result, these complex rules could have economic costs and other unintended consequences and risks that are not readily apparent. These uncertainties regarding the appropriate calibration and method for measuring systemic importance undermine, in the view of the Associations, the credibility of the design and indicator-based methodology of the G-SIB Final Rules Text.

²⁵ As the BCBS itself readily acknowledges, these questions also regard the appropriate method to calibrate such a surcharge. See G-SIB Final Rules Text, Annex 2 at 23 (noting that with regard to its empirical analysis undertaken in support of the assessment of the magnitude of additional loss absorbency that "[i]t is important to note that there is no single correct approach that is reliable enough to inform the assessment of the magnitude of additional loss absorbency All the approaches suffer from data gaps and the results are sensitive to assumptions made The estimates of the magnitude of additional loss absorbency based on the expected impact approach, assessment of the long-term economic impact and too-big to-fall [*sic*]. . . subsidies are based on imperfect models and involve numerous assumptions and judgements.").

²⁶ Cf. John B. Taylor, *Systemic Risk in Theory and in Practice*, at 51 (stating that systemic risk is still not well defined and that reform proposals relying on systemic risk to determine in advance whether a firm should be deemed systemically significant "are not ready for prime time") (2010), available at http://www.stanford.edu/~johntayl/Onlinepaperscombinedbyyear/2010/Defining_Systemic_Risk_Operationally.pdf.

²⁷ Public sector officials have acknowledged that the aggregate impact of the current financial services regulatory reforms in the United States, including Dodd-Frank and Basel III, has not yet been fully analyzed. See, e.g., Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke's Speech on the U.S. Economic Outlook (June 7, 2011) (transcript available at <http://video.cnbc.com/gallery/?video=3000026289>).

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B. The G-SIB Final Rules Text has fundamental flaws in its design.

1. The G-SIB Final Rules Text creates a “black box” for calculating surcharges, rendering banks unable to determine their capital surcharge or what actions to take to reduce their global footprint.

It is essential that the determination of the surcharge – including, in particular, the calculation of the “indicator-based scores” and the allocation of affected banks to “buckets” – be conducted in a transparent manner for at least two reasons. First, banks should have the information necessary to adjust their risk profiles and business models in order to adapt to the new regulatory capital regime. Second, without transparency, a cloud of uncertainty is created over each potential G-SIB, which adversely affects the market price for its securities and thereby potentially affects the availability of capital. This uncertainty comes at a particularly inopportune time given the already acute uncertainty under which banks and their holding companies currently operate as a result of a multitude of new, complex rules following the financial crisis, many of which have not yet been finalized and therefore carry their own uncertainty.

Because the G-SIB Surcharge described in the G-SIB Final Rules Text effectively punishes size, global footprint and certain activities, banks should have the ability to evaluate their structure and operations and proactively determine the potential magnitude of the applicable surcharge in order to manage and/or mitigate its potential impact. However, a bank cannot determine its systemic importance score – and thus its surcharge – with any degree of accuracy over time because of two features of the G-SIB Surcharge’s methodology for determining the surcharge. First, systemic importance scores are determined on a relative basis and the thresholds of the buckets may change. As a result, in order for a bank to calculate its individual systemic importance score and determine its surcharge, it will need the ability to calculate and forecast not just the amount of each of the individual indicators for it, but also the denominators of each of the respective indicators and the thresholds of the buckets. The metrics chosen for the indicators are difficult to model even internally for an individual bank; modeling how the denominators will change every three years for a subjective sample of 73 banks is not feasible. Moreover, the thresholds of the buckets may change every three years, further undermining a bank’s ability to determine its surcharge in advance.²⁸

Second, data for many of the indicators do not at present exist as acknowledged by the BCBS.²⁹ Creating a cross-jurisdictional uniform aggregated database that earns the confidence of the

²⁸ In response to concerns regarding the G-SIB Surcharge’s lack of transparency, the BCBS noted that it will disclose the values of the buckets’ thresholds and the denominators of the indicators, the cut-off score for a bank to be a G-SIB and the threshold scores for the buckets by November 2014 based on year-end 2013 data. See BCBS, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement – Rules Text* (November 2011) (the “Cover Note”), ¶ 25-28. The disclosure of this information, however, does not address the issue of the feasibility of modeling how the denominators of the various indicators will change over time, nor does it address the feasibility of predicting how the cut-off score threshold scores for the buckets will change over time.

²⁹ G-SIB Final Rules Text, ¶ 71 (“The [BCBS] acknowledges that the data used to construct the indicator-based measurement approach currently may not be sufficiently reliable or complete. . . [T]he [BCBS] will address any outstanding data issues and re-run the indicator-based measurement approach using updated data well in advance of the implementation. This includes issues such as providing further guidance on the definition of the indicators, how to standardise further the reporting across the sample banks and how to address data that are currently difficult to collect or not publicly available.”). Although

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markets will involve substantial challenges that require addressing different business and reporting practices, different accounting regimes and currency conversion. If this database is not successfully created, the surcharges will almost certainly be unreliable and inequitable.³⁰ The present lack of such a database obviously creates a great deal of uncertainty in the capital and business planning of banks potentially subject to the proposed surcharge.

The inability of a bank to estimate its surcharge with any accuracy frustrates management's ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held. In general, given the potentially severe supervisory consequences of holding too little capital, uncertainty regarding the magnitude of the regulatory surcharge will require banks to hold a much higher amount of capital in the form of an "uncertainty surcharge". Although this result may seem to some like an acceptable, or even desirable, regulatory outcome, capital is not free, and the incidence of the costs of holding more capital than is necessary or appropriate will not fall solely on banks, but also on customers of the banks and the general economy.³¹ The lack of transparency surrounding the calculation of a bank's systemic importance score also makes the banking industry more difficult to understand for investors by introducing volatility and uncertainty in capital and associated profitability projections.

2. The G-SIB Final Rules Text discourages banks from diversifying their assets across jurisdictions and business lines.

It is well established that an undiversified portfolio of securities or other assets is subject not only to systemic (i.e., market) risks but also to security specific risks, and that security specific risks can be reduced by investing in a variety of assets, the returns of which are not necessarily correlated. The G-SIB Final Rules Text not only fails to provide any offsetting benefits for banks with diversified assets, but actually penalizes them for diversifying their assets geographically and across business lines, which is inconsistent with best risk management practices. This failure constitutes another serious flaw in the G-SIB Final Rules Text's methodology that may increase rather than reduce the chances of G-SIB failure.

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

There are risks inherent in any rigid indicator-based methodology that effectively taxes business lines regulators deem to be "risky". Over time, banks subject to the G-SIB Final Rules Text will tend to allocate assets and deploy capital in business lines not subject to this tax, thereby concentrating

rerunning the data and approach at a later date may prove helpful, it will be too late to mitigate the impact of the current uncertainty.

³⁰ We strongly believe that the G-SIB Surcharge should not be implemented – whether formally or informally – prior to the completion of this database, regardless of whether this database is completed before the beginning of the proposed phase in period (i.e., January 1, 2016).

³¹ See Part III.A for a discussion of these costs.

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risk in these non-penalized businesses. If another crisis occurs, and the business lines not penalized by the indicator-based methodology turn out to be a primary source of systemic risk, then the externalities of failures of G-SIBs could in fact increase in spite of, or even because of, the additional capital surcharge. As demonstrated by the recent financial crisis, it is difficult to identify in advance what asset classes will prove problematic, and the BCBS has not provided any substantive empirical evidence in support of the selection of categories and indicators used to determine the G-SIB Surcharge or the weighting of those categories and indicators. The Associations are thus deeply skeptical that the proposed indicators – or indeed any set of rigidly defined indicators – will be helpful in reducing systemic risk and believe such indicators may, to the contrary, actually increase it.

C. Numerous aspects of the G-SIB Final Rules Text’s indicator-based methodology are seriously flawed.

The Associations generally agree that no measurement approach will perfectly measure systemic importance across all global banks, and perfection should not be demanded of any methodology. Nevertheless, we have serious concerns with various aspects of the G-SIB Final Rules Text’s indicator-based methodology, including the following:

1. Under the G-SIB Final Rules Text’s methodology, banks could collectively reduce their systemic importance but not reduce the capital surcharge applicable to them.

The deeply flawed nature of the G-SIB Surcharge is demonstrated by the fact that a significant and proportional downward adjustment in systemic risk among the 73 banks used to determine the denominators of the indicators might not produce any change in their individual capital surcharges. The G-SIB Final Rules Text provides that, after its implementation, the cut-off score, the threshold scores for buckets and the denominators used to normalize the indicators will be fixed for three years.³² At the end of the three-year period, the entire process, as well as the cut-off scores and threshold scores for buckets, will be revisited and recalibrated. During each three-year period, each bank will have an incentive to reduce the aggregate value of its systemic importance score, in order to decrease its G-SIB buffer. However, if all 73 banks in the sample reduced the magnitude of each of their indicators over the three-year window by the same percentage (e.g., by 20%), all scores would decrease (assuming the denominator was unchanged) and, during the next calibration period, the total denominator would be reduced by the same amount that each bank reduced its numerator (i.e., 20%). As a consequence, every bank’s score would return to its initial level (unless the threshold scores for buckets were also adjusted). This result is not sensible given that banks would have lowered their systemic importance scores and thus their systemic importance, as measured by the G-SIB Final Rules Text. We believe this result is indicative of serious flaws in the G-SIB Final Rules Text’s methodology and alone would be sufficient to require reconsideration of the G-SIB Final Rules Text as a whole.

³² See G-SIB Final Rules Text, ¶¶ 69, 70.

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2. The G-SIB Final Rules Text's indicator-based methodology creates perverse incentives to increase instead of decrease risk.

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

The G-SIB Final Rules Text's indicator-based methodology creates an incentive to fund local assets with home country liabilities, rather than with local liabilities – an objectively riskier practice in view of various factors, including exchange rate and exchange control risks and interest rate risks. To illustrate this issue, consider the following hypothetical structures:

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

Assume the size of the local currency assets in each of the 25 branches or subsidiaries are identical in Structures 1 and 2. All else held constant, Structure 2 would be the riskier structure of the two. However, according to the methodology for determining a G-SIB's score for the cross-jurisdictional activity indicator, Structure 2 would have the smaller indicator score, because in Structure 2 the BHC does not have any "cross-jurisdictional liabilities" for purposes of this indicator.³³ In other words, the proposed methodology would penalize a G-SIB for holding local assets in foreign jurisdictions that are funded by local liabilities, and instead encourage it to fund those assets with liabilities in its home country, even though match funding with local liabilities is far less risky. Thus, the methodology would incentivize cross-border funding of foreign operations, a practice that is objectively riskier as described above. We do not believe this is sensible.

- b. The indicators' failure to account for the risk of assets, derivatives or exposures held by a bank is inconsistent with the stated aim of the G-SIB Final Rules Text to reduce the probability of failure of G-SIBs.

Each of the cross-jurisdictional activity, size, interconnectedness and complexity categories contains an indicator or indicators that attempt to quantify the amount of assets, derivatives or other exposures held by a bank. None of these indicators, however, takes into account the risk profile of those assets, derivatives or exposures for purposes of determining a bank's indicator-score. For example, the complexity category does not differentiate between (i) a \$100 billion available for sale portfolio of local currency and investment grade sovereign debt, whether held for liquidity or as a safe investment of excess liquidity, and (ii) a \$100 billion local currency trading portfolio of illiquid non-investment grade securitization tranches, even though the bank with the former portfolio has sharply less liquidity and credit risk and, therefore, a lesser risk of failure. This failure to account for the riskiness of the assets, derivatives and other exposures of G-SIBs is not consistent with the goal of reducing the probability of default of G-SIBs and highlights another serious flaw in the G-SIB Final Rules Text's methodology.

³³ Structure 1 and Structure 2 are equivalent with respect to the other individual indicator for this category -- cross-jurisdictional claims.

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

The G-SIB Final Rules Text provides that individual G-SIB systemic importance scores will be updated annually based on changes in the bank indicator amounts, and that the cut-off score and the threshold scores for the surcharge buckets will be initially fixed for three years and then reviewed, but does not appear to provide for a reassessment of the overall calibration of the surcharge itself and an adjustment downward if warranted. Given that the calibrations of the surcharge appear to have been based on current estimates and judgments regarding the probability of default of G-SIBs and the costs of such default, a meaningful reduction in the magnitude of either of these key variables would provide a compelling justification for reducing the size of the capital surcharge as a whole and therefore reducing the size of the buckets. The introduction of a mechanism to lower the surcharge (if warranted) would also encourage G-SIBs collectively to “reduce their systemic importance”, one of the objectives of the G-SIB Final Rules Text.³⁴ The failure to provide for such a mechanism underscores a structural flaw in the design of the G-SIB Final Rules Text.

4. Several of the indicators are inaccurate measures of systemic importance.

Several of the indicators of the G-SIB Surcharge’s indicator-based methodology do not, in our view, accurately reflect systemic importance.³⁵

- We do not believe that assets under custody is inherently indicative of systemic importance. The G-SIB Final Rules Text states that the failure of a large custodian bank holding assets on behalf of customers could disrupt the operation of financial markets.³⁶ It therefore appears to assume that assets held under custody at a failed bank would become inaccessible to the customers as a result of the failure. We do not believe that assumption is warranted. Under U.S. law, it is quite clear that assets held by a bank as custodian are not part of the bank’s receivership estate in a failure.
- The market for underwriting services is deep and competitive. Accordingly, we believe that the value of underwritten transactions is not indicative of systemic importance.
- Most over-the-counter (“OTC”) derivatives activity is conducted pursuant to legally enforceable netting arrangements, and the exposure of such derivatives is limited to a net obligation. As a

³⁴ See G-SIB Final Rules Text, ¶ 55.

³⁵ Regulators informally have acknowledged the absence of any apparent logical connection between certain indicators (e.g., securities underwritten or assets under custody as an indicator for substitutability) and systemic risk but have asserted that the indicators are nevertheless appropriate because they are “proxies” for systemic risk. The Federal Reserve and OCC, in their April 4, 2011 “*Supervisory Guidance on Model Risk Management*,” state that “[i]f data proxies are used, they should be carefully identified, justified, and documented.” We are not aware of any attempt by the BCBS to meet that standard as to the G-SIB Surcharge. We urge the Federal Reserve to address the standard as it considers a surcharge for covered companies that builds on the BCBS’s G-SIB Surcharge.

³⁶ See G-SIB Final Rules Text, ¶ 37.

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result, a gross notional measure of OTC derivatives overstates the risks associated with holding such derivatives.

- If exposure as defined for purposes of the Basel III leverage ratio is the individual indicator for size, the Associations believe it is very important that concerns with respect to the breadth of that measure be addressed, including, among other concerns, (i) the inclusion of gross “sold” credit derivative positions without recognition of off-setting hedges and (ii) the failure to use reasonable conversion factors for off-balance sheet commitments (e.g., an assumed 100% draw-down on liquidity facilities, which is not justified by the available empirical data). Until these issues are resolved, the Basel III definition of exposure is not a meaningful indicator of size.
- There is significant overlap between the size category, on the one hand, and the interconnectedness, substitutability, cross-jurisdictional activity and complexity categories, on the other. As a consequence, size is significantly over-counted in the determination of a bank’s systemic importance score. This over-counting is especially problematic given that size, by itself, is a poor indicator of systemic importance.

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

In determining a bank’s systemic importance score, the G-SIB Final Rules Text compares big banks to big banks – that is, an individual bank’s indicator score is determined by dividing the bank’s amount for a particular indicator by the aggregate amount for that indicator for all banks in the sample. Because the G-SIB Final Rules Text determines systemic importance in this way, the G-SIB Final Rules Text’s methodology could disadvantage well-managed banks if, by virtue of their safety and soundness, they maintain or grow their share of businesses – either organically or through acquisition of institutions (including institutions in financial distress) – measured by the indicators during periods when the industry shrinks as a whole or even remains the same. We do not believe it is sensible to penalize these banks under such circumstances.

V. Responses to Certain Specific Questions.³⁷

Question 8. *What is the appropriate scope of application of a quantitative capital surcharge in the United States in light of section 165 of the Dodd-Frank Act? What adaptations to the BCBS framework, or alternative surcharge assessment methodologies, would be appropriate for determining a quantitative capital surcharge for covered companies that are not identified as global systemically important banks in the BCBS framework?*

The Associations strongly believe that the Proposed Capital and Leverage Rules’ application of the Capital Plan Rule to covered companies, combined with the stress testing regime applied as part of CCAR 2012 as it will be further developed by the Proposed Stress Test Rules (whether adopted as proposed or after giving effect to our comments in *Annex E* concerning those rules), satisfy Dodd-Frank’s “more stringent” capital standard. We do not believe a capital surcharge is appropriate

³⁷ As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

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for any banks or is required in any event by Dodd-Frank for covered companies (or a subset of covered companies) and, in light of other regulatory reforms, consideration of a quantitative capital surcharge is premature. See the further discussion in Part II.

Proposed Liquidity Rules (Subpart C) – Liquidity Requirements¹

The Associations are committed to effective liquidity-risk management and strongly support efforts by the Federal Reserve and other U.S. and international regulators to improve both regulatory standards and banking-industry practices in this area. Deficiencies in liquidity risk management were among the most glaring lessons learned from the financial crisis.

Since the onset of the financial crisis, banks have substantially enhanced their liquidity risk management practices – currently rooted in dynamic forward-looking stress testing, disciplined corporate governance, contingency funding plans, and comprehensive liquidity risk gradation of how a bank’s various balance-sheet instruments will behave under stress.² We urge the Federal Reserve to consider our comments in the context of the substantially more solid foundation on which bank liquidity risk management currently rests, particularly in the case of the larger banking organizations that are covered companies under the Proposed Liquidity Rules.

The core principles embedded within the Proposed Liquidity Rules reflect and are consistent with current enhanced practices of many banks. However, the Associations have significant concerns with certain aspects of the Proposed Liquidity Rules, particularly with respect to two conceptual considerations. The first is the detailed and prescriptive approach of their governance-related provisions. Addressing such a complex subject (the risk-management approaches to which are rapidly evolving) with such granularity and rigidity raises the risk that managing to compliance with rules will impede managing the liquidity risk the rules are designed to address. That approach to the governance aspects of the Proposed Liquidity Rules stands in contrast to the Proposed Liquidity Rules’ approach to quantitative analyses and metrics, where they take a more flexible principles-based approach. The second is the blurring of the proper oversight role of the Board of Directors and the management role of senior management.

The Federal Reserve notes in the Preamble that “too much liquidity can entail substantial opportunity costs and have a negative impact on the covered company’s profitability.” We agree with that observation but suggest that it understates the potential negative effects of too much liquidity. More important are the consequences for the financial system and economy more broadly of too much liquidity, not only as maintained by individual banks but also as maintained across the banking system. The consequences are little understood but almost certainly include, among others, (i) reduced lending as banks replace loans with investments in highly liquid assets and (ii) distortions in the markets for longer-term securities (including U.S. Treasury securities and mortgage-backed securities), as banks

¹ Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

² U.S. regulators played an important role in improving industry practices by establishing new policies on liquidity risk and by stepping up scrutiny of practices firm-by-firm, including most importantly the U.S. banking agencies’ March 2010 *Interagency Policy Statement on Funding and Liquidity Risk Management*, 75 Fed. Reg. 13656 (March 22, 2010) (the “**Interagency Policy Statement**”). U.S. banks’ enhancements to their liquidity risk management practices since the onset of the financial crisis are discussed in Chapter V (Enhanced Practices for Liquidity-Risk Management) of The Clearing House’s white paper concerning liquidity risk management entitled, *The Basel III Liquidity Framework: Impacts and Recommendations*, dated November 2, 2011, available at <http://www.theclearinghouse.org/index.html?f=073043> and included in the Prior Submissions (“**The Clearing House Liquidity White Paper**”).

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invest more heavily in shorter-term securities to satisfy regulatory requirements.³ The Federal Reserve's approach to liquidity-related quantitative analyses and metrics for the most part permits covered companies to achieve a proper balance between appropriate levels of liquidity over a range of time horizons, on the one hand, and the dangers of too much liquidity, on the other hand. The exception is the 30-day time horizon, discussed in Parts III.G and III.H, below.

Part I of this Annex summarizes our comments on the Proposed Liquidity Rules; Part II addresses several key recommendations and concerns; Part III sets forth our more specific comments on the Proposed Liquidity Rules; and Part IV sets forth our responses to certain of the specific questions posed in the NPR.

I. Executive Summary

Key recommendations and concerns with respect to the Proposed Liquidity Rules

(Part II):

- The Proposed Liquidity Rules address a number of the Associations' concerns with the Basel III methodology, including (i) permitting U.S. government-sponsored entity securities (most importantly, Fannie Mae and Freddie Mac debt and mortgage-backed securities) to be included in "highly liquid assets" without the artificial L1/L2 distinction in Basel III's LCR and (ii) permitting covered companies to develop their own run-off factors and assumed drawn-down rates, provided that they rely on reasonably high-quality data and information to produce creditable outcomes. The Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts to move aspects of the Basel III liquidity framework's approach to the quantitative analysis of liquidity risk, implemented through its LCR and potentially its NSFR, to an approach more aligned with the Proposed Liquidity Rules.
- The Proposed Liquidity Rules' governance provisions are so detailed and prescriptive as to risk impeding directors' proper discharge of their oversight duties. We strongly urge the Federal Reserve to consider an approach more in line with the strategic and oversight responsibility of the Board of Directors, as addressed in Part II.A.
- In several areas, the Proposed Liquidity Rules' risk governance provisions blur the distinction between the proper oversight rule of the Board of Directors and management's responsibility for day-to-day operations. We believe these provisions should be adjusted so that the focus of the Board of Directors or risk committee, insofar as liquidity risk is concerned, is on the oversight of liquidity risks, including approval of risk management policies developed and recommended by management, as discussed in Part II.C.

Other specific comments with respect to the Proposed Liquidity Rules include (Part III):

³ Since the onset of the financial crisis, there has been a relative dearth of research focused on the macroprudential and macroeconomic effects of enhanced liquidity risk standards of the type contemplated by the Basel III liquidity framework or the Proposed Liquidity Rules as compared to the attention accorded capital requirements. See Part VI, Subchapter C (Other Qualitative Considerations – Research Assessment), of The Clearing House Liquidity White Paper for a discussion of liquidity-related research as of the fall of 2011.

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- Although the Associations appreciate the less prescriptive approach of the definition of “highly liquid assets” in the Proposed Liquidity Rules as compared to Basel III’s LCR, we believe the definition should be further expanded to encompass foreign sovereign securities and securities or other obligations issued by multi-lateral development banks and central banks of sovereign countries whose debt is included, and should provide a broader-based flexibility for inclusion of high-quality securities and instruments at future dates.
- Assets that hedge trading positions should not be treated as encumbered, as covered companies can monetize the asset while still retaining the economic exposure and therefore the desired trading view of hedge relationship.
- Covered company assets that are technically subject to a lien but are excess collateral that the covered company may withdraw or otherwise free from the lien at any time should not be treated as encumbered for purposes of the Proposed Liquidity Rules.
- The risk committee’s (or designated subcommittee’s) quarterly reviews of stress testing practices, methodologies and assumptions should focus on material aspects of those practices, methodologies and assumptions.
- The cashflow provisions in Section 252.55 should permit a covered company discretion to use a methodology for projecting liquidity that it determines is most appropriate for its business model. Also, covered companies should be permitted reasonable discretion in determining the time horizon for “long-term cashflow projections” under Section 252.55.
- Covered companies should be permitted to take into account “other appropriate funding sources”, including Federal Home Loan Bank (“FHLB”) advances, for purposes of Section 252.57’s liquidity buffer and 30-day or shorter time horizons for liquidity stress testing under Section 252.56.
- The final liquidity rule should acknowledge that, during a period of stress, covered companies may use their liquidity buffer, temporarily falling below the minimum requirement without adverse regulatory consequences.
- Securities issued or guaranteed by the U.S. government, a U.S. government agency or a U.S. government-sponsored agency should not be subject to the “sufficiently diversified” standard in Section 252.57 or to concentration limits under Section 252.59(a)(1).
- Section 252.59’s requirement that covered companies establish “specific limits” as to designated items should incorporate the flexibility standard at the heart of Section 165 of Dodd-Frank and acknowledged elsewhere in the Proposed Rules – namely, “taking into consideration [the covered company’s] capital structure, riskiness, complexity, financial activities (including the financial activities of [its] subsidiaries), size and any other risk-related factors that the [Federal Reserve] deems appropriate.”

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II. Key Recommendations and Concerns

A. **The Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts to move aspects of the Basel III liquidity framework’s approach to the quantitative analysis of liquidity risk, implemented through its LCR and potentially its NSFR, to an approach more aligned with the Proposed Liquidity Rules.**

The Federal Reserve recites in the Preamble that the Proposed Liquidity Rules are part of a multi-stage process that ultimately will include requirements “based on the Basel III liquidity ratios.”⁴ The area where the Proposed Liquidity Rules and the Basel III liquidity framework most overlap is (i) the Proposed Liquidity Rules’ dynamic principles-based approach to stress testing as opposed to (ii) the formulaic approach to liquidity risk embodied in Basel III’s LCR and NSFR. The Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts, as they continue to evaluate the LCR and potentially the NSFR (depending upon changes made in the NSFR as a result of insights gained during the observation period) in their current proposed forms, to more closely align aspects of the approaches taken in those ratios to the approach of the Proposed Liquidity Rules, which would allow the Proposed Liquidity Rules and the pending Basel III rules to be integrated in a seamless and non-contradictory manner.⁵

The Basel III liquidity framework in its current form has serious flaws in its calculation methodology, addressed at length in prior comment letters of the Associations.⁶ The Proposed Liquidity Rules address a number of our concerns with the Basel III methodology. Specifically:

- The Proposed Liquidity Rules’ definition of “highly liquid assets” (i.e., the assets that a covered company maintains for the 30-day buffer) eliminates the Basel III L1/L2 distinction and, accordingly, does not limit the amount of U.S. government-sponsored entity securities (most

⁴ 77 Fed. Reg. at 604.

⁵ The Group of Governors and Heads of Supervision (“GHOS”), the oversight body of the BCBS, in a January 2012 press release noted the BCBS members’ commitment to introducing the LCR as a minimum standard in 2015, acknowledging the BCBS’s “timeline to finalize key aspects of the LCR by addressing specific concerns regarding the pool of high-quality liquid assets as well as some adjustments to the calibration of net cash outflows.” Press Release, GHOS, *Basel III Liquidity Standard and Strategy for Assessing Implementation of Standards Endorsed by a Group of Governors and Heads of Supervision* (Jan. 8, 2012). A number of the Associations’ comments in this Annex concerning the interplay between the Proposed Liquidity Rules and the LCR relate to those key aspects.

⁶ See Letter from the ABA to the BCBS, dated April 16, 2010, regarding the Basel III liquidity framework; Letter from The Clearing House to the BCBS, dated April 16, 2010, regarding the Basel III liquidity framework; Letter from The Clearing House to Timothy F. Geithner, *et al.*, dated November 5, 2010, regarding various capital and liquidity reforms including the Basel III liquidity framework; Letter from The Clearing House to Timothy F. Geithner, dated November 2, 2011, regarding the LCR; Letter from the Global Financial Markets Association (of which SIFMA is a member), British Bankers’ Association and the International Swaps and Derivatives Association, dated April 16, 2010, regarding the Basel III liquidity framework; The Clearing House, *Assessing the Liquidity Coverage Ratio* (Nov. 2, 2011); The Clearing House, *The Basel III Liquidity Framework: Impacts and Recommendations* (Nov. 2, 2011). These materials are included in the Prior Submissions.

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importantly, Fannie Mae and Freddie Mac debt and mortgage-backed securities) that may be included.

- Although the Proposed Liquidity Rules impose rigorous cash flow projections and stress testing requirements and a 30-day liquidity buffer, they do not follow the Basel III approach of specified uniform run-off factors and assumed draw-down rates for purposes of calculating net cash outflows. Instead, they require covered companies (i) in producing cash flow projections, to use reasonable assumptions taking into account the company's capital structure, risk profile, complexity, activities, size and other related factors⁷ and (ii) although the Proposed Liquidity Rules themselves do not specify a severity standard for run-off factors and assumed draw-down rates for stress testing purposes, the Preamble states that covered companies must "rely on reasonably high-quality data and information to produce creditable outcomes."⁸⁹ We understand that the LCR is not likely to provide for that degree of company-by-company flexibility, even after giving effect to insights developed during Basel III's observation period for the LCR. However, we believe the LCR should be revised at the least to provide that national supervisors for the banks under their jurisdiction (the U.S. banking agencies in the case of the United States) may adopt calibrations for their jurisdictions that differ from calibrations specified in the Basel III LCR where they determine that a different calibration is warranted and supported by reasonably high-quality data.
- The Proposed Liquidity Rules permit each covered company to establish its own liquidity risk tolerance for each time horizon other than the liquidity buffer's 30-day horizon, taking into account the covered company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. In the context of the Basel III framework, that approach would mean permitting a covered company to target a less than 100% NSFR.
- The Proposed Liquidity Rules address short-term liquidity risk by requiring covered companies to maintain a liquidity buffer of unencumbered highly liquid assets sufficient to meet projected net cash flows for 30 days over a range of liquidity stress scenarios, taking an approach that is conceptually similar to Basel III's LCR but less prescriptive. They address overnight, 90-day and one-year time horizons through stress testing, replacing Basel III's NSFR with the one-year stressed time horizon.
- The Proposed Liquidity Rules treat liquidity regulation as a supervisory, prudential and management function, and do not provide for disclosure of specific ratios. This is consistent with the industry's strongly-held view that liquidity risk management (unlike capital adequacy) does not lend itself to a standardized approach. We continue to believe the risk of market participants not understanding the implications of disclosure (and reacting in a way that is not

⁷ Section 252.55(b).

⁸ 77 Fed. Reg. at 608-609.

⁹ This is consistent with the U.S. banking agencies' acknowledgment, in response to FAQ 11 in their January 12, 2012 *Interagency Advisory on Interest Rate Risk Management – Frequently Asked Questions*, that for purposes of interest rate risk management "decay rates" (i.e., run-off rates) on non-maturity deposits should reflect the institution's profile and activities as opposed to standardized industry estimates, given inconsistencies across geographic areas and other considerations.

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warranted by the disclosure or that unnecessarily exacerbates any liquidity weakness) substantially outweighs the benefits of any hoped-for market discipline resulting from disclosure.

Subject to our specific comments set forth below, the Associations strongly believe that these improvements to the quantitative analysis of liquidity risk should be incorporated into the Basel III liquidity framework.

B. The Proposed Liquidity Rules' governance provisions are so detailed and prescriptive as to risk impeding directors' proper discharge of their oversight duties.

The Associations agree with and endorse the liquidity risk management tools addressed in the Proposed Liquidity Rules, with their emphasis on stress testing, contingency funding plans and more rigorous oversight. As noted above, use of these tools as core principles reflects and is consistent with current enhanced practices in many banks.

However, we are concerned that the governance aspects of the Proposed Liquidity Rules are so detailed and specific that they would in fact impede directors' proper discharge of their duties and oversight. Boards of Directors have duties of care and loyalty that are well established under applicable corporate law. The role of directors is one of oversight and review, not operational or day-to-day management. Given the demands on directors in today's environment (particularly directors of financial institutions), it is critically important, in our view, that directors preserve the flexibility to determine how to discharge their duties and allocate their time among various tasks. The time allocation issue becomes more important the more complex the institution, raising a concern that too much time and energy will be devoted to liquidity risk at the expense of other issues, including potentially other risk disciplines.¹⁰ Section 252.52 of the Proposed Liquidity Rules, specifying actions that must be taken by the Board of Directors in connection with liquidity risk management, is unusually detailed and prescriptive – really to an unprecedented degree, specifying, among other things, (i) which tasks must be undertaken by the Board of Directors as a whole and which may be delegated by the Board of Directors to the risk committee or by the risk committee to a subcommittee, (ii) the frequency with which the Board of Directors (or risk committee or a designated subcommittee) must conduct reviews, (iii) the precise items that must be reviewed and established and, in some cases, reviewed and approved, and (iv) that the risk committee or designated subcommittee must establish “procedures governing the content” of senior management reports. For some covered companies, the Proposed Liquidity Rules' requirements may largely align with current practices; for others they may not; and for all covered companies, as liquidity risk management tools progress and approaches to liquidity risk management are refined, they almost certainly will not align with best practices at some future date.¹¹

¹⁰ In response to President Obama's initiatives to identify and reduce unnecessary governmental burdens on the private sector, the American Association of Bank Directors (“AABD”) undertook a review of laws, regulations and federal banking agency regulatory guidance that direct bank Boards of Directors to take certain actions. The AABD report, released on March 14, 2012, states in the first paragraph of the executive summary that “[a]fter months of review, AABD found in excess of eight hundred such provisions. They were not easy to find, spread over numerous issuances and pronouncements, with no instructions to bank directors on how to find them.” AABD, *Bank Director Regulatory Burden Report 2012*.

¹¹ We address in Part III, below, certain provisions in Section 252.52 that raise particular concerns.

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We strongly urge the Federal Reserve to consider an approach more in line with the strategic and oversight responsibility of the Board of Directors. Such an approach would require each covered company to develop and implement a liquidity risk management program that (i) addresses the areas covered by the substantive provisions in Sections 252.55 through 252.59 of the Proposed Liquidity Rules (i.e., the covered company's liquidity risk tolerance, cash flow projections, liquidity stress testing, liquidity buffers, contingency funding plans, specific limits and on-going monitoring requirements, subject to our further comments below) but with a more flexible approach as to specific action items, (ii) addresses the company's approach for considering the liquidity costs, benefits and risks associated with significant new products and lines of businesses and the entry into new markets, and establishes the company's policies with respect to these matters, and (iii) provides that the Board of Directors (or, at its discretion, the risk committee) must approve and review the liquidity risk management program on at least an annual basis and identify the overall purpose of such reviews and approvals, but (iv) otherwise leaves the details for governing review and oversight, including frequency, to the discretion of the board.

C. In several areas, the Proposed Liquidity Rules' risk governance provisions blur the distinction between the proper oversight role of the Board of Directors and management's responsibility for day-to-day operations.

The Associations agree with the Federal Reserve's premise in the Proposed Liquidity Rules that an appropriate and robust internal governance approach to liquidity risk management is critically important. However, a number of provisions in the Proposed Liquidity Rules and the Proposed Risk Management Rules blur (and in our view cross) the line between the proper oversight role of the Board of Directors and the management role of senior management. In *Annex E*, we discuss this concern more broadly in the context of the Proposed Risk Management Rules. Blurring the traditional distinction between the Board of Directors' oversight responsibility and management's management responsibility raises its own risks. The focus of the Board of Directors or risk committee, insofar as liquidity risk is concerned, should be on the oversight of liquidity risks, including approval of risk management policies developed and recommended by management. We note four key provisions of the Proposed Liquidity Rules in this regard, as follows:

- Section 252.52(b)(1)(i) provides that the Board of Directors "must establish the covered company's liquidity risk tolerance at least annually." We strongly believe that the board's role should be to review and approve the covered company's risk tolerance, and that senior management should be responsible for proposing to the covered company's Board of Directors from time-to-time the appropriate liquidity risk tolerance for the covered company, including the quantitative and qualitative ways in which the covered company's liquidity risk tolerance is expressed and measured.¹²

¹² The BCBS, in its *Principles for Sound Liquidity Risk Management and Supervision* (Sept. 2008), notes in the text accompanying Principle 2 that a Board of Directors "should establish the bank's liquidity risk tolerance," and then goes on to say that "[t]here are a variety of qualitative and quantitative ways in which a bank can express its risk tolerance." The U.S. banking agencies, in paragraphs 11 and 12 of the Interagency Policy Statement, deal generally with policies articulating a liquidity risk tolerance but do not specify that a Board of Directors must establish the company's liquidity risk tolerance. Instead, paragraph 7 states that "the board should ensure that the institution's liquidity risk tolerance is established and communicated in such a manner that all levels of management clearly understand . . .". We agree with that standard. While standard measures of risk are useful, banking organizations' managements should

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- Section 252.52(b)(2)(i) requires the risk committee or a designated subcommittee to review and approve the liquidity costs, benefits and risks of each significant new business line and each significant new product before the covered company implements the business line or offers the product. In addition, Section 252.52(b)(2)(ii) requires the risk committee (or designated subcommittee) to annually review all *previously approved* significant business lines and products – the number of which likely would grow over time substantially. We urge the Federal Reserve to delete these requirements from the final rules. Liquidity risk is only one of the risks and relevant considerations that require consideration in connection with new business lines and product. In our view, proper risk management (liquidity and otherwise) will not be best served by isolating the liquidity component of the relevant considerations and, instead, should be left to the broader evaluation and approval process that would customarily apply (beginning with business level commitment committees, complex structured product committees and reviews, etc.). Moreover, requiring annual review of each previously approved product or business line could impose, over time, substantial burdens on the risk committee (or the designated subcommittee) and detract from its ability to have and maintain a holistic view of the firm’s liquidity risk profile. If reduced to a regulatory compliance exercise, it will be exceedingly important to establish with clarity what is a “significant new business line” or “significant new product”.
- Section 252.52(b)(4)(i)(F) requires the risk committee (or a designated subcommittee) to “[r]eview liquidity risk management information necessary to identify, measure, monitor, and control liquidity risk” (emphasis added). Identifying, measuring, monitoring and controlling liquidity risk in the first instance is a management responsibility, subject to oversight by the Board of Directors. Accordingly, we believe this section should be revised to require the risk committee (or a designated subcommittee) to “oversee and review liquidity risk management information developed and used by management for the purposes of identifying, measuring, monitoring and controlling liquidity risk.”
- Section 252.52(b)(4)(iii) provides that the risk committee or a designated subcommittee “must establish procedures governing the content of senior management reports on the liquidity risk profile of the covered company.” Although we are uncertain as to the precise intent of this clause, it seems to require that the risk committee or designated subcommittee determine the content of senior management reports on liquidity risk. We strongly believe that the proper role of the Board of Directors, whether exercised directly or through a committee, is to oversee the liquidity risk management process on an informed basis but that, in the first instance, the structure of the liquidity risk management program, including in the first instance the content of reports provided to directors, should be the role of senior management.

III. Specific Comments

A. Although the Associations appreciate the less prescriptive approach to the definition of “highly liquid assets” in the Proposed Liquidity Rules, we believe the definition

be encouraged to continue to develop liquidity risk management approaches (and analytics for measuring liquidity risks) that take into account the liquidity position, vulnerabilities and capabilities of the specific firm. For example, stress test and scenario analysis taking into account these firm-specific items are essential to effective liquidity risk management. The Board of Directors should be briefed on these measures in sufficient detail to understand them and provide oversight.

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should be further expanded to encompass foreign sovereign securities and securities or other obligations issued by multi-lateral development banks and central banks of sovereign countries whose debt is included. It should also provide flexibility for inclusion of high-quality securities and instruments at future dates.

The liquidity buffer and stress testing requirements must be met by “highly liquid assets”, as defined in Section 252.51(g) of the Proposed Liquidity Rules. As indicated in the introductory paragraphs, we commend the Federal Reserve for including within the definition of highly liquid assets U.S. government, government agency and government-sponsored entity securities. However, we believe the definition should be expanded in five respects.

First, high-quality securities of foreign sovereigns should be included as highly liquid assets.¹³ We appreciate that the U.S. banking agencies are currently evaluating comments received on their December 2011 notice of proposed rulemaking implementing Section 939A of Dodd-Frank to replace use of ratings in their revisions to their market risk capital rules, known as “**Basel II.5**”, with other metrics.¹⁴ Given the premise that highly liquid assets have low credit risk, the Federal Reserve and the other U.S. banking agencies will need to consider the interplay between the treatment of sovereign debt exposures under the market-risk rules and their qualification as highly liquid assets for purposes of the Proposed Liquidity Rules. The methodologies for evaluating sovereign debt exposures (and, for that matter, other exposures) under the market-risk rules are likely to evolve over the next several years. We urge the Federal Reserve to address the inclusion of high-quality sovereign debt (in each case with limitations on maturity that are appropriate for the particular time horizon involved) within highly liquid assets either by permitting the inclusion of:

- sovereign debt securities that are assigned a specific risk-weighting factor of 1.6 or less (equivalent to a risk-weighting of 20% or less under the U.S. banking agencies’ Basel I-based capital rules) under the market-risk rules as they are amended, or
- securities issued or guaranteed by the government of a country that is a full member of the Organization for Economic Cooperation and Development or that has concluded special lending arrangements with the International Monetary Fund (which is the current standard under the U.S. banking agencies’ Basel I-based capital rules for 20% risk-weighted sovereign securities).

Second, covered companies with international operations should be permitted to include securities issued or guaranteed by the sovereign government of any country (whether or not covered by the preceding paragraph) and recorded on the books and records of a branch, agency or subsidiary located within the relevant sovereign country (and subject to appropriate maturity constraints), at least to the extent of the liabilities of the covered company recorded on the books and records of a branch, agency or subsidiary located within such country. There have, of course, been numerous sovereign debt crises over the years. With limited exceptions, the debt of the affected sovereigns restructured in those crises has been debt issued cross-border to financial institutions and

¹³ Similar considerations with respect to the treatment of non-U.S. sovereign securities arise under the Proposed SCCL Rules and are discussed in Part II.F of *Annex C*.

¹⁴ 76 Fed. Reg. 79380 (Dec. 21, 2011). The Associations, along with the American Securitization Forum and the International Swaps and Derivatives Association, Inc., commented on the proposed market risk rules by letter dated February 7, 2012.

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others outside the sovereign country; customarily debt issued or guaranteed by the sovereign domestically, including to branches, agencies or subsidiaries of banking organizations organized or headquartered elsewhere but located within the sovereign, have been paid in accordance with their terms.¹⁵ The eligibility of domestic debt for liquidity purposes hinges, of course, on the liquidity characteristics of the instruments. However, it is important to recognize that covered companies (including their bank subsidiaries) with international reach generally are required to maintain on the books and records of branches, agencies or subsidiaries within foreign countries securities issued by the relevant sovereign country.¹⁶ It is important to the proper functioning of the international financial system that international banking organizations (which include many of the covered companies) continue to provide financial services within international reach in a broad array of areas, including trade finance, lending more generally, custody, and cross-border payments. The final version of the Proposed Liquidity Rules, as well as the Basel III liquidity framework, should not unnecessarily impede those important functions.

Third, securities or other obligations issued by multi-lateral development banks (including The International Bank For Reconstruction and Development, The International Finance Corporation, The Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the European Financial Stability Fund, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member), in each case if maturing or withdrawable within the relevant time horizon (e.g., 30 days for the liquidity buffer), should be recognized as highly liquid assets. Under the Federal Reserve's and other U.S. bank agencies' risk-based capital guidelines, claims on these entities are recognized as high quality (assigned a 20% risk weighting) and, insofar as their liquidity characteristics are concerned, their performance during the financial crisis raised no issues.

Fourth, Section 252.51(g)(3) provides flexibility for the inclusion at future dates of additional assets as highly liquid assets, but it does so in a manner that would require each covered company to make an independent demonstration to the satisfaction of the Federal Reserve as to the relevant criteria and, apparently, would allow only the petitioning covered company to include the particular security or asset as a highly liquid asset if the Federal Reserve is satisfied with the demonstration. We urge the Federal Reserve to provide in the final rules that other securities specified from time-to-time by Federal Reserve order as highly liquid assets may be included. We believe it is important that the final rules include a mechanic for expanding the scope of highly liquid assets that is

¹⁵ See, e.g., Congressional Research Service Report for Congress, *Argentina's Sovereign Debt Restructuring* (Oct. 19, 2004) (addressing the categories of Argentinian peso-denominated debt that was proposed to be restructured in its crisis that became acute in 2001, noting that restructuring of certain instruments placed domestically "with depositors and financial institutions, under some government pressure, . . . could jeopardize the banking system. Restructuring BODENs held by public sector pensions would be politically unfeasible for similar reasons.").

¹⁶ Some countries require banking institutions operating in that country to hold a percentage of their demand and time liabilities in the form of government securities. For example, the Reserve Bank of India mandates this in the form of a "Statutory Liquidity Ratio", which is currently at about 25% of the demand and time liabilities. To the extent that these government securities are not counted as eligible, banks with significant operations in these countries would be subject to a burdensome and duplicate reserve requirement.

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more streamlined than a formal rulemaking proceeding under the Administrative Procedures Act. U.S. and international banks are making substantial efforts to identify and analyze metrics that demonstrate the liquidity of securities and other instruments and facilities in time of stress. If these endeavors result in agreement upon metrics that the Federal Reserve and other bank regulators as well as the industry believe are appropriate indicators of liquidity for stress testing and buffer purposes, it will be important to create a mechanic for expanding the definition of highly liquid assets to accommodate them for all covered companies in an expeditious manner (and not simply on a company-by-company basis).

Fifth, we urge the Federal Reserve to revise the definition of highly liquid assets to clarify that securities issued by or claims against central banks of sovereign countries whose debt securities are risk-weighted 0% (including the Federal Reserve Banks for the United States) fall within its scope, provided that they may be withdrawn or transferred within the relevant time horizon (e.g., 30 days for the liquidity buffer). The U.S. banking agencies' Basel I-based capital rules apply a 0% risk weighting to central governments of OECD countries and specify that central banks (including the Federal Reserve Banks for the United States) are encompassed within central governments. For example, deposits that banks maintain with the Federal Reserve Banks, including amounts in excess of the amount needed to satisfy reserve requirements under the Federal Reserve's Regulation D, should be included within highly liquid assets. Similarly, any deposits that a covered company may maintain with a Federal Reserve Bank under the term deposit facility proposed by the Federal Reserve as a monetary policy tool to manage the aggregate quantity of reserve balances held by depository institutions should be included.

B. Assets that hedge trading positions should not be treated as encumbered, because covered companies can monetize the asset while still retaining the economic exposure and therefore the desired trading view of the hedge relationship.

The definition of "unencumbered" in Section 252.51(n) excludes an asset designated as a hedge on a trading position, as defined in Section 252.51(l). The example given in the Preamble is corporate bonds held by a covered company to hedge a corporate bond index in its trading account.¹⁷ This requirement appears to be focused on ensuring that liquid assets are segregated from assets that are traded. This segregation is unnecessary. Whether an asset is a trading position, or hedge to a trading position, does not prevent a covered company from being able to generate liquidity from it, including through repos in the secondary market, clearing houses or existing central bank facilities. In any of these instances, where the asset is used to generate funding, the covered company retains the economic exposure and therefore the desired trading view or hedge relationship.

C. Covered company assets that are technically subject to a lien but are excess collateral that can be withdrawn or freed of the lien at any time should not be treated as encumbered for purposes of the Proposed Liquidity Rules.

The Proposed Liquidity Rules define the term "unencumbered" very narrowly in a manner that would encompass many assets that are only technically encumbered and may be freed from the technical encumbrance at any time to serve as a liquidity source. Examples include (i) assets pledged to a central bank in excess of reserve requirements, (ii) assets pledged to a clearing counterparty in excess of the amounts required for clearing, and (iii) assets subject to ordinary course

¹⁷ 77 Fed. Reg. at 609.

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“bankers’ liens” that apply to securities held in depository accounts or custody accounts (e.g., Euroclear ordinarily has a lien over securities held to cover its fees, and custodians, more generally, customarily have a lien over custodied assets to cover their fees, expenses and indemnities). Banks properly, in our view, treat those assets as unencumbered for liquidity risk management purposes. The Associations urge the Federal Reserve, when it finalizes the Proposed Liquidity Rules, to take the same approach and treat assets that are technically subject to a lien, but that the covered company may at any time withdraw or free from the lien, as unencumbered.

D. Senior management, not the Board of Directors, should “establish” a covered company’s liquidity risk tolerances.

As discussed in Part II.C, senior management should be responsible for proposing to the Board of Directors from time-to-time the appropriate liquidity risk tolerance for the covered company, including the quantitative and qualitative ways in which the risk tolerance is expressed and measured. The Board of Directors’ proper duty is to review and approve the covered company’s liquidity risk tolerance as proposed and defined by senior management, not to establish it.

E. The Federal Reserve should not prescribe the approach taken by covered companies, or the role of the Board of Directors, in reviewing and evaluating significant new business lines and products.

As discussed in Part II.C, we urge the Federal Reserve to delete the requirement that the Board of Directors (or risk committee or a designated subcommittee) must review and approve significant new business lines and products. A covered company’s approach to evaluating significant new business lines and products, and when and whether a covered company determines to involve its Board of Directors (or such committee or designated subcommittee), should be left to the purview of the Board of Directors, taking into account the broader array of considerations that relate to new business lines and products.

F. The risk committee’s (or designated subcommittee’s) quarterly reviews of stress testing practices, methodologies and assumptions should focus on material aspects of those practices, methodologies and assumptions.

Section 252.52(b)(4)(i)(B) requires that the risk committee (or a designated subcommittee) at least quarterly “[r]eview and approve . . . stress testing practices, methodologies, and assumptions.” Because there is no materiality qualifier, this could potentially require that the risk committee (or subcommittee) review and approve practices, methodologies and assumptions at a very granular level. We urge the Federal Reserve to qualify the requirements of this provision so it requires the risk committee or designated subcommittee to review only material stress testing practices, methodologies and assumptions. Boards of Directors (whether acting through the whole board or through committees or subcommittees), should be acknowledged to have discretion as to the level of their review of particular matters and where, at any given time and taking into account the circumstances of a particular company, they choose to allocate their time and resources.

Also, once material practices, methodologies and assumptions are approved, we urge the Federal Reserve to consider replacing the requirement of a quarterly review with a requirement that the risk committee or a designated subcommittee (i) review and approve on an annual basis the material stress testing practices, methodologies and assumptions but (ii) review and approve material changes to those practices, methodologies and assumptions prior to their being implemented.

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Quarterly review of unchanged practices, methodologies and assumptions is unnecessary and creates the potential for the reviews becoming perfunctory.

- G. The cash flow provisions in Section 252.55 should be flexible enough to permit a covered company, in appropriate circumstances and with the Federal Reserve’s approval, discretion to use an alternative methodology for projecting liquidity that it determines is more appropriate for its business model. Also, covered companies should be permitted reasonable discretion in determining the time horizon for “long-term cash flow projections” under Section 252.55.**

The Associations urge the Federal Reserve to re-word Section 252.55 to require covered companies to produce comprehensive projections of their liquidity positions (which may be addressed by providing cash flow projections). Although “cash flow projections” of the type contemplated by Section 252.55 of the Proposed Liquidity Rules are a common management tool, for some firms they may not provide much insight into the firm’s liquidity position. We believe that the Proposed Liquidity Rules should require covered companies to project liquidity needs but permit flexibility and discretion in choosing a methodology that is most appropriate for the covered company’s business model. Mere cash flow projections are a somewhat blunt “one-size-fits-all” approach. For example, scenario analysis incorporating different assumptions with respect to asset balances and contractual/contingent liquidity outflows may be more relevant to some companies’ business models (broker-dealers, for example) than individual security cash flows such as interest payments.

Section 252.55 requires that cash flow projections cover short-term and long-term periods but does not specify what time horizon satisfies the long-term requirement. We appreciate the Federal Reserve’s approach in leaving determinations of the time horizons to covered companies. The Associations’ members expect that their cash flow projections and liquidity stress testing will be integrated processes and, accordingly, that customarily a one-year time horizon would be the long-term time horizon for cash flow projection purposes. We would appreciate the Federal Reserve confirming, in the preamble or introductory statement to the final liquidity rules, that no time horizon longer than one year is required in order to achieve compliance with Section 252.55. Individual covered companies may, of course, choose to use longer-term time horizons depending on their circumstances.

- H. Covered companies should be permitted to take into account “other appropriate funding sources” for purposes of Section 252.57’s liquidity buffer and 30-day or shorter time horizons for liquidity stress testing under Section 252.56.**

The Proposed Liquidity Rules provide that “only highly liquid assets that are unencumbered” may be used as cash flow sources for the first 30 days of a liquidity stress scenario, apparently encompassing the required overnight and 30-day time horizons, whereas, for other time horizons, “other appropriate funding sources” may also be taken into account. We believe that a covered company should also be permitted to include, for purposes of the overnight and 30-day time horizons, other funding sources that the covered company concludes are appropriately reliable and stable (i) within that time horizon and (ii) taking into account the parameters of the particular liquidity stress scenario involved. Two examples include:

- FHLB borrowing capacity. The Associations have commented at length on the Basel III liquidity framework’s exclusion of FHLB borrowing capacity as a component of the stock of liquid assets

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for purposes of the Basel III LCR.¹⁸ The FHLB system and the role of the FHLBs as a liquidity source for banks are unique to the United States. The FHLB system has proven itself vital not only to mortgage finance over the decades, but also to providing emergency liquidity support during the most recent financial crisis, when FHLB advances grew to \$1.01 trillion at the height of the crisis. This was essential to banks of all sizes in the United States, including not only large banks but also mid-size and smaller ones for which access to capital markets is principally effected through the FHLB system. Implementation of any liquidity risk-management standard – whether the Proposed Liquidity Rules or the Basel III framework – without regard to the value of this facility and the liquidity it provides will undermine, not advance, sound liquidity risk management. We continue to believe that some portion of FHLB borrowing capacity should be included in applicable short-term liquidity ratios as a source of liquidity, including (i) in the case of the Proposed Liquidity Rules for purposes of the liquidity buffer, whether as a component of highly liquid assets or as an “other appropriate funding source”, and (ii) in the case of the Basel III LCR as finally implemented, as a component of the stock of highly liquid assets. We address this issue further in our response to Question 14 in Part IV.

- Inventory positions maintained by covered companies with significant broker-dealer businesses. In many cases those positions are highly liquid, although they include equity and other securities that do not fit within the definition of highly liquid assets. At least for covered entities with these types of operations, we believe that some portion of those inventory positions should be includible as “other appropriate funding sources”, including for time horizons of 30 days or less, subject to appropriate haircuts and, in the case of time horizons of 30 days or less, perhaps a limitation on the proportion of the projected net cash outflows that can be addressed with those assets (20%, for example).
 - I. **The final liquidity rules should acknowledge that, during a period of stress, covered companies may use their liquidity buffer, temporarily falling below the minimum requirement without adverse regulatory consequences.**

Section 252.57(a) provides that the “liquidity buffer must be sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios.” Notwithstanding Section 252.52(b)(1)’s language contemplating that a covered company shall establish its liquidity risk tolerance at least annually (and, impliedly, acknowledging that its liquidity risk tolerance for a particular horizon could be less than 100%), Section 252.57(a) as currently written effectively contemplates no liquidity risk tolerance (and, accordingly, a 100% buffer) over the 30-day time horizon. Provided that the final liquidity rules permit covered companies to take into account other appropriate funding sources for purposes of the liquidity buffer, the Associations agree that covered companies should maintain a 100% liquidity buffer during normal times. However, during periods of stress covered companies inevitably use their stock of highly liquid assets to meet liquidity needs and, as a consequence, temporarily may fall below the liquidity buffer’s implicit 100% requirement. We urge the Federal Reserve to provide in the final rules that the

¹⁸ See Letter from the ABA to the BCBS, dated April 16, 2010, regarding the Basel III liquidity framework; Letter from The Clearing House to the BCBS, dated April 16, 2010, regarding the Basel III liquidity framework; Letter from The Clearing House, dated November 5, 2010, regarding various capital and liquidity reforms; The Clearing House, *The Basel III Liquidity Framework: Impacts and Recommendations* (Nov. 2, 2011); The Clearing House, *Assessing the Liquidity Coverage Ratio* (Nov. 2, 2011). These materials are included in the Prior Submissions.

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100% requirement applies during normal times but that, during periods of stress, covered companies may fall below the 100% requirement without being deemed to have violated the liquidity buffer requirement.¹⁹

J. Securities issued or guaranteed by the U.S. government, a U.S. government agency or a U.S. government-sponsored agency should not be subject to the “sufficiently diversified” standard in Section 252.57 or to concentration limits under Section 252.59(a)(1).

Section 252.57(d) requires that the unencumbered highly liquid assets included in the liquidity buffer be “sufficiently diversified”. Similarly, Section 252.59(a)(1) reads broadly, providing that a covered company must establish and maintain, among others, limits on concentrations of funding by single-counterparty and counterparty type. Although limiting concentrations of liquidity sources is appropriate in some contexts, we believe it is not appropriate as applied to securities of the U.S. government, U.S. government agencies and U.S. government-sponsored entities. These securities are among the most liquid and safest liquidity sources and, inevitably, will be maintained (and need to be maintained) by covered companies at levels that will likely make concentration limits as applied to them not meaningful. The Federal Reserve’s commentary in the Preamble appears to agree with this view. The Preamble states that “if a covered company holds high-quality assets other than cash and securities issued by the U.S. government, a U.S. government agency, or a U.S. government-sponsored entity, the assets should be diversified by collateral, counterparty, or borrowing capacity, and other liquidity risk identifiers.”²⁰ Similarly, we note that Section 252.97 of the Proposed SCCL Rules exempts exposures to the United States and its agencies as well as Fannie Mae and Freddie Mac from the concentration limits addressed in those rules.

Apart from securities issued by the U.S. government, U.S. government agencies and U.S. government-sponsored agencies, specific limits on concentrations without question are appropriate for liquidity risk management purposes more generally. However, we urge the Federal Reserve, in considering comments concerning the scope of the definition of “highly liquid assets”, to be mindful that the more narrow the definition, the more concentrated covered companies’ exposures will be to particular types of obligors, particularly if U.S. government, U.S. government agencies and U.S. government-sponsored agencies securities are not exempted from the specific limits on concentration.

K. Section 252.59’s requirement that covered companies establish “specific limits” as to designated items should incorporate the flexibility standard at the heart of Section

¹⁹ The GHOS acknowledged the same principle as applied to the LCR in its January 2012 press release referred to in footnote 5, stating:

“Once the LCR has been implemented, its threshold will be a minimum requirement in normal times. But during a period of stress, banks would be expected to use their pool of liquid assets, thereby temporarily falling below the minimum requirement.”

Press Release, Group of Governors and Heads of Supervision, *Basel III Liquidity Standard and Strategy for Assessing Implementation of Standards Endorsed by Group of Governors and Heads of Supervision* (Jan. 8, 2012).

²⁰ 77 Fed. Reg. at 608.

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165 of Dodd-Frank and acknowledged elsewhere in the Proposed Rules – namely, “taking into consideration [the covered company’s] capital structure, riskiness, complexity, financial activities (including the financial activities of [its] subsidiaries), size and any other risk-related factors that the [Federal Reserve] deems appropriate.”

Section 252.59, as written, is too prescriptive. We believe Section 252.59 should require covered companies to establish specific limits only as to those items that are relevant for the company’s business, funding models, and the instruments that it holds and issues. For example, requiring limits on counterparties that do not have a future obligation to provide liquidity to the covered company (e.g., debt holders) is of limited utility in managing liquidity risk. As another example, setting limits on collateral could require the unwinding of risk-mitigating contracts and increase risk. For example, if a covered company were forced to unwind interest rate swaps, it could then have a mismatch between the interest basis of its assets and the interest basis liabilities (e.g., floating rate accounts receivable financed with fixed-rate debt).

IV. Responses to Specific Questions

We have set forth below responses to certain of the specific questions raised by the Federal Reserve in the NPR.²¹

Question 10. *Is the Federal Reserve’s approach to enhanced liquidity standards for covered companies appropriate? Why or why not?*

The liquidity risk management tools addressed by the Proposed Liquidity Rules – particularly cash flow projections, liquidity stress testing, the maintenance of a short-term liquidity buffer, and contingency funding planning – are consistent with liquidity risk-management practices as they have evolved and improved since the onset of the liquidity crisis. Accordingly, the Associations are largely supportive of the Proposed Liquidity Rules; in broad scope we believe they focus on the right tools.

Our key recommendations and concerns are set forth in Part II. In particular:

- The Proposed Liquidity Rules address a number of our most serious concerns with the Basel III methodology. Accordingly, the Associations urge the Federal Reserve to work with the other U.S. banking agencies and their international counterparts to move the Basel III liquidity framework’s approach to the quantitative analysis of liquidity risk to an approach more aligned with the Proposed Liquidity Rules.
- However, we urge the Federal Reserve to revisit aspects of the governance provisions of the Proposed Liquidity Rules. In our view, they are so detailed and prescriptive as to risk impeding directors’ proper discharge of their oversight duties. Additionally, in several areas they blur the distinction between the proper oversight rule of the Board of Directors and management’s responsibility for day-to-day operations.

See the more detailed discussion in Part II.

²¹ As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

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Question 11. *Are there other approaches that would effectively enhance liquidity standards for covered companies? If so, provide detailed examples and explanations.*

As indicated above, we believe the Proposed Liquidity Rules focus on the right tools for robust liquidity risk management. We also believe, however, that the Federal Reserve should revise the cash flow provisions in Section 252.55 to permit a covered company discretion to use a methodology for projecting liquidity that is most appropriate for its business model. See the discussion of this issue in Part III.G.

Question 12. *The Dodd-Frank Act contemplates additional enhanced prudential standards, including a limit on short-term debt. Should the Federal Reserve adopt a short-term debt limit in addition to or in place of the LCR and NSFR? Discuss why or why not?*

The level of short-term debt appropriately maintained by a covered company depends upon the entire mix of its assets and liabilities and the nature of its operations. A covered company's establishment of its liquidity risk tolerance under the Proposed Liquidity Rules requires the company to address the level of its short-term debt in any event as part of stress testing over the required time horizons, and the level of short-term debt inherently is a consideration that the company takes into account in establishing its required liquidity buffer. Further, specifically limiting short-term debt could work counter to the general principle of achieving the diversification in funding sources that could be vital in a crisis. Accordingly, the Associations strongly believe that a specific limit on short-term debt would not enhance prudent liquidity (or other) risk management and, accordingly, should not be adopted.

Question 13. *What challenges will covered companies face in formulating and implementing liquidity stress testing described in the proposed rule? What changes, if any, should be made to the proposed liquidity stress testing requirements (including the stress scenario requirements and required assumptions) to ensure that analyses of the stress testing will provide useful information for the management of a covered company's liquidity risk? What alternatives to the proposed liquidity stress testing requirements, including the stress scenario requirements and required assumptions, should the Federal Reserve consider? What additional parameters for the liquidity stress tests should the Federal Reserve consider defining?*

Subject to our comment in Part III.H (concerning the importance of permitting covered companies to take into account other appropriate funding sources in addition to highly liquid assets for purposes of the liquidity buffer) and our comment below concerning validation, we believe that Section 252.56's approach to liquidity stress testing is appropriate.

With respect to validation, Section 252.56(c)(2)(ii) requires that a covered company must have an effective system of control and oversight to ensure that the "stress process and assumptions are validated." We are uncertain as to what it means to "validate" the "stress process" or the "assumptions" used in that process and urge the Federal Reserve to provide clarification, either in the preamble or introductory statement accompanying the final liquidity rules or perhaps even in the final liquidity rules themselves. Validating the "stress process" may mean proving the arithmetic accuracy of the liquidity stress models once the data points are fed into the models, although we are not sure of the intent. With respect to validating the "assumptions", we urge the Federal Reserve to clarify that this does not mean back-testing. Back-testing of projected stress scenarios is a developing "art".

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Moreover, it is not clear which assumptions must be validated. Does the reference encompass the parameters of the assumed stress scenarios, the run-off (i.e., “decay”) and draw-down rates used for those scenarios, or both (and the interplay between the two)?

Question 14. *The Federal Reserve requests comment on all aspects of the proposed definitions of “highly liquid assets” and “unencumbered.” What, if any, other assets should be specifically listed in the definition of highly liquid assets? Why should these other assets be included (that is, describe how the asset is easily and immediately convertible into cash with little or no loss in value during liquidity stress events)? Are the criteria for identifying additional assets for inclusion in the definition of highly liquid assets appropriate? If not, how and why should the Federal Reserve revise the criteria?*

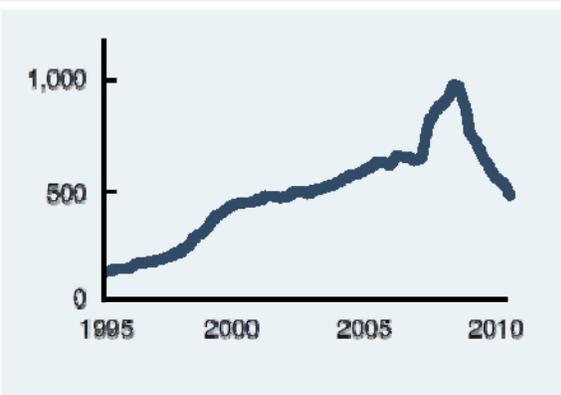
See our comments in Parts III.A and III.B.

Additionally, we wish to comment on two additional matters relating to the qualification of assets for the liquidity buffer and liquidity stress testing.

1. FHLB Advances as a Source of Liquidity.

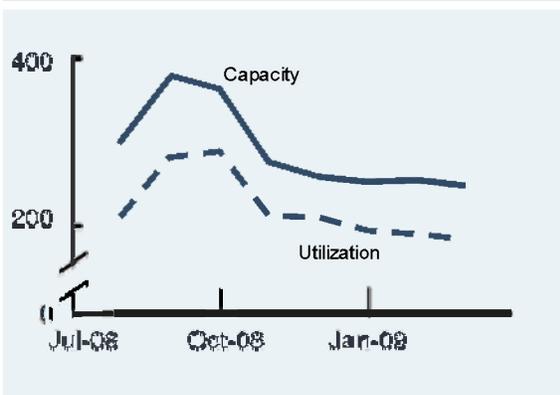
The first is the critical role of FHLB borrowing capacity as a source of liquidity, introduced in our comments in Part III.H. As demonstrated by the charts below, the FHLBs continued to provide liquidity that banks could draw upon during the crisis, in addition to other markets that maintained liquidity.

Quarterly FHLB advances 1995–2010 (\$B)



- FHLB continued to provide liquidity even during the crisis

FHLB capacity and utilization (\$B), TCH members



- Capacity and utilization increased during the crisis while excess capacity remained relatively constant

Source: Fed Flow of Funds; The Clearing House LLC member banks' supplemental data

Established by law in 1932,²² FHLBs provide “advances” – that is, loans collateralized by eligible mortgages and other assets – to support residential-mortgage finance by member institutions.

²²

Federal Home Loan Bank Act of 1932, Pub. L. 72-304, 12 U.S.C. §§ 1421-1449.

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Members – now more than 8,000 for the FHLB system as a whole²³ – are large and small banking organizations, as well as certain other eligible firms.

The FHLB System increased its lending to members in every part of the country by over 50% – or \$300 billion – between the second quarter of 2007 and the third quarter of 2008.²⁴

Some in the official sector have expressed concern that the FHLB role does not warrant recognition because the FHLBs pose taxpayer risk. However, several layers of protection exist to make it highly unlikely that any taxpayer subsidy would be required, because:

- the FHLBs are 100% privately capitalized with member stock and retained earnings;²⁵
- joint and several liability within the FHLB System, through issuance of the FHLB system’s “consolidated system-wide obligations”, protects individual district FHLBs;²⁶
- FHLB haircuts on the collateral that must back all advances are conservative, generally ranging from 25% to 50%;
- no FHLB has experienced a credit loss on advances;²⁷ and
- none of the FHLBs required government assistance during the financial crisis.

FHLB advances may be provided on an overnight or a term basis. The Federal Reserve and the other U.S. banking agencies have expressed concern, in the context of Basel III’s LCR, as to whether a bank’s ability to borrow on an overnight basis from an FHLB should be recognized for LCR purposes in either the numerator or denominator, given that overnight borrowings would be negated by the obligation to repay within 30 days were the funds actually drawn down. The same concerns would apply to FHLB advances as a liquidity source for the Proposed Liquidity Rules’ liquidity buffer. The treatment of overnight FHLB facilities for any short-term liquidity metric requires further consideration.

The Proposed Liquidity Rules correctly address one of the Basel III LCR’s important flaws – caps on the proportion of the LCR’s stock of liquid assets that may consist of securities of government-sponsored entities (including debentures and mortgage-backed securities issued or guaranteed by Fannie Mae and Freddie Mac and consolidated system-wide obligations of the FHLB system). Presumably the reason for the Federal Reserve’s approach is that there is a long and well-documented history that shows these securities remain liquid during times of stress, and in fact benefit from a flight to quality. In other words, there is a high degree of confidence that all banks can find a buyer for these

²³ The Federal Home Loan Banks, *FHLBanks White Paper*, available at <http://www.fhlbanks.com/assets/pdfs/sidebar/FHLBanksWhitePaper.pdf>.

²⁴ *Id.* at 3.

²⁵ *Id.*

²⁶ Moody’s Investors Service, *Credit Opinion: Federal Home Loan Banks* (Aug. 5, 2011), available at http://www.fhlf-of.com/ofweb_userWeb/resources/MoodysCreditAnalysis080511.pdf.

²⁷ *Id.* at 3.

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securities, without incurring a loss, even in the midst of a crisis. When an FHLB member bank takes an advance from the FHLB system, it relies on the very same mechanism that allows FHLB consolidated system-wide securities to be included in the liquidity buffer. The FHLB's funding office sells consolidated system-wide obligations to raise cash for the borrowing member bank. These obligations are the very same securities that are included in a bank's liquidity buffer when they are held directly by a bank. There is no reason to believe that the market would be less willing to purchase securities directly from the issuer (as a new issue) than from a bank (as a secondary sale). Inasmuch as there is no reason to doubt the liquidity for FHLB consolidated system-wide obligations and there is no reason to differentiate between sellers, the exclusion of FHLB borrowing capacity from the liquidity buffer can only reasonably be attributed to the FHLBs' relationships with member banks. The FHLBs have a long history of lending to trouble institutions in times of crisis, provided the institution has sufficient collateral to support the advance. Washington Mutual, for example, obtained a sizable advance on the very day it was seized by the FDIC. The FHLBs are able to safely make these advances because they have extensive expertise supplying reasonable haircuts to pledged collateral. It is our understanding that no FHLB has ever lost any principal on a secured advance to a member bank. Given this long track record, there is no reason to doubt that the FHLBs will change this practice in the future. And because the FHLBs can be counted upon to continue this rational behavior, there is no reason to exclude a bank's existing borrowing capacity (with appropriate haircuts) from the liquidity buffer.

FHLB advances are a critically important liquidity source for U.S. banks, demonstrably available to U.S. banks throughout the financial crisis. The liquidity buffer, by limiting sources of liquidity to highly liquid assets, does not recognize the liquidity value of banks on drawn FHLB commitments. Subject to the open questions with respect to overnight FHLB advances discussed above, we strongly believe it should.

2. Clarification as to the Availability of Liquidity.

Second, in discussing the characteristics of highly liquid assets in the Preamble, the Federal Reserve comments that "highly liquid assets in the liquidity buffer should be readily available at all times to meet a covered company's liquidity needs."²⁸ We assume that the "at all times" reference in the quoted language, as applied to a particular asset, means that the asset will be available to the covered company by the end of the 30-day time horizon provided for in the liquidity buffer and not that the asset may not be included if it is subject to a repurchase agreement (as long as the maturity date of the repurchase agreement is at or before the end of the 30-day period as opposed to after the end of that period) or must mature on an overnight basis and continually be reinvested during the 30-day period in order to qualify. We would appreciate the Federal Reserve clarifying that understanding in the preamble or introductory text to the final rules.

Paragraph 26 of the Basel III liquidity framework uses slightly different terminology when it specifies that assets a bank includes in its stock of liquid assets for LCR purposes "must be available for the bank to convert into cash at any time to fill funding gaps between cash inflows and outflows during the stressed period."²⁹ The BCBS, in response to frequently asked questions, confirmed that paragraph 26 of the Basel III liquidity framework should be read together with paragraph 27; paragraph 27 provides that assets received in reverse repo and securities financing transactions that are

²⁸ 77 Fed. Reg. at 609.

²⁹ Basel III liquidity framework, ¶ 26 (emphasis added).

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held by a bank and have not been re-hypothecated, and are legally and contractually available for the bank's use, can be considered as part of the stock liquid assets. We believe the Federal Reserve should take the same approach for purposes of addressing the scope of unencumbered high-quality liquid assets in the Proposed Liquidity Rules. The repo markets continued to function during the financial crisis. A robust repo market is important both as a liquidity source for covered companies and other banking organizations and to a functioning financial system.

Question 15. *What changes, if any, should the Federal Reserve make to the proposed definition of unencumbered to make sure that assets in the buffer will be readily available at all times to meet a covered company's liquidity needs? The rule would require a covered company to discount the fair market value of assets that are included in the liquidity buffer. Please describe the process that covered company will use to determine the amount of the discount.*

See our comments in Parts III.A and III.B and our additional comments in response to Question 14.

Question 16. *Are the proposed CFP requirements appropriate for all covered companies? What alternative approaches to the CFP requirements outlined above should the Federal Reserve consider? If not, how should the Federal Reserve amend the requirements to make them appropriate for any covered company? Are there additional modifications the Federal Reserve should make to the proposed rule to enhance the ability of a covered company to comply with the CFP and establish a viable and effective plan for the management of liquidity stress events?*

Section 252.58's approach to contingency funding plans ("CFPs") is a principles'-based approach that we believe is sufficiently flexible to accommodate BHCs that are covered companies irrespective of size or the nature of their businesses. (As indicated in footnote 19, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve relating to, nonbank covered companies.)

There is one aspect of the CFP provisions, however, on which we request clarification – namely, the testing provisions in Section 252.58(b)(4). That section requires, among other things, that a covered company "must periodically test the methods it will use to access alternative funding sources to determine whether these funding sources will be readily available when needed." Our concern is that that language could be read to require covered companies to actually draw-down on liquidity lines or other funding sources (including, for example, the Federal Reserve discount window) or sell assets that they would not otherwise sell, albeit on a temporary basis, in order to assure that the funding mechanics actually work – essentially, take steps to "monetize" their liquidity sources, actually raising funds (even if only on an intraday basis). We strongly believe that covered companies should not be required to actually monetize liquidity sources as part of the testing process. Whether a particular covered company chooses as part of its testing process to actually monetize a liquidity source should be left to the discretion of the covered company, taking into account market conditions and the possibility that market participants may recognize but misinterpret the action. Financial markets that become aware of monetization activities likely will not understand that the particular step taken was merely part of the testing component of the covered company's CFP and may assume that the monetization action is an indication of liquidity stress, possibly resulting in responsive actions by market participants that are unnecessary, inappropriate and contribute to financial instability. Equally importantly, we believe that

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covered companies can test the components of their CFP's reliability on a "war room" basis by simulating communication, coordination, and decision-making (as contemplated by Section 252.58(b)(4)(i)), but not only within the covered company but also involving outside providers of liquidity) in a way that provides adequate assurance of the continued availability of liquidity sources. We urge the Federal Reserve either to confirm in the preamble or introductory statement to the final liquidity rules that the testing requirements under Section 252.58 may be satisfied on a simulation basis without actual monetization of liquidity sources or, alternatively, to clarify in Section 252.58(b)(4) that the testing may be on a simulation basis.

Question 19. *The Federal Reserve requests comment on all aspects of the proposed rule. Specifically, what aspects of the proposed rule present implementation challenges and why? What alternative approaches to liquidity risk management should the Federal Reserve consider? Are the liquidity management requirements of this proposal too specific or too narrowly defined? If, so explain how. Responses should be detailed as to the nature and impact of these challenges and should address whether the Federal Reserve should consider implementing transitional arrangements in the rule to address these challenges.*

Liquidity risk management is a discipline that has undergone significant improvement and advancement during the last several years but continues to evolve and progress. As a consequence, our key concern at this juncture is not that the Proposed Liquidity Rules have not encompassed the appropriate tools, based on current "best" or "enhanced" practices, but that they are cast so specifically that they may impede the development of new and better tools – for example, recognition by regulators and the industry, including as a result of the ongoing substantial efforts of U.S. and international banks to identify and analyze metrics that demonstrate liquidity (referred to in Part III.A), that instruments not recognized by the final version of the Proposed Liquidity Rules as highly liquid should be, or, conversely, that instruments that are recognized as highly liquid should no longer be so recognized. See our comments in Part II.B.

Proposed SCCL Rules (Subpart D) – Single-Counterparty Credit Limits¹

The principal objective of the single-counterparty credit limit is to reduce risk in the U.S. financial system posed by the interconnectivity among large financial companies.² The Proposed SCCL Rules, however, take no account of the actual risk posed, or the degree of interconnectivity created, by the exposures the rule is designed to limit and instead impose an arbitrary, one-dimensional and one-size-fits-all methodology for calculating credit exposures that has no economic or analytical basis. This methodology would result in a gross overstatement of the exposure of any covered company to any counterparty.

The 10% credit limit imposed on major covered companies—and even the 25% credit limit imposed on all covered companies—may severely restrict legitimate and economically desirable credit-related business, even where the actual risk of that credit has been mitigated in sound ways. To comply with the proposed requirements, the provision of some credit products and services may have to be reduced significantly with consequences for the liquidity of many asset classes. Constrained liquidity would lead to higher costs for all market participants. In a crisis, the Proposed SCCL Rules would have the pro-cyclical impact of further preventing access to liquidity. Consequently, if implemented, the Proposed SCCL Rules will have impacts that are felt well beyond the covered companies themselves and will actually increase risk to U.S. financial stability—the very antithesis of the purpose of Dodd-Frank and the prudential measures in Section 165 of Dodd-Frank in particular.

Strikingly, there is no mention in the NPR of the enormous magnitude of the effect of the Proposed SCCL Rules. As discussed in Part I.C. of the Comment Letter to which this Annex is attached, the preliminary results of The Clearing House SCCL Study demonstrate that the effect of the Proposed SCCL Rules would be significant. As noted, preliminary results indicate:

- there would be in the aggregate 100 exposures to 29 unique counterparties in excess of the applicable credit limit;³
- the average counterparty exposure for those excesses would be 248% of the applicable credit limit;⁴ and
- the counterparty exposures that would exceed the credit limit include exposures to seven highly-rated non-U.S. sovereigns and two CCPs.

¹ Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

² 77 Fed. Reg. at 612.

³ If no allowance is made for short-term breaches of the credit limit (as discussed in Part III.C.2 of this Annex), covered companies inevitably will have to manage to a lower limit (e.g., 80% of the limit that would otherwise apply). Using 80% of the limit that would otherwise apply as the threshold, there would be 120 exposures in excess of that threshold.

⁴ This average represents a “count-weighted” average (i.e., a straight average of the percentage for each of the 100 incidents of exposures in excess of the applicable credit limit).

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These “excesses” are the result of several factors. The calculation methodologies are flawed in a number of ways that result in an overstatement of actual economic exposure. The proposed use of CEM for all covered companies, rather than the IMMIs used by the larger covered companies for capital and risk management purposes, creates an overstatement of the realistic economic exposure. The “add on” approach for calculating exposure under repo and securities lending transactions similarly overstates exposure. The automatic exposure-shifting (or substitution) that is required when a covered company purchases credit protection sharply exaggerates risk by requiring a shift of the face amount of the credit protection, which disregards the creditworthiness of the reference name and ignores the fact that any loss would require a double default.

Another cause of the limit excesses relates to the proposed reduction of the statutory credit limit. Maintaining the statutory credit limit of 25% rather than dramatically lowering the credit limit to an arbitrary 10% for certain major covered companies would mitigate the impact of the Proposed SCCL Rules on the financial markets, and still leave the Federal Reserve with the ability to lower the limit if, as required by Section 165, it is in fact determined at a later time to be “necessary to mitigate risks to the financial stability of the United States.” Maintaining the 25% credit limit for all covered companies also would avoid the forced shifting of activity from larger financial institutions to their smaller and potentially less well-capitalized and less regulated counterparts that are not covered companies or to the largely unregulated shadow banking system. Finally, the Proposed SCCL Rules’ approach of subjecting CCPs and non-U.S. sovereigns to the credit limit also drives the limit excesses.

We also believe that the focus on the risks of “interconnectivity” or “interconnectedness”, which the Federal Reserve has identified as the driving force of the Proposed SCCL Rules,⁵ may reflect a view of the risk of financial contagion that we believe is conceptually flawed. The Associations recognize that the failure of one large institution can place substantial pressure on other large institutions. This is, however, because investors and funders are concerned that the other institutions have invested in similar classes of assets as the first institution, or have other similar risk issues, and will experience similar losses. As demonstrated in the financial crisis, it is not principally because the other institutions have substantial exposure to the first. Indeed, the absence of interconnectivity losses during the crisis creates a very high barrier for the Federal Reserve to justify a departure from the BHCs’ risk-based approach.

The Associations strongly urge the Federal Reserve to reconsider the approach taken in the Proposed SCCL Rules. Rushing into a rule that would upset existing legitimate credit-related business and constrain market liquidity would needlessly cause significant harm to U.S. financial institutions, their customers and the U.S. economy that will not be easily undone. Furthermore, the single-counterparty credit limit is not the lone guardian of U.S. financial stability, nor is it the sole means of addressing concerns of interconnectivity among large financial institutions and the related systemic risk. These concerns are being addressed through many other means—increased regulatory capital requirements, liquidity requirements, the new liquidation authority, and a host of other requirements (many of which are contained in the Proposed Rules). Taking into account these other supervisory and regulatory initiatives that seek to address similar concerns as the single-counterparty credit limit, as well as the concerns set forth herein, will result in a rule that is workable and achieves the purpose of the concentration limit without threatening the proper functioning of the credit markets or the availability

⁵ See 77 Fed. Reg. at 612, 616.

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of liquidity or increasing risk in the financial system. In addition, because the Federal Reserve retains the authority to adjust any rule it adopts, based on its experience and actual data it will gather in administering the rule, it should not act precipitously on the basis of speculation and assumptions regarding the effects of the Proposed SCCL Rules.

To be clear, the Associations support an organization-wide single-counterparty credit limit. In fact, monitoring counterparty exposure is a central component of the risk management functions of our members today. The Proposed SCCL Rules, however, largely ignore the existing systems and methods that BHCs use to measure and monitor credit exposures for regulatory capital purposes, and are completely divorced from the credit risk management and other systems that BHCs have developed over many years in close collaboration with their supervisors. In addition, the Proposed SCCL Rules diverge from other regimes applicable to banking organizations, such as state or federal bank lending limits. As a result, the Proposed SCCL Rules would require covered companies to develop a duplicative and less effective risk management system, the operational and system costs of which would far outweigh any supervisory benefits. This would divert resources and management attention from the systems actually used and relied upon by covered companies and their regulators to monitor and control risk to developing and maintaining an arbitrary system that has no basis or use in the economic functioning of the company. In addition, because the Proposed SCCL Rules differ in significant ways from similar regimes in other jurisdictions, covered companies with global operations will have to administer multiple, inconsistent risk management systems. For example, the EU Commission's large exposure regime, which is implemented by member countries, excludes from the applicable credit limit exposures to sovereigns with a 0% risk-weight and certain CCPs.⁶ In addition, that regime would permit the use of models to measure certain exposures and would not impose a lower 10% credit limit.

There is no indication that, in proposing the Proposed SCCL Rules, the Federal Reserve weighed the significant costs and burdens associated with developing, tracking, reporting, and other compliance mechanisms against the likely benefit to covered companies or the U.S. financial system stability that would be derived from this approach. Similarly, the NPR does not consider whether the benefits could be achieved, and the unnecessary costs avoided, by aligning the requirements of the single-counterparty credit limit with existing systems. The Proposed SCCL Rules thus contravene U.S. government policy requiring an analysis and "reasoned determination" regarding the costs and benefits of a proposed rule and consideration of less burdensome alternatives.⁷ These are principles the Federal Reserve has stated it endeavors to abide by in developing regulatory proposals, including specifically those required under Dodd-Frank.⁸

In addition, the Proposed SCCL Rules disregard the fundamental requirements of the APA by denying to those affected by the rule a meaningful opportunity to comment on the basis and

⁶ See Capital Requirements Directive II (2009/111/EC)("CRD II"). CRD IV, which modifies CRD II in certain respects, is intended to come into force on January 1, 2013.

⁷ Exec. Order 13563 (Jan. 18, 2011). Exec. Order 13579 (July 11, 2011) states that independent regulatory agencies, such as the Federal Reserve, should comply with the cost-benefit analysis and regulatory balance burden reduction requirements of Exec. Order 13563.

⁸ Letter from Federal Reserve Chairman Bernanke to Mr. Cass R. Sunstein, Office of Information and Regulatory Affairs, dated Nov. 8, 2011.

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rationale for a number of these draconian changes to risk management. There is not, for example, any explanation as to why CEM was selected as an appropriate measure for all covered companies or BHCs' IMMIs disregarded. Nor is any explanation provided for the proposed reduction from the 25% statutory limit to 10% or how such a reduction meets the statutory requirement that the reduction be "necessary" to mitigate risk to U.S. financial stability. Similarly, the NPR does not describe the basis for the \$500 billion asset threshold for "major covered companies" and "major counterparties". In the interest of fundamental administrative fairness, the Federal Reserve should republish for comment revised Proposed SCCL Rules in order to provide a meaningful opportunity to comment as required under the APA given the lack of any rationale in the NPR on these issues.

Part I of this Annex summarizes our comments concerning the Proposed SCCL Rules; Part II addresses our key concerns and recommendations; Part III addresses certain other concerns; and Part IV sets forth our responses to certain of the specific questions posed in the NPR.

I. Executive Summary

The Associations strongly urge the Federal Reserve to incorporate the recommendations below into a final rule. These recommendations are designed to address the gross overstatement of exposure, and the inclusion of exposures that do not pose significant risk, to covered companies, while in no way undermining the overall purpose of the single-counterparty credit limit.

- Allow covered companies the option to measure derivative exposures using Federal Reserve-assigned stress measures as an alternative to CEM. Requiring all covered companies to use CEM to calculate derivative exposure will result in a substantial overstatement of the exposure in relation to the risk posed by the exposure with potentially severe consequences for liquidity of the derivative markets. The Associations propose two alternative approaches to CEM for measuring exposure. These alternatives are designed to address the Federal Reserve's concerns with IMMIs and capture the effect of future market volatility but still provide meaningful and realistic measures of exposure. Both approaches address the most significant flaw of CEM, which is its failure to appropriately take into account collateral and legally enforceable netting in the calculation of potential future exposure.
 - The first approach is a stressed IMM ("**Stressed IMM Approach**"), which could be effected in one of two ways. Under one method, the covered company would calculate the exposure under its IMM and then subject the result of that calculation to a multiplier specified by the Federal Reserve in order to provide an additional buffer against excessive credit exposure. Alternatively, the Federal Reserve could assign both (i) the confidence level that would be used by the covered company to calculate its estimate of potential future exposure under its IMM and (ii) the period of stress to be used in calibrating the IMM to either a historical lookback period or a set of market implied data, or specify criteria for selection of such period of stress. A multiplier or higher confidence level and lookback period provided by the Federal Reserve would alleviate concerns with the potential fallibility of IMMIs in times of market distress.
 - The second approach, the "**Supervisory Stress Approach**", would require a covered company to use a replacement cost, calculated consistently with regulatory capital rules, of derivative transactions under specific stress scenarios specified by the Federal

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Reserve as the measure of exposure, similar to the approach recently used by the Federal Reserve for the CCAR 2012 stress tests. The Supervisory Stress Approach would be uniform across the covered companies using that approach.

- Allow covered companies to determine whether to shift exposure in accordance with the covered company's policies and procedures. The Proposed SCCL Rules include a substitution approach under which the covered company automatically and universally substitutes the credit of the eligible protection provider for the credit of the underlying obligor. This substitution requirement overstates actual exposure because, among other things, it does not take into account the reduced likelihood of a double default. The overstatement is exacerbated because, when the covered company substitutes the protection provider, the exposure must be measured at the face or notional amount of the credit protection purchased (up to the gross credit exposure to the underlying obligor), treating all exposures the same and disregarding differences in creditworthiness entirely. With respect to credit and equity derivative markets, the use of notional amounts would severely limit the ability of covered companies to continue to provide such products. The final rules should permit a covered company to make its own good faith determination, subject to written policies and procedures reviewed by the company's principal regulator and the Federal Reserve, whether to shift an exposure from an underlying obligor to an eligible credit protection provider when the covered company purchases eligible credit protection. Furthermore, the exposure that would be shifted to the eligible protection provider would be the covered company's net default value exposure. The exposure shifted to the reference name when the covered company is the protection provider would be calculated in the same way.
- Allow covered companies the option to measure their exposure in repo and securities lending transactions using a simple VaR method as an alternative to the proposed "add-on" approach. The proposed add-on that would be applied to a covered company's exposure as a seller or lender in a repo and securities lending transaction and the haircut applied to the collateral result in a significant overstatement of exposure and the risk associated with it. The overstatement results from the use of arbitrary haircuts that are not empirically supported. This approach also fails to take into account the relationship between the securities transferred/lent and the type of collateral securing the transaction, as well as the risk-mitigating attributes of the portfolio as a whole. To address these concerns, the Associations propose that covered companies be permitted to use a simple VaR method to calculate net credit exposure when acting as the seller or lender in repo and securities lending transactions. A covered company would not need separate and distinct approval by the Federal Reserve for this purpose if the covered company has already received approval to use a VaR method for regulatory capital compliance purposes. If the Federal Reserve determines that a more standardized approach is necessary, it could prescribe inputs and assumptions for the models. At a minimum, a new set of more reasoned haircuts should be developed to be applied to repo and securities lending transactions that reflect static correlations between different types of loaned securities and collateral in the transaction.
- Do not reduce the statutory 25% credit limit for any covered companies. The extraordinary reduction in the credit limit for "major covered companies", when combined with the calculation flaws described in the previous three bullets points, will force these companies to engage in a massive reduction of their current credit exposures. There does not appear to be

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any basis to determine that the dramatic reduction from the 25% credit limit to 10% is necessary to mitigate risks to U.S. financial stability, and the Federal Reserve has provided no explanation of the basis or reasoning for the reduction. As a result, covered companies are denied their statutory right to provide meaningful comment, a right that is especially critical given the enormous impact of the proposal. In light of the many other initiatives that will have an impact on covered companies, we recommend proceeding cautiously, and only with a full understanding of the impact and effect of the Proposed SCCL Rules. This understanding can only be achieved through the assessment of data of the type that would be submitted to the Federal Reserve under Section 252.96 of the Proposed Rules and Section 165(d)(2) of Dodd-Frank. The argument for caution is especially compelling in the face of the potentially severe negative consequences for the markets.

- Exempt exposures to CCPs from the credit limit. The Proposed SCCL Rules are in tension with the mandate in Dodd-Frank to clear transactions through CCPs because they subject exposures to CCPs to the credit limit. Imposing a limit on a covered company's transactions with a CCP ignores the special regulatory scrutiny and regime to which CCPs are subject, and application of the limit to them will impede progress towards the goal of centralized clearing. Instead, any limitation of exposures to CCPs should be addressed in tandem with the development of the regulatory regime for CCPs, both in the United States and internationally.
- Do not apply the credit limit to exposures to high-quality non-U.S. sovereigns. Section 165(e) does not require that exposures to sovereigns be subject to the credit limit because sovereigns are not companies under any accepted definition of that term. Given the Federal Reserve's decision not to cover exposure to the U.S. Government under the credit limit, coverage of exposure to non-U.S. sovereigns with similar levels of liquidity and creditworthiness is not justified as a matter of policy or logic and cannot be supported under the applicable legal standards for agency action specified in the APA. Applying a 25% credit limit to all non U.S. sovereigns and their various agencies and authorities may prevent covered companies from investing in, or accepting as collateral, non-U.S. sovereign obligations, and, as a consequence, will distort the market for non-U.S. sovereign obligations and reduce liquidity for these obligations. To preserve liquidity in these markets, exposures to high-quality non-U.S. sovereigns should not be covered by the credit limit. The Associations believe that the same approach to non-U.S. sovereign obligations recommended by the Associations for inclusion as "highly liquid assets"⁹ under the Proposed Liquidity Rules should be used here as well.
- Individuals should not be covered as counterparties. Section 165(e) covers credit exposure to companies, not to individuals, and the Federal Reserve has not articulated any rationale for covering individuals as counterparties under the Proposed SCCL Rules. In light of the fact that credit exposures to individuals are highly unlikely to approach the credit limit or pose systemic interconnectivity risk, coverage of individuals as counterparties under the Proposed SCCL Rules is not justified. Moreover, coverage of individuals as counterparties fails any reasonable cost/benefit analysis for the same reasons.

⁹ See Part III.A of Annex B.

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- Define “control” to include only companies that are consolidated for financial reporting purposes to ensure the definition is readily administrable and appropriately reflects credit risk. The Proposed SCCL Rules adopt a broad definition of “control”. This broad definition creates an aggregation of exposures that is inconsistent with financial reality and accurate risk-evaluation and goes beyond the requirements of the statute or its intent. The proposed definition of “control” would require that a covered company include all affiliates of a counterparty in calculating its aggregate exposure to that counterparty no matter how tenuous or remote the affiliation and regardless of the existence of any actual obligation or responsibility of the “individual company” for the affiliate or likelihood of support. For example, because a private equity firm is typically the general partner of each of its funds and, therefore, under a Bank Holding Company Act control analysis may be deemed to control 100% of a class of the fund’s voting securities, all exposures to all companies “controlled” by all the firm’s funds would be aggregated with the firm’s exposures. To avoid this gross overstatement of credit exposure, “control” should be defined to include only companies that are consolidated for a company’s financial reporting purposes, such as under U.S. GAAP. In addition, the proposed definition of “control” is unworkable because it assumes ongoing access to information regarding all of a counterparty’s investments that in reality is generally unavailable.
- Do not require daily compliance and monthly reporting for counterparty exposures that are not reasonably likely to approach a specified percentage of the credit limit. If a covered company’s policies and procedures are sufficient to prevent an exposure from approaching a specified percentage of the credit limit (which specified percentage would be set below that limit), there is no reason to require daily monitoring or any reporting of exposures that fall well below the credit limit. Because a covered company’s exposure to most counterparties will never come close to the credit limit, a daily determination of compliance for all counterparties that is based on calculating aggregate exposure to each counterparty would impose a burden that cannot be justified under a cost/benefit analysis or for financial stability purposes.
- Provide a more reasonable effective date. The Proposed SCCL Rules would require significant adjustments to existing credit relationships even if the rules are modified to address the flaws identified in this Comment Letter. To allow markets to absorb these shifts, the Federal Reserve should delay the effective date for the full two-year transition period (July 2015). Moreover, all covered companies will require additional time to develop or enhance systems to comply with the requirements of the final rules.

II. Key Concerns and Recommendations

- A. The Associations strongly urge the Federal Reserve to provide a covered company the option, as an alternative to CEM, to measure derivative exposures under either the Stressed IMM Approach or Supervisory Stress Approach.**

The proposed calculation methodology for derivative transactions results in a gross overstatement of the exposure in relation to the risk posed by such transactions. Section 252.94 requires that the exposure to a counterparty under a derivatives contract entered into pursuant to a qualifying master netting agreement be measured using the method provided in 12 C.F.R. Part 225,

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Appx. G, Sec. 32(c)(6), which is generally referred to as the “current exposure method”, or CEM.¹⁰ CEM is a misnomer because it includes an artificial future exposure as well as actual current exposure.

The limitations of CEM are readily apparent. Overall, CEM’s flaws lie in its risk-insensitivity, which results in an overstatement of the realistic economic exposure of derivative transactions. In particular, counterparty credit exposure under CEM is calculated as net current exposure plus potential future exposure, and the overstatement is driven mostly by the calculation of potential future exposure. Under CEM, the potential future exposure calculation significantly limits the degree to which netting may be taken into account, even though the transactions are subject to a qualifying master netting agreement. In addition, the potential future exposure does not include collateral that will be posted against future exposures. Any methodology for calculating derivative exposure must address these fundamental limitations of CEM to avoid an outsized measure of exposure that will limit the ability of covered companies that are active in these markets to continue these activities.

In fact, the CEM approach produces exposures that are, in many cases, not merely significantly higher than those calculated under IMM (which seek to measure actual risk), but are substantial *multiples* of the IMM calculations. In the case of credit and equity derivatives, this is compounded by the “substitution” requirement discussed in Part II.B below. The only conceivable reason for using CEM is if there were no viable alternative for dealing with the potential fallibility of models, but there are viable alternatives.

BHCs that regularly engage in a significant volume of derivative transactions generally have developed IMM for purposes of measuring counterparty credit risk for compliance with regulatory capital requirements and internal risk management. These IMM are reviewed by the appropriate federal bank supervisor and subject to rigorous back testing. Notwithstanding these protections, the Federal Reserve appears to be reluctant to permit the use of IMM to measure derivative exposure, presumably because of models’ potential fallibility in times of market distress and a possible “doubling down” of risk due to their use for regulatory capital purposes (“**model risk**”). We believe, however, that when the testing and reliability of the models are taken into account, they are far more accurate than the CEM approach in measuring risk. In addition, models could be subject to continuous review by the Federal Reserve on a horizontal basis.

We understand the potential limitations of model-based approaches. The Associations acknowledge that the financial crisis exposed deficiencies in models used to measure and evaluate risk. Likewise, we recognize that, in the case of internal models that are or will be used by banks for capital purposes (principally for purposes of the A-IRB approach under the U.S. banking agencies’ Basel II-based capital guidelines and, for a broader group of banks, the agencies’ market risk capital rules), the magnitude of the understatement of risk was significant. Nonetheless, the areas where significant deficiencies existed were quite limited, mostly dealing with the treatment of mortgage securitizations and correlation trading positions. It is also important to recognize that the deficiencies in models were not with respect to the models themselves but, instead, were principally with respect to one flawed assumption used in the models. This mis-assumption in many bank and rating agency models was the

¹⁰ Derivative transactions not subject to such a netting agreement are calculated pursuant to a similar methodology but with no allowance for netting. The Associations’ proposal for calculating derivative exposure would cover both types of derivatives.

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failure to recognize that the assumed default rates and potential losses on mortgage and mortgage-backed securities were premised on historical data during periods (albeit relatively long periods) of only stable or rising housing prices, that housing prices could fall (potentially sharply), and that the consequences could be sharply increased defaults and losses. These deficiencies can be addressed in the context of single-counterparty credit limits without abandoning models altogether.

Our proposed approaches—the Stressed IMM Approach or the Supervisory Stress Approach—are meant to solve for these deficiencies while at the same time providing a measure of exposure that is both realistic and consistent with the purposes of the single-counterparty credit limit. The Associations propose that either one of these two approaches be provided in the final SCCL rules as an alternative to CEM for measuring derivative transactions, including for credit and equity derivatives.

The Associations' proposed Stressed IMM Approach would use the basic mechanics of a covered company's IMM, but then solve for the potential fallibility of even well-conceived and examined models. It could be implemented in one of two ways. Under one method, the covered company would calculate the exposure under its IMM and then subject the result of that calculation to a multiplier specified by the Federal Reserve. This would provide a meaningful buffer to try to address unexpected market volatility. Alternatively, the Stressed IMM Approach, rather than using a multiplier, could instead change certain inputs to the IMM. First, the estimation of potential future exposure would be based on a confidence level to be provided by the Federal Reserve. In particular, to calculate potential future exposure, the company would not use the Effective Expected Positive Exposure ("EEPE") that is used for regulatory capital purposes, but instead would measure counterparty exposure at a confidence level provided by the Federal Reserve that would represent a stressed market environment. Second, the Federal Reserve would determine a period of stress to be used in calibrating the IMM to either a historical lookback period or market implied data, or specify the criteria for selection of such a period of stress. This approach also would ensure that the calibration of a covered company's model is sufficiently stressed and uniform across covered companies using the Stressed IMM Approach. This approach also would be consistent with Basel III, which retains risk-sensitive counterparty exposure models but requires calibration to a period of market stress.

Our other proposed alternative—the Supervisory Stress Approach—would not rely on IMM. Instead, the Supervisory Stress Approach would provide a simple, uniform method to measure exposure based on a stress scenario. In order to address the concern that the measure of exposure account for potential future distressed market conditions, the Supervisory Stress Approach would estimate a covered company's counterparty exposure based on the replacement value of derivative transactions assuming a severe, instantaneous shock to market risk factors, less applicable collateral. The specific stressed market conditions would be established by the Federal Reserve, similar to the approach recently used for CCAR 2012. For this purpose, replacement value would be defined consistently with regulatory capital rules. In particular, under current Basel II rules, replacement cost or current exposure is defined as "with respect to a netting set, the larger of zero or the market value of a transaction or portfolio of transactions within the netting set that would be lost upon default of the counterparty, assuming no recovery on the value of the transactions."¹¹

¹¹ 12 C.F.R. Part 225 Appx. G, §2.

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The Associations and their members are committed to working with the Federal Reserve to develop these or other alternatives for measuring exposure for derivative transactions. We firmly believe, however, that any approach to calculating potential future exposure must take into account legally enforceable netting and collateral in order to provide a realistic measure of exposure that more accurately reflects risk.

- B. The “substitution” requirement in the Proposed SCCL Rules should be modified to require a shift only in accordance with a covered company’s established policies and procedures. Without such a change, the ability of covered companies to provide credit protection to, and obtain credit protection from, market participants may be significantly limited.**

The Proposed SCCL Rules create an entirely new methodology for calculating exposures involving credit and equity derivatives that is unrelated to the way these exposures currently are measured and managed for credit risk purposes or for regulatory capital compliance. In particular, the requirement in Section 252.95(e) to shift automatically the amount of the underlying exposure to the protection provider (up to the notional amount of the protection purchased) may have significant market impacts, as discussed below.

The substitution requirement represents a transmogrification of the role of credit protection. When a lender obtains credit protection, it is for the purpose of reducing its risk. The lender is then exposed to risk of loss only if both the borrower and credit protection provider default (double default). The Proposed SCCL Rules, however, ignore this basic financial architecture and provide absolutely no credit for this risk mitigation approach. Even worse, this substitution concentrates the risk in the protection provider. Because the protection is typically provided by another financial institution and the lender will often have unrelated transactions with that financial institution, the mandatory substitution requirement reduces lenders’ ability to obtain protection and exaggerates the exposure created by these independent transactions. If a covered company has purchased eligible credit protection on multiple reference names from an eligible protection provider, the effect is multiplied because the covered company must shift the exposure associated with each reference name.

Because credit and equity derivatives are “derivative transactions” under Section 252.92(p), but also may be “eligible credit derivatives” or “eligible equity derivatives”, the rule read literally would appear to have the consequence (which may be unintentional) of requiring a covered company to include both of those exposures when calculating its exposure to that counterparty even though it would in a sense be counting the same exposure twice. The first exposure arises when the covered company enters into a credit or equity derivative transaction with a counterparty that would be calculated under Section 252.94(a)(10) or (11). The second exposures arises when that credit or equity derivative transaction is an eligible credit or equity derivative and is entered into with an eligible protection provider with respect to a reference name held by the covered company, and the covered company is required to shift the exposure in accordance with Section 252.95(e).

The Proposed SCCL Rules’ substitution requirement would have a significant impact on the ability of covered companies, in particular major covered companies, to continue to provide credit protection. Because of the capital and expertise required to manage a credit default swap trading book, there are relatively few entities that are in a position to offer these services. A consequence of the constraints imposed by the Proposed SCCL Rules is that the availability of these products would

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decrease and the costs would increase. This in turn will limit the ability of major covered companies to manage their risk, as well as limit the risk management options of other market participants. It could also drive this business into the shadow banking market, where it would be both unregulated and opaque.

The Associations recommend that a covered company be permitted to choose whether to shift the exposure to the eligible credit protection provider in accordance with written policies and procedures that are subject to review during the examination process. Such an approach would result in more realistic measures of exposure. For example, a shift generally could be required under a covered company's policies and procedures when the risk posed by the protection provider is highly correlated with the underlying exposure (so-called "wrong way risk"). These policies and procedures would be subject to continuous supervisory review (including, potentially, horizontal review) during the examination process for both substance and implementation. If a shift is not required under a covered company's policies and procedures, the covered company would treat its counterparty exposure to the eligible protection provider as a derivative (with the exposure measured under one of the stress approaches we have proposed or CEM) and would continue to include any net protection sold as an exposure to the reference name (in accordance with Section 252.94(a)(12)). The exposure to the reference name should be measured as suggested in Question 56, taking into account netting pursuant to legally enforceable netting agreements of protection bought and sold within that reference name.

In line with the above, the final rules should clarify that a covered company may net credit protection that the covered company has sold on a reference name with eligible credit protection purchased from an eligible protection provider on the same reference name pursuant to legally enforceable netting agreements. This will have an impact on the amount of the exposure that a covered company would shift to a protection provider when such shift is required under its policies and procedures. The Associations propose that the amount the covered company would shift to the protection provider would be the amount of the covered company's net default exposure value (as described in Question 56) rather than the face amount of the underlying exposure. In this way, reference name exposure and any shift of that exposure to a protection provider would be measured on the same basis – net default with zero recovery.

Finally, irrespective of whether the exposure is shifted, a covered company could still be required under Section 165(d)(2) of Dodd-Frank to modify its reporting to identify the exposure to the eligible protection provider to provide the Federal Reserve with a fuller understanding of the scope of transactions in this market.

C. A VaR-based methodology should be available as an alternative way to measure exposure under repo and securities lending transactions to avoid potentially significant negative consequences for the securities markets.

Under Section 252.94(a)(4), repurchase agreements would be valued at the market value of securities transferred by the covered company to the counterparty plus an add-on representing the collateral haircut applicable to the securities transferred. The haircut is determined by applying a static conversion factor in Table 2 of the Proposed SCCL Rules. Similarly, under Section 252.94(a)(7), securities lending transactions would be valued at the market value of the securities loaned by the covered company to the counterparty plus an add-on representing the collateral haircut applicable to the securities transferred (under Table 2). This add-on approach in both types of transactions provides

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an inaccurate and overstated measure of exposure because the haircuts are excessive in relation to the risk posed by such transactions.

These exposures may also be adjusted, or netted, under Section 252.95. In addition to permitting netting under a bilateral netting agreement for repo and securities lending transactions, Section 252.95 permits a covered company to reduce its gross credit exposure to a counterparty for any transaction, including a repo or securities lending transaction, by the adjusted market value of any eligible collateral. In accordance with the “substitution” rule, however, the covered company must include the “adjusted market value” of the eligible collateral when calculating its gross credit exposure to the issuer of the eligible collateral, among other requirements. Moreover, the “adjusted market value” is defined as the fair market value of the eligible collateral *after* application of the haircut in Table 2. These transactions, therefore, are penalized on both sides—in the “add on” when calculating gross exposure and in the haircut applied to the collateral when reducing gross exposure—which both individually and together result in a gross overstatement of the risk associated with the transaction.

The proposed methodology does not adequately take into account the built-in protections of repo and securities lending transactions—the daily marking-to-market and the posting of additional collateral to make up any shortfall. Nor does it take into account the relationship between the securities lent and non-cash collateral securing the transaction or potential portfolio diversification benefits.

Securities financing markets would be disproportionately affected by the proposal for a number of reasons. First, the add-on included in calculating gross exposure represents a significant increase to the actual exposure. Because securities lending frequently involves equity and other securities that are subject to higher haircuts under Section 252.94 and Table 2, the impact on securities lending is significant. In many cases, the overstatement of the exposure is not sufficiently mitigated by the ability of the covered company to reduce the amount of the exposure to the counterparty in a securities lending transaction through collateral. In addition, the collateral is subject to a haircut, as noted above.

The effects of this calculation methodology will differ depending on the particular circumstances, but the difference will not necessarily have any relationship to risk. In some cases, the covered company may, as part of its regular practice, or because of the size of its aggregate exposure to the counterparty, choose to shift the exposure to the collateral issuer as opposed to the counterparty. This is a workable solution if the covered company does not have significant exposure to the collateral issuer or the collateral is cash or U.S. government or other exempt obligations. In that case, the exposure to the counterparty is reduced by the collateral and there is no exposure to the collateral issuer that needs to be taken into account.¹²

¹² We note, however, that even in the case of collateral that is exempt U.S. government obligations it appears that the collateral still would be subject to the haircut. In other words, when calculating the amount of the exposure to the securities lending counterparty, the covered company would be permitted to deduct the fair market value of those obligations but in addition would have to adjust the value by the collateral haircut in Table 2. In Table 2, the United States would be a sovereign entity with a OECD risk classification of 0-1, and the haircut would be determined accordingly. In light of the fact that the direct obligation would be exempt, we believe the final rule should clarify that no collateral haircut would need to be applied to an obligation, such as a U.S. government obligation, that itself would not be subject to

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The calculation methodology may impose real limits on the ability of a covered company to engage in securities lending transactions, however, if the covered company lends securities to a counterparty to which it is credit-constrained or if the covered company is credit-constrained with respect to the collateral issuer. Based on our preliminary analysis, covered companies are most likely to be credit constrained in the following circumstances:

- High-quality non-U.S. sovereign obligations are frequently posted as collateral to secure securities lending transactions. As a result, a securities lender could become credit constrained with respect to these non-U.S. sovereigns when these transactions are aggregated with all other transactions with such sovereign.
- Because major covered companies are frequent participants in the securities financing markets, the 10% credit limit imposed on exposures between major covered companies and major counterparties may result in severe constraints on credit.

Even with an exemption for high-quality non-U.S. sovereign obligations and a uniform 25% credit limit, covered companies that are active in these markets will experience credit constraints that may limit their ability to provide these services.

A more accurate measure of exposure would alleviate the negative market effects while in no way undermining the intent of Section 165(e). The Associations propose that covered companies be provided the option to calculate net credit exposure for repo and securities lending transactions under a VaR methodology. A covered company would not need separate and distinct approval by the Federal Reserve for this purpose if the covered company has already received approval to use a VaR method for regulatory capital compliance purposes. Because VaR models take in account the type of collateral securing a loan, as well as the relationship between loaned securities and non-cash collateral, they provide a more risk-sensitive measure of actual economic exposure. In addition, covered companies that are active participants in these markets already use a VaR model to calculate regulatory capital requirements and those models have been and will continue to be subject to supervisory review and evaluated by auditors.

Although the Associations believe that the ongoing review to which the VaR models are subject help address concerns about their reliability in times of market distress, if the Federal Reserve determines that allowing firms to utilize their internal VaR-based models would not be appropriate, we propose as an alternative that the final rule permit a covered company to calculate net credit exposure using a simple VaR model with Federal Reserve mandated inputs, in particular, the assumptions and confidence levels.

If the Federal Reserve determines that a VaR-based model is not appropriate, the Associations request that, at a minimum, the Federal Reserve, with input from the industry, develop a new haircut matrix that would be used for calculating exposures to repo and securities lending transactions. The new haircut matrix would assign haircuts taking into account both the securities loaned and the particular collateral posted to capture at least some of the risk-mitigating benefits of that relationship.

the credit limit. A similar clarification should be made with respect to any high-quality non-U.S. governmental obligations if certain qualifications are met as discussed in Part II.F.

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Addressing these issues is critical. Securities financing activities are essential to the liquidity of the securities markets because they enable broker-dealers and their customers to meet security delivery obligations and enable short sales. A constrained securities financing market will have a negative impact on liquidity and efficiency in the broader capital markets, which could lead to constrained trading and settlement failures.

D. The statutory 25% credit limit should not be reduced unless or until there is a basis for determining that a lower limit is “necessary to mitigate risks to the financial stability of the United States,” the required statutory predicate for such a reduction.

In the case of the single-counterparty credit limit, Section 165(e)(2) of Dodd-Frank requires the Federal Reserve to issue regulations prohibiting certain nonbank financial companies and bank holding companies “from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus” of the covered company. The Federal Reserve has *discretion* to—i.e., it “may”—impose a “lower amount” for the single-counterparty credit limit, but only if it first “determine[s] by regulation” that a lower single-counterparty credit limit is “*necessary* to mitigate risks to the financial stability of the United States.”¹³ We believe that there are compelling reasons of both law and policy why that discretion should not and cannot be exercised here.

As a legal matter, the Federal Reserve’s determination to lower the single-counterparty credit limit to 10% for major covered companies is invalid on each of three separate grounds. First, there is no basis for the statement in the NPR that Dodd-Frank “indeed requires” the two-tier approach in the single-counterparty credit limit provisions or that this approach is a “directive” of Section 165,¹⁴ and the NPR cites none. There is no requirement or directive anywhere in Section 165 that the Federal Reserve distinguish between covered BHCs with assets of more or less than \$500 billion with respect to the single-counterparty credit limit, as opposed to distinguishing between all covered BHCs and smaller BHCs. The single-counterparty credit limit, therefore, was adopted under a mistaken interpretation of the statute, which *per se* invalidates the reduction of the credit limit.¹⁵

Second, Section 165(e)(2) deals specifically with the Federal Reserve’s authority to lower the single-counterparty credit limit below the statutorily mandated 25% level and, as mentioned, that authority is narrowly circumscribed. The requisite Federal Reserve determination that such a lower level be “necessary” creates a very high legal bar. As stated in a leading decision, *GTE Service*: “Something is *necessary* if it is *required* or *indispensable* to achieve a certain result.”¹⁶ “Necessary” does not mean “useful.”¹⁷ Rather, “a statutory reference to ‘necessary’ must be construed in a fashion that is

¹⁴ 77 Fed. Reg. at 616.

¹⁴ 77 Fed. Reg. at 616.

¹⁵ *MCI Telecommunications Corp. v. AT&T Co.*, 512 U.S. 218, 229 (1994) (“[A]n agency’s interpretation of a statute is not entitled to deference when it goes beyond the meaning that the statute can bear...”).

¹⁶ *GTE Service Corp. v. F.C.C.*, 205 F.3d 416, 422 (D.C. Cir. 2000).

¹⁷ *Id.* at 422.

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consistent with the ordinary and fair meaning of the word, i.e., so as to limit ‘necessary’ to that which is required to achieve a desired goal.”¹⁸

The D.C. Circuit’s decision in *GTE Services* is particularly relevant here because it was issued in the context of a review of an agency regulation rather than a *de novo* analysis of statutory language. The Court explicitly recognized the *Chevron* analysis of judicial deference,¹⁹ but held that the FCC’s interpretation of “necessary” as “useful” “appear[s] to diverge from any realistic meaning of the statute.”²⁰

If Congress had wanted to adopt a more flexible standard, it certainly knew how to do so. For example, to grant an exemption to the requirements of Section 619 of Dodd-Frank, the Federal Reserve need only show that the exemption “promote[s]” financial stability. The exemption need not be “necessary to promote” financial stability.²¹ This distinction is apparent in other contexts as well. For example, in a leading case involving the Truth in Lending Act, *Mourning v. Family Publication Service, Inc.*,²² the relevant statute authorized rules that were either “necessary or proper” —a more lenient standard than the “necessary” standard that Congress imposed here. Therefore, Section 165(e)(2) requires the Federal Reserve “to apply *some* limiting standard” to its determination to impose a lower single-counterparty credit limit on specified covered companies, one that is “rationally related to the goals of the [Dodd-Frank] Act”: preserving the financial stability of the United States.²³ The Federal

¹⁸ *Id.* at 423 (citing *AT&T Corp. v. Iowa Util. Bd.*, 525 U.S. 366 (1999)) (emphasis added).

¹⁹ *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

²⁰ *GTE Service*, 205 F.3d at 421. We recognize that, in another case, *Cellular Telecommunications*, the word “necessary” has been given a somewhat broader meaning in a particular context. *Cellular Telecommunications & Internet Association v. Federal Communications Commission*, 330 F. 3d 502 (D.C. Cir. 2003). The Court there stressed, however, that its broader reading was appropriate because the context was a “forbearance” statute. *Id.* at 506, 509-513. The statute instructed the FCC to take a certain action and to forbear from that action only upon a petition demonstrating that the action was *not* necessary to protect the consumer. In other words, Congress’ decision could be overridden only if the petitioner could demonstrate that the action was not necessary.

In the case of the SCCL, the statutory context is virtually the opposite. Congress has established a statutory regime and authorized the Federal Reserve to vary from that regime only if the action is necessary. It is understandable that the courts would impose a higher standard when the regulator would be acting contrary to Congress’ general mandate. Moreover, unlike the situation in *Cellular Telecommunications*, a narrow reading of “necessary” for purposes of Section 165 does not produce an “absurd result”. *Id.* at 511.

²⁰ Furthermore, the Court in *Cellular Telecommunications* acknowledged that the “indispensable” standard could be appropriate in a case such as *GTE Service*. *Id.* at 510-11.

²¹ Section 619(d)(1)(J) of Dodd-Frank (emphasis added).

²² 411 U.S. 356, 361–62 (1977).

²³ *AT&T Corp.*, 525 U.S. at 388.

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Reserve's failure to use a definition of "necessary" that is at least similar to the definition in *GTE Service* would also invalidate the reduction of the credit limit.²⁴

Third, the Federal Reserve's Proposed Rule, contains no determination that a lower single-counterparty credit limit is in fact "necessary" to mitigate a threat to the financial stability of the United States—and certainly provides no reasoned explanation for any such finding. For example, the Proposed Rule does not address any of the following questions: What is the nature and extent of the threat to financial stability? Why does the Federal Reserve believe that the 10% limit is the right limit—the one "necessary" to mitigate risks to financial stability? Why institutions with \$500 billion in assets? The Federal Reserve has offered no evidence, explanation, theory, or rationale to support any "necess[ity]" for its proposed 10% single-counterparty credit limit.²⁵

We respectfully submit that, in the absence of an articulated rationale for its determination, the Federal Reserve would not be entitled to deference in a judicial proceeding. An agency's self-professed expertise in performing certain calculations is no substitute for demonstrating how it is actually performing those calculations.²⁶ Because this failure to provide a rationale denies the public of the opportunity to provide any meaningful comment, adoption of a reduction in the credit limit below 25% would be arbitrary and capricious.²⁷

We also submit that, under clear legal precedent, this deficiency cannot be cured by a rationale developed for the first time in a final rule. That approach negates the obligation of notice and opportunity for comment.²⁸ At this point, the Federal Reserve has articulated no basis for concluding that a lower limit is necessary. Without even an initial analysis of the application of the Proposed SCCL Rules to real-life circumstances, it is not possible to support the conclusion that a more restrictive limit for larger companies is "necessary." By failing to articulate a basis for these determinations, the proposal does not abide by a fundamental principle of the APA, which requires that the public have a meaningful opportunity to comment on the basis and rationale for a rule. The APA requires the Federal Reserve to "provide sufficient notice and opportunity to comment for its [proposed rule]."²⁹ The

²⁴ *Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983); *Business Roundtable and Chamber of Commerce v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

²⁵ *See Appalachian Power Co. v. EPA*, 249 F.3d 1032, 1053-54, 1063 (D.C. Cir. 2001) (per curiam) ("There must be an actual reason articulated by the agency at some point in the rulemaking process.").

²⁶ *See, e.g., id.; Bluewater Network v. EPA*, 370 F.3d 1, 21 (D.C. Cir. 2004) ("[I]n order to determine whether that decision reflects a 'rational connection between the facts found and the choice made,' a reasonable explanation of the specific analysis and evidence upon which the Agency relied is necessary. . . . It will not do for a court to be compelled to guess at the theory underlying the agency's action." (internal citations omitted)).

²⁷ *NetCoalition v. SEC*, 615 F.3d 525, 539 (D.C. Cir. 2010) ("[Courts] do not defer to the agency's conclusory or unsupported suppositions."); *U.S. Air Tour Ass'n v. FAA*, 298 F.3d 997, 1008 (D.C. Cir. 2002).

²⁸ *Rep. Airline Inc. v. Dep't of Transp.*, 669 F.3d 296, 299-300 (D.C. Cir. 2012).

²⁹ *Appalachian Power*, 251 F.3d at 1039.

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purpose for this requirement is to ensure that the “most critical factual material” used by the agency” and the terms of its proposal have “been tested through exposure to public comment.”³⁰

But the Federal Reserve has precluded any such testing by not only failing to make the required determination that the 10% single-counterparty credit limit even is necessary to mitigate a threat to the financial stability of the United States, but also failing to provide any such rationale to the public. As a result, market participants are essentially commenting in a vacuum with no insight or guidance from the Federal Reserve regarding the necessity of such lower limit. The Proposed Rule simply fails to afford commenters any *meaningful* opportunity to comment on the statutorily-required basis for the proposed 10% single-counterparty credit limit. Before promulgating the 10% single-counterparty credit limit as a final rule, the Federal Reserve accordingly must afford commenters that meaningful opportunity to confront the Board’s evidence and rationale for why the proposed 10% single-counterparty credit limit is necessary to mitigate risks to the financial stability of the United States.³¹ If the Federal Reserve determines that a lower limit is necessary for a class of covered companies, it should repropose the requirement and clearly explain the basis for any such limit and the corresponding classification of certain covered companies

Moreover, in the absence of an articulated rationale to support the necessity of the 10% single-counterparty credit limit, and with all due respect to its expertise, the Federal Reserve’s apparent *ipse dixit* that 10% is the right amount for the single-counterparty credit limit is wholly insufficient.³² It is well established law that an agency must provide “a rational connection between the facts found and the choice made,” and that the failure to do so is a basis for vacatur of the agency’s action.³³

In any event, the Associations respectfully submit that there is no rational basis for the Federal Reserve to conclude *at this time* that the 10% limit is “necessary” to mitigate risks to the financial stability of the United States. As a policy matter, a 10% single-counterparty credit limit, combined with the calculation methodology flaws described above, could be highly disruptive, reduce market liquidity and loan capacity, drive financial services into the opaque and largely unregulated shadow banking sector, and adversely affect the safety and soundness of banking institutions. Moreover, until the full ramifications of the multiple regulatory, supervisory and other changes are understood, the necessity, and indeed even the desirability, of the proposed 10% single-counterparty credit limit cannot be evaluated.

Dodd-Frank and other legislative, regulatory, and supervisory changes will continue to have a substantial impact on the financial industry in the United States. Because so many significant

³⁰ *Chamber of Commerce of the United States v. SEC*, 443 F.3d 890, 900 (D.C. Cir. 2006) (quoting *Association of Data Processing Serv. Orgs., Inc. v. Board of Governors of the Fed. Reserve Sys.*, 745 F.2d 677, 684 (D.C. Cir. 1984)).

³¹ *Owner-Operator Independent Drivers Ass’n, Inc. v. Federal Motor Carrier Safety Admin.*, 494 F.3d 188, 203 (D.C. Cir. 2007).

³² *NetCoalition v. SEC*, 615 F.3d 525, 539 (D.C. Cir. 2010) (“[Courts] do not defer to the agency’s conclusory or unsupported suppositions.”) (internal citation omitted); *Blewater*, 370 F.3d at 21.

³³ *State Farm*, 463 U.S. at 43; *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

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changes must happen largely at the same time, it is difficult to anticipate what the effect of any one change will be. As a result, where possible, substantial changes in market practice should be approached cautiously and on a sound evidentiary basis, especially where those changes may pose real danger of negative consequences for market liquidity and U.S. financial stability. Accordingly, we believe the more prudent approach is to monitor the impact of the required 25% credit limit in the context of the many other changes affecting the availability of liquidity and the proper functioning of the credit markets before determining whether or at what level a lower limit should be imposed. The Federal Reserve would have the opportunity to review the information regarding credit exposure that would be submitted to the Federal Reserve under the Proposed SCCL Rules and Section 165(d)(2) of Dodd-Frank and use that data to make a more informed decision regarding whether a lower limit is necessary.³⁴

The same principles apply to determining which covered companies should be considered “major covered companies” and which counterparties should be considered “major counterparties.” The NPR does not explain the basis for using a \$500 billion asset threshold to determine which covered companies are major and, therefore, should be subject to a lower credit limit when engaging in covered transactions with similarly sized counterparties. Again we urge caution in establishing a threshold before sufficient information has been gathered and analyzed to assist with this determination.

E. Exposures to certain CCPs should be exempt from the credit limit, at least initially, to support the policy objective of moving most over-the-counter (“OTC”) derivative transactions to central clearing.

A key component of Dodd-Frank is the enhanced regulation of OTC derivatives. Chief among the changes to the OTC derivative markets is the requirement that most OTC derivative transactions be cleared through a regulated CCP. This represents a fundamental shift in the OTC derivatives market and will force the migration of transactions to CCPs. CCPs will be subject to substantial regulation and, in appropriate cases, the FSOC has the authority to determine that a CCP is “systemic” and therefore subject to heightened supervision as a financial market utility.³⁵ All CCPs will be required to develop systems and procedures intended to address member failures, market crises, operational failures and manage exposures.

Despite the heightened scrutiny to which CCPs are or will be subject, and the special role to be played by CCPs in the post-Dodd-Frank market system, the Proposed SCCL Rules would subject exposures to a CCP, including the guaranty and initial and excess variation margin posted to the CCP, to the single-counterparty credit limit on exactly the same basis as it would apply to a credit exposure to a completely unregulated entity. Subjecting exposures to CCPs to the credit limit may discourage covered company market participants from facilitating the clearing of transactions as they become eligible for clearing and affect liquidity in the markets.

Given the mandate to use a CCP for OTC derivative transactions where possible, the regulatory scrutiny to which CCPs are or will be subject, the risk management systems that CCPs must

³⁴ The Federal Reserve will be receiving reports under Section 252.96.

³⁵ See Section 804 of Dodd-Frank.

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implement, and the heightened supervision to which “systemic” CCPs may become subject, it is unnecessary to subject exposure to these entities to the single-counterparty credit limit. Moreover, because there are likely to be so few CCPs, at least initially, subjecting these exposures to the credit limit could have the effect of preventing covered companies from engaging in certain types of transactions altogether and limiting their ability to provide their customers with a full range of products.

To ensure that the exemption applies only to CCPs that meet rigorous standards, the Federal Reserve could limit the exemption to CCPs that meet the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions principles for financial market infrastructures. Over time, the appropriate treatment of CCPs under the single-counterparty credit limit could be determined in the context of framing the regulatory regime that will be applicable to CCPs, both in the United States and globally.

F. Exposures to high-quality non-U.S. sovereign obligations and those sovereigns’ central banks should not be covered by the single-counterparty credit limit.

Section 165 of Dodd-Frank does not cover non-U.S. sovereigns under the credit limit because they are not “companies” under any normal definition.³⁶ Moreover, the NPR provides little discussion or support for subjecting exposure to all non-U.S. sovereigns to the credit limit, nor is there any indication that the consequences of doing so, including the costs and potential damage to U.S. financial institutions and markets, have been weighed against potential supervisory and systemic benefits. The Proposed SCCL Rules would exempt exposures to the U.S. government, but no basis is provided for not also exempting exposure to non-U.S. sovereigns that have liquidity and creditworthiness similar to that of the United States. Such differential treatment in the absence of a reasoned basis on which meaningful comment may be provided is, therefore, unsustainable under the APA. Under the final rule, exposure to high-quality non-U.S. sovereigns should also be exempt.

The coverage of such high-quality non-U.S. sovereigns under the Proposed SCCL Rules could have unintended negative effects on covered companies, our economic and strategic national partners, and market liquidity for non-U.S. sovereign obligations because the 25% credit limit does not accommodate current activity that is important to proper market functioning. The Proposed SCCL Rules may have the effect of forcing covered companies to restrict the acceptance of high-quality obligations issued by non-U.S. governments as collateral and preventing covered companies from placing excess, temporary liquidity with non-U.S. central banks, as is the current practice.

As has been extensively discussed in the comments to Section 619 of Dodd-Frank by covered companies and non-U.S. sovereigns, the liquidity of non-U.S. sovereign obligations relies on the ability of covered companies to invest in them.³⁷ In addition, subjecting high-quality obligations of non-

³⁶ Under the Bank Holding Company Act, the Federal Reserve has explicitly excluded sovereigns from the definition of “company”. 12 U.S.C. 1841(b). Banca Commerciale Italiano, 68 Fed. Res. Bull. 423 (1982); Letter dated August 19, 1988 from William W. Wiles, to Patricia S. Skigen.

³⁷ See letters from: Office of the Superintendent of Financial Institutions Canada, *available at* http://www.federalreserve.gov/SECRS/2012/January/20120111/R-1432/R-1432_122811_88639_481623396475_1.pdf; Canadian Minister of Finance, *available at* http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1432/R-1432_021312_104923_519924448346_1.pdf; Deutsche Bundesbank and BaFin, *available at*

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U.S. sovereigns to the single-counterparty credit limit is in tension with other regulatory reform initiatives, such as the Basel III liquidity framework, which encourage organizations to hold a stock of highly liquid assets. Under the Basel III liquidity framework, marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities, the Bank for International Settlements, the International Monetary Fund, the European Commission, or multilateral development banks that meet certain conditions³⁸ are considered highly liquid assets.

We believe that the inclusion of creditworthy non-U.S. sovereigns and their central banks as “counterparties” will have a significant impact on the balance sheet and liquidity management function at individual covered companies as well as adverse systemic implications. Furthermore, we believe that the resulting limitation on holdings of such instruments may complicate efforts to limit contagion risk. Holdings of instruments and exposures to such entities may be both necessary and beneficial from a risk-management perspective for any covered company with operations in, and exposures to, the relevant jurisdictions.

As noted, the capacity of many covered companies to deal with a number of creditworthy countries with stable economies will be limited by the Proposed SCCL Rules. This will immediately affect covered companies with significant non-U.S. operations for a number of reasons. As one example, an increasing number of jurisdictions are requiring subsidiaries and affiliates of the Associations’ members regulated by those jurisdictions to hold sovereign obligations issued by the relevant jurisdictions in order to meet those jurisdictions’ liquidity rules. Restricting covered companies’ holdings of these instruments will constrain these non-U.S. subsidiaries and the ability of covered companies to operate and compete in those jurisdictions.

http://www.federalreserve.gov/SECRS/2012/February/20120221/R-1432/R-1432_021312_104929_536151947408_1.pdf; U.K. Financial Services Authority, *available at* http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1432/R-1432_022212_105560_462867299076_1.pdf; EU Council of Ministers (ECOFIN), *available at* http://www.federalreserve.gov/SECRS/2012/February/20120228/R-1432/R-1432_022212_105564_326398330626_1.pdf; Mexico CNBV, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021312_105416_439625820801_1.pdf; Banco de Mexico, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_030512_105861_508765807767_1.pdf; The Reserve Bank of Australia, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_022112_105565_411082456530_1.pdf; Chairmen of the *Autorite de controle prudentiel* and the *Autorite des marches financiers* of France and the Head of the French Treasury, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120305/R-1432/R-1432_021412_104999_542080131636_1.pdf.

³⁸ The conditions are that “the securities are assigned a 0% risk-weight under the Basel II Standardised Approach; traded in large, deep and active repo or cash markets characterised by a low level of concentration; proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions; and not an obligation of a financial institution or any of its affiliated entities.” We also understand that the BIS is considering broadening the types of instruments that qualify as highly liquid assets under Basel III.

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Even where such holdings are not specifically required, central bank and sovereign obligations are key elements in banks' response to stress conditions, serving as relatively safe and liquid assets that are important in maintaining liquidity and managing exposures to banks in those jurisdictions. Imposing severe limits on covered companies' holdings of these assets will amplify systemic risk. The recent experience of major banks in responding to the Eurozone crisis is an example of how the use of central bank facilities is important in allowing major financial institutions to maintain sufficient liquidity while at the same time reducing counterparty exposure to financial institutions.

These constraints on holdings of non-U.S. sovereign and central bank obligations will force some covered companies to hold more liquidity at the Federal Reserve or in other instruments where there are no limitations on counterparty concentrations or where the covered company is not constrained. This also could have adverse systemic implications, because some of these institutions would likely then be forced to swap out of "excess" non-U.S. currencies in order to place their excess funds at the Federal Reserve, which could both result in artificial elevation in measures of contagion risk, such as swap spreads relating to the affected currencies, as well as withholding liquidity from other market participants.

For these reasons, we believe that exposures to high-quality non-U.S. sovereigns should be exempt. In determining which non-U.S. sovereigns should be exempt, the criteria used in other related regulatory contexts are instructive. The Associations believe that the same approach to non-U.S. sovereigns recommended by the Associations for inclusion as "highly liquid assets"³⁹ for use under the Proposed Liquidity Rules should be used here as well. Accordingly, the following securities should be exempt from the single-counterparty credit limit:

- sovereign debt securities that are assigned a specific risk-weighting factor of 1.6 or less (equivalent to a risk-weighting of 20% or less under the U.S. banking agencies' Basel I-based capital rules) under the market-risk rules as they are amended; and
- securities issued or guaranteed by the government of a country that is a full member of the Organization for Economic Cooperation and Development or that has concluded special lending arrangements with the International Monetary Fund (which is the current standard under the U.S. banking agencies' Basel I-based capital rules for 20% risk-weighted sovereign securities).

In addition, the Associations propose that the central banks in countries that are identified through these criteria should also be exempt.

G. Individuals should not be covered as "counterparties".

Although Section 165(e) subjects credit exposures to "companies" rather than "persons" to the credit limit, the Proposed SCCL Rules improperly subject credit exposures to individuals and their families as well. The Associations believe that the Federal Reserve should respect the decision and clear intent of Congress not to subject credit exposures to individuals to the credit limit. As noted, the Federal Reserve has provided no explanation or basis for the decision to cover individuals. Nor do the Associations believe any such decision can be justified on the basis of safety and soundness or financial stability, given the extreme unlikelihood that exposure to an individual by a covered company would

³⁹ See Part III.A of *Annex B*.

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ever reach the statutory 25% limit or pose any risk of systemic interconnectivity among “large financial companies” that Section 165(e) was designed to address. On this basis, it would also be unwarranted under any reasonable cost/benefit analysis to require covered companies to develop and maintain the mechanisms for tracking exposure to an individual and the individual’s immediate family for purposes of this limit. Exposures to individuals are already amply covered by existing lending limits and by internal risk management systems of covered companies. Any concern regarding exposures to individuals that may arise out of an attempt to evade the requirements of the single-counterparty credit limit would be covered by the attribution rule in Section 165(e)(4), which applies to a transaction with “any person” where the benefits of the transaction “are used for the benefit of, or transferred to,” a company.

H. A company should “control” another entity only if it consolidates that entity for financial reporting purposes.

Under Section 252.94(a), a covered company is required to include in its calculation of exposure to a counterparty both its own exposure and that of all its “subsidiaries”. Similarly, in aggregating exposures to a counterparty, the covered company (or its subsidiaries) must include all exposure to the counterparty and its subsidiaries. For this purpose, “subsidiary” is defined as a company that is “directly or indirectly controlled by” the covered company, and a company “controls” another company if it (i) owns, controls, or has power to vote 25% or more of a class of voting securities of the company; (ii) owns or controls 25% or more of the total equity of the company; or (iii) consolidates the company for financial reporting purposes.⁴⁰ This definition would be difficult, if not impossible in certain instances, to administer in practice and would subject to the credit limit exposures that do not appreciably increase the risks the rule was designed to address.

Section 165(e) limits the risk that “failure of an individual company” could pose to a covered company by restricting the covered company’s credit exposure to “any unaffiliated company”. The Proposed SCCL Rules, however, calculate credit exposure not only to the “individual company”, or “unaffiliated company”, but to all companies that are in any way affiliated with the company, even where the affiliation may be remote or tenuous and presumes that, because of this affiliation, the individual company is responsible for the obligations of the affiliate or that repayment by the affiliate depends upon the resources of the individual company. We submit that this approach goes far beyond the provisions or intent of the statute to capture the risk of failure of an individual company to a covered company and greatly exaggerates the credit exposure of a covered company to its counterparties.

The main purpose of including subsidiaries of a company in the definition of “counterparty” should be to identify those entities where the covered company is looking to the same source of funds for repayment of the exposure. The approach should be aimed at capturing only those subsidiaries. Minority investments that would be deemed “controlling” under the Proposed SCCL Rules’ expansive definition are common in many industries, and, in most cases, the investing company has no obligation in respect of the “subsidiary’s” obligations beyond its investment in the subsidiary, and would not be required to contribute capital or assume liabilities if the subsidiary were unable to meet its obligations. Nor could the parent counterparty seek to utilize the assets of the minority subsidiary to satisfy its own obligations. As another example of the expansive reach of the Proposed SCCL Rules, if a

⁴⁰ Sections 252.92(j)(j), 252.92(i).

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general partnership or managing member interest is treated as a voting security using a Bank Holding Company Act-type definition, exposure to all of the controlled portfolio companies of all the private equity funds and exposure to the funds themselves could potentially be aggregated. Furthermore, under the Proposed SCCL Rules, a covered company would be required to aggregate each company that has a 25% investment in the counterparty. This could result in the same exposures being aggregated with multiple different counterparties.

There would be practical issues as well with administering the “control” definition in the Proposed SCCL Rules. With respect to the counterparty, covered companies do not have access to information to determine, either initially and certainly not on an ongoing basis, whether the credit exposures of two counterparties should be aggregated where one counterparty has, for example, only a minority investment in another company. For example, it is unlikely that a covered company would have the ability to determine whether a counterparty’s voting equity interest constitutes a separate class of securities if that interest votes together with other classes on some issues, but votes separately on other issues. This type of information is often not publicly available. When indirect subsidiaries are considered, implementation becomes even more problematic. The issue is further complicated when voting and equity ownership are not coterminous; this differentiation is commonplace in a number of widely-used business vehicles such as investment funds and other limited partnerships. If the proposed “control” definition is applied to such entities, the result would be a massively overstated exposure to the companies directly or indirectly comprising fund investments for private equity firms and similar fund management firms.

Similar complications arise with the “control” definition in the context of the covered company itself. Of course, the covered company is in a position to know and track which companies it has an investment in that would meet the “control” definition in the Proposed SCCL Rules. Even in this context, however, the definition remains overly broad. For example, a covered company may make a minority investment in a company that exceeds 25% of a class of voting stock or total equity but still not have the ability to monitor all the transactions in which the company engages or to prevent that company from engaging in credit transactions. Moreover, this approach is again over-inclusive—the covered company must include the entity as a subsidiary for purposes of calculating aggregate exposure while at the same time the covered company does not have the benefit of the “subsidiary’s” capital (in fact, under certain circumstances, the covered company’s investment in the subsidiary may even be deducted from the covered company’s regulatory capital). This is particularly true for collective investment vehicles where the equity and control ownership is not coterminous, but is also generally the case for all minority investments. In effect, this reduces the limit for all covered companies to the extent they must aggregate the exposures of entities that are not consolidated.

To address these concerns, and to ensure a more transparent and accessible test that is much easier to use, we recommend that “control” should be defined for this purpose to include only companies that are consolidated for the company’s financial reporting purposes (e.g., U.S. GAAP or IFRS, as applicable).⁴¹ We believe that this standard is a reasonable proxy for situations where a company will

⁴¹ The Associations also believe that a limited exemption would be appropriate for investment vehicles that are seeded by a covered company, similar to the exemption provided for seeding funds under the Volcker Rule. As part of the process of developing and marketing new investment vehicles, a covered company generally needs to invest its own capital on an initial basis to demonstrate its own commitment to the investment and to provide potential investors with the ability to evaluate the performance record of the investment vehicle. To provide covered companies with the flexibility needed to conduct this key part of

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have responsibility for another company in which it invests. In addition, a covered company's own internal credit risk management policies may require aggregation in other situations, which would address safety and soundness concerns. Revising the definition in accordance with a company's financial accounting consolidation requirements would lessen the burden associated with identifying subsidiaries while still capturing the credit exposures that are likely to concentrate risk.

- I. **The rule should clarify that the daily compliance and monthly report requirements do not require tracking and aggregating exposures to counterparties where the exposures do not approach the credit limit.**

Section 252.96 would require covered companies to be in compliance on a daily basis and to submit on a monthly basis a report demonstrating its daily compliance. In some cases, monitoring compliance on a daily basis is prudent because a covered company may approach the applicable credit limit on a regular basis. In most cases, however, exposures to a counterparty will always be far below the applicable credit limit—whether 25% or 10% (if retained in the final rule). In order to meet the daily compliance requirement, a covered company should not have to aggregate exposures across the organization with respect to each and every counterparty and document what that exposure is every day. The burden of running the calculation for each counterparty on a daily basis when only a relatively small number of counterparties at most will approach the limit would not be justified by any possible supervisory benefit.

Instead, a covered company should be required to monitor on a daily basis only those counterparty exposures that exceed a buffer of a significant percentage of the credit limit (for example, 25%). In this regard, a covered company could be required to have and maintain policies and procedures that are reasonably designed to identify aggregate credit exposures to a counterparty that exceed such buffer. For example, it would be expected that, as part of its regular credit risk monitoring, the covered company would evaluate whether as the result of any change in circumstance exposure to a particular counterparty could exceed the threshold.

In addition, the monthly report required under Section 252.96 should include a report of only the exposures that are within a stated percentage of the limit in order to demonstrate daily compliance rather than requiring a report that lists the aggregate exposure to each counterparty.

- J. **To ensure markets can accommodate the shifts in credit relationships and covered companies have sufficient time to develop the new systems to comply with the rules, the Federal Reserve should exercise its discretion to extend the compliance date to the end of the two-year transition period.**

As noted, the Proposed SCCL Rules could require significant shifting of credit relationships. To achieve this result without disrupting the market unduly, covered companies will need sufficient time to unwind these relationships in an orderly manner.

their asset management businesses, we request that a seeded fund not be considered part of the covered company for a 12-month period from the date of the creation of the fund regardless of whether they are consolidated for U.S. GAAP financial reporting purposes.

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Moreover, as discussed in many contexts above, implementation of the single-counterparty credit limit as proposed would necessitate the development of new systems for monitoring and tracking exposures to all the counterparties of the covered company on a consolidated basis. The extent of the system development that will be required will depend on the approach taken in the final rule. Based on the Proposed SCCL Rules, however, we anticipate that new systems, or enhancements to existing systems, will be required at a minimum for the following purposes:

- Development of monthly reports to demonstrate compliance with the single-counterparty credit limits;
- Daily aggregation of some amount of exposures across the organization and across all business lines;
- Tracking of exposure shifts associated with collateral, guarantees, and credit and equity derivatives;
- Tracking of exposure to issuers of securities on a dual basis—market value and purchase price;
- Measurement of exposures for repo and securities lending transactions and derivative transactions if different from the systems used to comply with IMM or other existing credit risk management models; and
- Modifications to, or a development of, systems to account for the new definitions that would be introduced under the Proposed SCCL Rules, including the “control” definition, and the aggregation requirements for non-U.S. sovereigns and U.S. states.

Based on the sheer number of systems changes required and the amount of additional time required to integrate and test such systems changes so that covered companies can make their required certifications, an October 2013 compliance date is unrealistic.

We urge the Federal Reserve to use the authority granted under the statute to delay the effective date for two years.

III. Other Concerns

A. Counterparty and Covered Company Definitions

1. **Non-U.S. sovereigns and U.S. states, including agencies, instrumentalities, and political subdivisions, should be treated in accordance with their treatment under the lending limit applicable to the covered company’s lead depository institution.**

- a. **Non-U.S. sovereigns**

Section 252.92(k)(5) would include in the definition of “counterparty” a non-U.S. sovereign entity and all of its agencies, instrumentalities, and political subdivisions, collectively. The Associations do not believe this aggregation is reasonable or justified absent some showing that one entity is responsible for the obligations of the other, particularly where the repayment of the credit is

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supported by a defined source of revenue. In addition, this aggregation requirement may lead a covered company to become credit-constrained with respect to a non-U.S. sovereign with all the negative effects on covered companies, non-U.S. governments, and market liquidity discussed above for any sovereign that is not exempted from the credit limit. Such aggregation also would cover situations where the government has taken control of an institution for systemic reasons. In a crisis, aggregating such companies with the government likely would have a procyclical effect of triggering and magnifying a retraction of interbank credit, the very phenomenon at issue in the financial crisis in 2007-2008.

Moreover, because this method of aggregation is inconsistent with covered companies' existing credit risk management practices, covered companies would need to alter existing systems for purposes of complying with this rule, even though it would provide little if any benefit for credit risk management purposes. Rather than impose a new, separate tracking regime on exposures to non-U.S. sovereign entities, the standards under which a covered company's lead subsidiary depository institution would aggregate exposures (*i.e.*, the national bank lending limit or applicable state law lending limit) should be used under the Proposed SCCL Rules as well. The depository institution subsidiaries of covered companies subject to the Proposed SCCL Rules already have systems to measure and monitor these exposures, which could be used to capture exposures organization-wide. In addition, this approach would more accurately capture and aggregate only those exposures that present a true concentration risk.

b. U.S. States

Section 252.92(k)(4) similarly would aggregate a U.S. state and its agencies, instrumentalities, and political subdivisions (including municipalities). As with non-U.S. sovereigns, the Associations do not believe that the proposed aggregation is reasonable or justified absent a showing of financial responsibility between the entities, particularly where there is a dedicated source of repayment for the obligation. For example, there does not appear to be any reasonable basis to aggregate exposures to all municipalities in the same state simply because they are in the same state and irrespective of their local economy, revenues or creditworthiness. In addition, the consolidation of the agencies, instrumentalities, and political subdivisions of a U.S. state with the state also is inappropriate principally because the aggregation method does not accurately capture actual concentration of credit risk.

As with non-U.S. sovereigns, a covered company should be permitted to treat exposures to U.S. states and their agencies, instrumentalities, and political subdivisions in the same manner as its lead insured depository institution is required to under applicable law (*i.e.*, the national bank lending limit or applicable state law lending limit). In some cases this may mean that those exposures are exempt. However, each covered company's existing credit risk management framework, which is subject to supervisory oversight, would still provide ample protection.

At a minimum, exposures to the agencies, instrumentalities, and political subdivisions of a U.S. state should not be aggregated to the extent the obligation is supported only by a defined source of revenue. For example, municipal revenue bonds, which are generally issued to finance public works, are supported directly by the revenues that are derived from the project, and the bondholders do not have any claim on the issuer's other resources. Because of the clear delineation of the obligations, aggregation would not be appropriate in these circumstances.

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2. **Special purpose vehicles should not be deemed to be controlled by or otherwise consolidated with the issuer of the underlying assets or vehicle sponsor and such exposures should be managed under a covered company's credit risk management policies and procedures rather than potentially be subject to a retroactive determination under a proposed reservation of authority.**

The Preamble identifies certain entities that would not be considered subsidiaries, as defined in the Proposed SCCL Rules, but that, in the Federal Reserve's view, may raise the same issues.⁴² In particular, the Federal Reserve notes that under a proposed reservation of authority, the Federal Reserve may look through certain SPVs either to the issuer of the underlying assets in the vehicle or to the sponsor. In some circumstances, under this authority, the Federal Reserve may require covered companies to look through to the underlying assets of an SPV but "only if the SPV failed certain discrete concentration tests, such as having more than 20 underlying exposures."⁴³ If the Federal Reserve determines to exercise this authority, the Associations believe the Federal Reserve should first publish for comment a notice of proposed rulemaking.

As an initial matter, the Associations believe that such entities should be aggregated only where a legal obligation exists to support the entity financially rather than based on subjective, hypothetical possibilities. Moreover, the determination of whether to look through SPVs to an issuer of the underlying assets or the sponsor should align with a covered company's existing internal risk management policies. No look-through should be required if the covered company is not relying on the issuer or sponsor for repayment or if the income stream from the assets in the SPV is sufficient to repay principal and accrued interest. From a business and compliance perspective, a covered company needs certainty regarding the treatment of SPVs. Lack of clarity would require a covered company to develop additional monitoring capabilities for SPVs in case a retroactive determination is made that a particular SPV should be treated on a look-through basis.

3. **Money market mutual funds and other collective investment vehicles should not be included as part of the covered company in the absence of any legal financial support obligation.**

The Federal Reserve specifically asks whether money market mutual funds ("MMMMF") and other funds that the covered company sponsors or advises should be included as part of the covered company for purposes of the Proposed SCCL Rules because a covered company may have strong incentives to provide support in times of distress.⁴⁴ We do not believe that it is necessary or appropriate to include sponsored or advised funds such as MMMFs within the definition of "covered company" in the absence of any legal financial support obligation. With respect to MMMFs, these funds

⁴² 77 Fed. Reg. at 615.

⁴³ *Id.*

⁴⁴ 77 Fed. Reg. at 614.

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are subject to a regulatory framework that has increased their ability to sustain themselves in the face of economic stresses and reduce the risks of large, sudden redemptions of the funds' shares.⁴⁵

With respect to other mutual funds, the market expectation for support is even weaker since they are generally viewed as investment vehicles rather than alternatives to cash. With respect to private equity and similar fund investments that have the ability to limit withdrawals and postpone redemptions during periods of economic stress, there is certainly no expectation of support. As pointed out under the discussion of "control" above, there are practical difficulties of looking through various funds managed by the covered company to determine exposure. Furthermore, such a look-through would result in a massively overstated exposure for the covered company.

Consequently, to address these concerns we recommend that MMMFs and other collective investment vehicles be excluded from the definition of "subsidiary" both for purposes of the covered company (as well as for purposes of the counterparty) absent express support obligations.

B. Other Calculation Methodology Issues

1. The proposed methodology for measuring exposure related to equity and debt securities would provide little, if any, risk management benefit.

With respect to debt securities, gross exposure for trading and available for sale debt securities as proposed would be equal to the greater of amortized purchase price and market value. Equity securities would be held at the greater of the purchase price and market value.

The Preamble states that a floor of purchase price was introduced to protect against the possibility that credit transactions could increase if the security loses value and thereby allows for more credit transactions. This requirement assumes that there are no other risk management mechanisms in place that take account of the creditworthiness of the counterparty and, therefore, the credit limit is necessary to protect against a covered company increasing its exposures to counterparties with impaired credit. As a matter of prudent risk management, the creditworthiness of the counterparty is taken into consideration before entering into any type of credit transaction. The proposed requirement layers purchase price as a floor on top of existing credit risk management practices. The added requirement is not necessary to protect against credit quality risk but at the same time imposes an additional tracking requirement that is not consistent with the existing risk-management systems of covered companies.

The Associations recommend that the exposure to debt and equity securities be measured in accordance with the accounting treatment of the asset utilized by the company under its applicable accounting standards. This would eliminate the need to develop costly new systems to track the market value of the securities relative to purchase price, and would provide a straightforward mechanism for covered companies to distinguish among distinct types of investments in equity securities—for example, equity securities held as part of trading activity as opposed to strategic minority investments.

⁴⁵ See, e.g., Money Market Fund Reform, SEC Release No. IC-29132 (Feb. 23, 2010), 75 Fed. Reg. 10060 (adopting release), available at: <http://www.sec.gov/rules/final/2010/ic-29132fr.pdf>.

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2. Substitution should not be required for guarantees.

As with eligible credit and equity derivatives, Section 252.95(d) would require a covered company to shift the underlying exposure to a guarantor that is an eligible protection provider (up to the amount of the eligible guarantee). As discussed in Part II.B, the substitution requirement overstates risk because it fails to take into account the lower likelihood of double default. Because of this shortcoming, an automatic substitution requirement is not part of covered companies' credit risk management processes. As a result, covered companies would need to develop new systems or undertake significant modifications to existing systems to incorporate this substitution approach. Because requiring substitution for all guarantees would not materially reduce risk to covered companies, the Associations believe that the cost and burden associated with the requirement outweigh any possible supervisory benefit. Accordingly, the Associations recommend that substitution in connection with a guarantee be required only in accordance with a covered company's written credit risk management policies and procedures (as discussed above in Part II.B).

3. If the treatment of credit and equity derivatives is not fundamentally changed in the final rule, clarification of the calculation methodology is needed in several respects.

The calculation methodologies for credit and equity derivatives under Sections 252.94 and 252.95 raise a number of issues that would benefit from clarification in the final rule.

- The Proposed SCCL Rules do not address the situation where a covered company, as part of its credit or equity derivative trading or otherwise, purchases an eligible credit or equity derivative for which it has no underlying reference asset/issuer. We believe that in this circumstance the covered company's gross exposure would be calculated under the methodologies used for other derivative transactions in Sections 252.94(a)(10) or (11).
- As discussed above in Section II.B, because credit and equity derivatives are "derivative transactions" under Section 252.92(p) but also may be "eligible credit derivatives" or "eligible equity derivatives", the rule would appear technically to require a covered company to include both of those exposures when calculating its exposure to that counterparty even though it would in a sense be counting the same exposure twice. This perhaps unintended double-counting is inappropriate, and the final rule should be clear that it is not required.
- The Proposed SCCL Rules do not specifically address exposures to indices, but indices raise some of the same issues discussed in the context of SPVs above. Similar to our position that it is not appropriate generally to look through SPVs, a covered company should not have to look through an index except as otherwise required by a company's internal risk management policy. Requiring a look-through in all cases would be impractical and unnecessary from a risk management perspective.

4. The limitation of the application of the attribution rule to prevent evasions as proposed in the Preamble should be reflected in the rule text itself.

Section 252.94(b) includes the statutory attribution rule, which requires a covered company to treat a transaction with any person as a credit exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of or transferred to that counterparty. We

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appreciate the acknowledgment in the Preamble that “an overly broad interpretation of the attribution rule would lead to inappropriate results and create a daunting tracking exercise for covered companies” and agree that the scope of application of the rule should be limited to preventing evasions.⁴⁶ In other words, the attribution rule should apply only where the covered company effectively has sought to evade a true exposure to one party by structuring the transaction with another party. The Preamble includes a useful example of how broadly the language of the attribution rule itself could be read but where its application would not be appropriate—a situation where a covered company makes a loan to a counterparty that uses the loan proceeds to purchase goods from another person (i.e., are transferred to or benefit the other person). Section 252.94(b) itself, however, does not include this clarification. In light of the broad language of the attribution rule, it is important that the intention to limit the application of the rule to preventing evasions be reflected in the final rule itself.

The term “evasion” would be difficult to define in this context. Even without a definition, however, we believe the language limiting the application of the attribution rule to situations where evasion is present would play an important role in defining the scope of the attribution rule’s application. The final rule also should include, as an example, the example provided in the Preamble that the attribution rule does not apply when a covered company makes a loan to a person that uses the proceeds to purchase goods from another person.

C. Compliance Requirements

- 1. A transition period should be provided for covered companies that become major covered companies and entities that become counterparties or major counterparties to allow all parties to adjust to a potentially more stringent credit limit.**

The Proposed SCCL Rules do not contain a transition period for circumstances where a covered company crosses the “major” threshold. If the “major” determination is retained in the final rules, the Associations recommend that there be a transition period of six months from the date the covered company crosses the asset threshold to allow a company to adjust to the new limits without unduly upsetting existing credit relationships.

In addition, transition periods would be appropriate based on the status of the counterparty in the following circumstances:

- Under Section 252.97(a)(2), credit transactions that are direct claims on, and the portion of claims that are directly and fully guaranteed as to principal and interest by, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are exempt from the limits but only while they are operation under the conservatorship or receivership of the Federal Housing Finance Agency. Significant adjustments will be necessary if and when those entities are no longer under conservatorship. To avoid reduced liquidity and market losses, covered companies would need a period of at least one year to bring those entities within the credit limit.

⁴⁶ The Preamble states that “The Board thus proposes to minimize the scope of application of this attribution rule consistent with preventing evasion of the single-counterparty credit limit.” 77 Fed. Reg. at 618.

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- If a counterparty becomes a major counterparty (other than through merger of two counterparties as provided in Section 252.96(b)(3)), there is no grace period for a major covered company to bring its credit transactions with that counterparty within the proposed lower 10% credit limit. If the 10% credit limit is maintained in the final SCCL rules, a major covered company would need a transition period of six months to bring its exposure to a counterparty that becomes a major counterparty for any reason into compliance with the 10% credit limit.
2. **The final rule should provide a short grace period for a breach of the credit limit with respect to a counterparty provided that the exposure does not exceed the credit limit by more than 25% where the covered company reasonably believes that the breach can be rectified in that time period.**

Without a limited, short-term exception, the credit limits will effectively be set even lower because covered companies will need to establish buffers below the actual limit to protect against inadvertent breaches. This could have the effect of further constraining market liquidity and the availability of credit. A limited exception to the credit limit that includes a short grace period will provide needed flexibility without introducing significant risk.

3. **A limited exemption should be provided for temporary breaches that result from short-term exposures related to payment and settlement services.**

An exemption for operational payments and deposits is necessary to allow covered companies to continue to provide the same level of low-risk services for transaction settlement that they provide today. Requiring a covered company to include in the credit limit exposures that result from temporary overdrafts or delivery failures will result in increased operational and systemic risk and would limit the ability of covered companies to manage operational exposures in a manner consistent with how those exposures are managed by institutions in other jurisdictions.

Although the vast majority of transactional payments settle as expected and, therefore, would be exempt intraday exposures under the Proposed SCCL Rules, on occasion settlement is delayed for a variety of technical, operational reasons beyond the control of the parties. Such delays are explicitly recognized and provided for in a number of other regulatory contexts:

- Under regulations implementing the national bank lending limits, “amounts paid against uncollected funds in the normal process of collection” are excepted from the limit.⁴⁷
- The Federal Reserve’s Regulation F relating to interbank liabilities excludes “exposures related to the settlement of transactions, intraday exposure, and transactions in an agency or similar capacity where losses will be passed back to the principal or other party...”

Regulation F also contains a requirement that a bank should structure its transactions so that the exposure “ordinarily does not” exceed the internal limit, but permits “occasional excesses resulting from unusual market disturbances, market movements favorable to the bank, increases in activity, operational problems, or other unusual circumstances.” In addition, other jurisdictions have

⁴⁷ 12 C.F.R. Part 32.

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recognized the need for an exception to cover operational payments in similar contexts, for example the EC “large exposure” regime.⁴⁸

The Associations recommend that an exemption for such exposures, subject to the following conditions, be included in the final rules:

- The exposure arises in the ordinary course of providing payment and settlement services for transactions, including foreign exchange, securities, derivatives, commodities and similar transactions;
- The covered company has policies and procedures that appropriately govern the credit and liquidity risks of the counterparty and exposures related to payments and settlements, and provide for the daily monitoring of exposures;
- To the extent that the aggregate exposure to the counterparty exceeds the credit limit, the covered company takes appropriate action, consistent with safety and soundness considerations, to reduce the excess exposure as quickly as reasonably practicable and in any event within a reasonable period of time from the day the excess first occurred; and
- The covered company reports the excess exposure to its Federal Reserve Bank not later than the first business day after the excess occurs, and advises as to actions it has taken or will take to eliminate the excess exposure consistent within an appropriate timeframe specified by the Federal Reserve.

This proposal and further description of settlement issues is addressed in a comment letter concerning the Proposed SCCL Rules being submitted by certain custody banks.⁴⁹

4. The grace period in the rule should be automatic rather than subject to Federal Reserve approval and additional credit transactions should be permitted during the grace period under certain circumstances.

As proposed in Section 252.96(b), a 90-day grace period to return to compliance with the credit limit would be permitted in the following cases: for a decrease in capital stock and surplus; merger with another covered company;⁵⁰ merger of two unaffiliated counterparties;⁵¹ or other appropriate circumstances as determined by the Federal Reserve if the covered company uses reasonable efforts to return to compliance during the grace period. The Proposed Rules suggest that none of the grace periods would be granted automatically. Instead, the Federal Reserve would have to

⁴⁸ See e.g., Committee of European Bank Supervisors, Implementation Guidelines on Article 106(2)(c) and (d) of Directive 2006/48/EC, providing exemptions related to clearing, settlement and custody services provided to clients.

⁴⁹ Letter from Northern Trust, State Street, and BNY Mellon to the Federal Reserve dated April 2012.

⁵⁰ We note that other transactions that are similar to mergers, such as stock or asset purchases, should similarly be afforded a grace period.

⁵¹ See footnote 50.

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grant approval.⁵² Because a grace period is permitted in such limited circumstances and those circumstances may be beyond the control of the covered company, the grace period should be automatic for the specified circumstances as well as other circumstances that the Federal Reserve may determine in the future, such as in cases where additional liquidity is needed in the markets during a financial crisis. The requirement that the covered company use reasonable efforts to return to compliance protects against a covered company relying too heavily on the grace period. A covered company could still be required to provide the Federal Reserve with prompt notice of any such breach.

Furthermore, we believe it would be appropriate to permit covered companies to continue to engage in credit transactions during the grace period provided that the covered company can demonstrate that the exposure can be brought into compliance within a reasonable period of time.

D. Other Issues

- 1. The final rule should clarify that any portion of a syndicated loan, letter of credit, or other extension of credit, that has been sold or otherwise transferred, under appropriate conditions, to another third party, is not included in the gross credit exposure to the counterparty.**

The final SCCL rules should reflect the actual credit exposure of each covered company to any given counterparty. When a covered company in any syndicated extension of credit or under a derivative transaction has transferred a participation in that extension of credit or credit exposure to a third party on terms and conditions that extinguish the legal obligation to extend the transferred portion of the credit, the covered company is no longer exposed to the transferred portion of the credit extension or credit exposure.

This approach to loan participations is reflected in the national bank lending limit, which disregards, for the purpose of calculating an originating bank's exposure to a counterparty, any portion of an extension of credit to that counterparty that has been sold as a participation on a nonrecourse basis, provided the participation results in a *pro rata* sharing of credit risk proportionate to retained interests of the originating and participating lenders.⁵³ The final rule should apply the same approach to both loan participations and risk participations in connection with derivatives.⁵⁴

⁵² Section 252.96 states that "In granting approval for such a special temporary credit exposure limit, the [Federal Reserve] will consider the following: (1) A decrease in capital stock and surplus. (2) The merger of the covered company with another covered company. (3) A merger of two unaffiliated counterparties. (4) Any other circumstances the [Federal Reserve] determines is appropriate."

⁵³ See 12 C.F.R. § 32.2(k)(2)(vi).

⁵⁴ Derivative transactions currently are not subject to the national bank lending limit, but will become so as a result of Section 610 of Dodd-Frank.

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- 2. The definition of “eligible collateral” is too limited and should be expanded to include other types of collateral commonly accepted in the market, subject to appropriate haircuts.**

The definition of “eligible collateral” in Section 252.92(q) includes cash on deposit with the covered company (including cash held for the covered company by a third-party custodian or trustee); debt securities (other than mortgage- or asset-backed securities)⁵⁵ that are bank eligible investments; equity securities that are public traded; or convertible bonds that are publicly traded.

The definition of “eligible collateral” is too narrow and could put significant limits on the ability of covered companies to lend on a secured basis. As long as collateral is given appropriate haircuts, there is a broader range of collateral that should be included for these purposes. Permitting a wider range of collateral would be appropriate in light of the fact that the covered company would have to include the exposure to the collateral issuer when calculating compliance with the limits to the extent it relies on that collateral to reduce other exposures. For example, private label asset-backed and mortgage-backed securities are frequently used as collateral today in a variety of credit transactions. As a result, covered companies have had to develop internal methodologies to estimate appropriate haircuts for such collateral, and those methodologies should be applied in this context as well. With appropriate haircuts, expanding the definition of eligible collateral would not materially increase the risk to the covered company nor would it undermine the goal of decreasing interconnectedness.

Furthermore, collateral that meets the “eligible collateral” definition would likely be favored, which could cause a significant decline in the demand for and liquidity of other types of collateral. This may artificially affect the price for eligible versus ineligible collateral. Expanding the definition would help avoid these unintended consequences.

- 3. If the “substitution” requirement is retained, the definition of “eligible protection provider” should be expanded to include other providers that are able to post sufficient high-quality collateral to avoid providing a disincentive to covered companies to purchase protection products.**

The Proposed SCCL Rules permit a covered company to reduce its gross exposure to a counterparty in certain circumstances if the covered company acquires an eligible guarantee or eligible credit or equity derivative if the protection is acquired from an “eligible protection provider”.⁵⁶ In light of the treatment of exposures to an eligible protection provider under the Proposed SCCL Rules, this definition is too narrow.

Under the Proposed SCCL Rules, a covered company may only “net” exposures to a counterparty with protection provided by an eligible protection provider. As a result, protection

⁵⁵ We assume that the exclusion for “mortgage-backed securities” was not intended to include mortgage-backed securities the principal and interest on which are fully guaranteed by the United States, one of its agencies, or Fannie Mae or Freddie Mac (while operating in conservatorship), as these exposures are completely exempted from the credit limit and, thus, should clearly qualify as “eligible collateral”. We request that this clarification be included in the final rule.

⁵⁶ Section 252.92(u).

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provided by a non-eligible protection provider does not replace an existing exposure but simply adds to it. Therefore, despite having purchased protection, a covered company continues to have to recognize the exposure to the initial counterparty for the full amount and must recognize a separate exposure to the non-eligible protection provider (each calculated in accordance with the rule).

With respect to credit and equity derivatives, there are a limited number of market participants among those that would qualify as eligible protection providers that have the infrastructure and capability to provide these products. Consequently, in order to obtain the benefit of the protection under the rule, covered companies will have to turn to a limited number of market participants that generally will be covered companies, which may have the effect of restricting the availability of these products. Among covered companies that would be considered major covered companies under the proposal, the effect is only magnified as most providers of credit and equity derivatives would be major covered companies and, therefore, subject to the 10% credit limit.

If the treatment of exposures to eligible protection providers is not substantially changed in the final rule, the definition of “eligible protection provider” should be expanded to accommodate providers that are capable of posting sufficient, high-quality collateral. This would provide covered companies with alternatives for purchasing protection.

IV. Responses to Questions Posed in the NPR

We have set forth below responses to, or cross-references to discussions in this *Annex C* of, certain specific questions raised by the Federal Reserve with respect to the Proposed SCCL Rules.⁵⁷

As an introductory comment, we note that the multiple questions that refer to a “more conservative” approach may reflect a misunderstanding of how extraordinarily conservative the Proposed SCCL Rules actually are.

Question 20. *How would the limits of section 165(e) and the proposed rule interact with the other existing limits such as the investment and lending limits applicable to banks and what other conflicts might arise in complying with these different regimes?*

The approach taken in the Proposed SCCL Rules imposes an entirely new framework on top of existing lending and investment limits. In many cases the exposure calculation and other requirements of the Proposed SCCL Rules are inconsistent with these existing requirements. Moreover, the imposition of a 10% credit limit on major covered companies would effectively lower the applicable national or state lending limit. We also note that the regime established by the Proposed SCCL Rules conflicts in some respects with similar regimes in other jurisdictions, such as the EC large exposure regime, as discussed in the Introduction.

Question 21. *Should the Federal Reserve consider a longer phase-in for all or a subset of covered companies?*

⁵⁷ As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

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See our comments in Part II.J.

- Question 22.** *Is the approach of including all subsidiaries of a covered company in the definition of covered company for purposes of the proposed rule appropriate? If not, explain why not.*

See our comments in Part II.H.

- Question 23.** *Should the Bank Holding Company Act/Regulation Y definition of “control” be adopted for purposes of the proposed rule? Are there alternative approaches to defining when a company is a subsidiary of another the Board should consider?*

The Bank Holding Company Act/Regulation Y definition of “control” should not be adopted for purposes of the Proposed SCCL Rules. The administrative difficulties described in Part II.H would be infinitely compounded if that definition of control with its subjective “controlling influence” prong were relied on. Indeed, administration could become a true impossibility.⁵⁸ Moreover, the rationale for a broad definition of control under the Bank Holding Company Act is not relevant to the Proposed SCCL Rules. See our comments in Part II.F for a discussion of our proposed alternative approach to define “control” in accordance with consolidation requirements under a covered company’s applicable accounting standard.

- Question 24.** *Since a covered company may have strong incentives to provide support in times of distress to MMMFs and certain other funds or vehicles that it sponsors or advises, the Board seeks comment on whether such funds or vehicles should be included as part of the covered company for purposes of this rule. Is the proposed rule’s definition of “control” effective, and should the proposal’s definition of “subsidiary” be expanded to include any investment fund or vehicle advised or sponsored by a covered company or any other entity?*

See our comments in Parts II.F and III.A.3.

- Question 25.** *Should the definition of “counterparty” differentiate between types of exposures to a foreign sovereign entity including exposures to local governments? Should exposures to a company controlled by a foreign sovereign entity be included in the exposure to that foreign sovereign entity?*

See our comments in Part III.A.1 on types of exposures and aggregation of entities with a non-U.S. sovereign entity.

- Question 26.** *Should certain credit exposures to foreign sovereign entities be exempted from the limitations of the proposed rule—for example, exposures to foreign central banks necessary to facilitate the operation of a foreign banking business by a covered company?*

⁵⁸

This is even more so the case because of the facts and circumstances nature of the Bank Holding Company Act control analysis.

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See our comments in Part II.F.

- Question 27.** *How should exposures to SPVs and their underlying assets and sponsors be treated? What other alternatives should the Federal Reserve consider?*

See our comments in Part III.A.2.

- Question 28.** *Are the measures of “capital stock and surplus” in the proposed rule effective in light of the intent and purpose of section 165(e) or would a measure of “capital stock and surplus” that focuses on tier 1 common equity be more effective? What other alternatives to the proposed definition of “capital stock and surplus” should the Federal Reserve consider?*

The Associations support the measure of “capital stock and surplus” in the Proposed SCCL Rules. Similar definitions are used in other comparable regulatory contexts, such as the national bank lending limit, which will help align regimes with similar purposes.

- Question 29.** *What other limits or modifications to the proposed limits on aggregate net credit exposure should the Federal Reserve consider?*

See our comments in Parts II.A – C and Part III.B. In addition, aggregate net credit exposure should include a mechanism for reducing exposure to take account of legally enforceable set-off netting.

- Question 30.** *Should the Federal Reserve adopt a more nuanced approach, like the BCBS approach, in determining which covered companies should be treated as major covered companies or which counterparties should be considered major counterparties?*

The Associations do not believe that any reduction in the credit limit is appropriate until there has been a thorough and reasoned quantitative impact analysis and an opportunity for meaningful comment on the rationale for any such reduction. See our comments in Part II.D.

- Question 31.** *Should the Federal Reserve introduce more granular categories of covered companies to determine to appropriate net credit exposure limit? If so, how could such granularity best be accomplished?*

See our comments in Part II.D and our response to Question 30.

- Question 32.** *Should the Federal Reserve supplement the net credit exposure limit with limits on gross credit exposure for all covered companies or a subset of covered company, i.e., major covered companies? Explain why or why not?*

The concentration limit is aimed at mitigating undue risk. Measuring exposure on a gross basis only and thereby not taking into account risk mitigants, such as netting, collateral and credit protection, would grossly overstate risk and actual exposure and would not be justified.

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Question 34. *What transactions, if any, should be exempt from the definition of credit transaction?*

See our comments in Part II.F, footnote 41 and Part III.C.

Question 35. *What alternative or additional valuation rules should the Federal Reserve consider for calculating gross credit exposure?*

See our comments in Part II.A and III.B.

Question 36. *What impediments to calculating gross credit exposure in the manner described above would covered companies face?*

See our comments in Part II.A and III.B.

Question 37. *Does the requirement to use the greater of purchase price or market value introduce significant burden for covered companies? Would the use of the market value alone be consistent with the purposes of section 165(e)?*

See our comments in Part III.B.1.

Question 38. *The Federal Reserve seeks comment on all aspects of the proposed approach to calculating gross credit exposures for securities financing and derivative transactions, including the add-on in the proposed gross valuation rule for repurchase agreements and securities lending transactions.*

See our comments in Parts II.A and C.

Question 39. *Should margin posted and contributions to a CCP guaranty fund be considered a credit exposure for purposes of the proposed rule? The Federal Reserve recognizes that there are competing policy concerns in considering whether to limit a covered company's exposure to central counterparties. The Federal Reserve seeks comment on the benefits and drawbacks of such limits.*

See our comments in Part II.E.

Question 40. *The Federal Reserve requests comment on whether the proposed scope of the attribution rule is appropriate or whether additional regulatory clarity around the attribution rule would be appropriate. What alternative approaches to applying the attribution rule should the Federal Reserve consider? What is the potential cost or burden of applying the attribution rule as described above?*

See our comments in Part III.B.4.

Question 41. *Should the list of eligible collateral be broadened or narrowed?*

See our comments in Part III.E.2.

Question 42. *Should a covered company be able to use its own internal estimates for collateral haircuts as permitted under Appendix G to Regulation Y?*

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See our comments in Part III.D.2.

- Question 44.** *What is the burden on a covered company associated with the proposed rule's approach to changes in the eligibility of collateral? Should the Federal Reserve instead consider introducing stricter collateral haircuts for collateral that ceases to be eligible collateral?*

As discussed in Part III.D.2, the Associations believe that the definition of "eligible collateral" should be expanded as long as appropriate haircuts are assigned to the collateral.

- Question 46.** *Alternatively, should eligible collateral be treated the same way eligible guarantees and eligible credit and equity derivative hedges are treated (as described below), thus requiring a mandatory look-through to eligible collateral?*

For the same reasons we support optional shifting to the protection provider, we would not support a mandatory look-through for collateral.

- Question 48.** *In what ways should the definition of eligible protection provider be expanded or narrowed?*

See our comments in Part III.E.3.

- Question 50.** *Should covered companies have the choice of whether or not to fully shift exposures to eligible protection providers in the case of eligible guarantees or to divide an exposure between the original counterparty and the eligible protection provider in some manner?*

See our comments in Part III.B.2.

- Question 51.** *Would a more conservative approach to eligible guarantees be more appropriate to penalize financial sector interconnectedness—for example, one in which the covered company would be required to recognize gross credit exposure both to the original counterparty and the eligible protection provider in the full amount of the original credit exposure? What other alternative approaches to the treatment of eligible guarantees should the Federal Reserve consider?*

We believe that the term "penalize" in this question illustrates an erroneous view of the role of interconnectivity among financial institutions in the financial crisis. See our comments in the introduction of this Annex C.

- Question 53.** *What alternative approaches, if any, should the Federal Reserve consider to capture the risk mitigation benefits of proxy or portfolio hedges or to permit covered companies to use internal models to measure potential exposures to sellers of credit protection?*

See our comments in Parts II.A and B.

- Question 54.** *Should covered companies have the choice to recognize and shift exposures to protection providers in the case of eligible credit or equity derivative hedges or to apportion the exposure between the original counterparty and the eligible protection provider?*

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See our comments in Part II.B.

- Question 55.** *Would a more conservative approach to eligible credit or equity derivative hedges be more appropriate, such as one in which the covered company would be required to recognize gross notional credit exposure both to the original counterparty and the eligible protection provider?*

See our comments in Part II.B.

- Question 56.** *Rather than requiring firms to calculate gross trading exposures and offset that exposure with eligible credit and equity derivatives or short positions, should the Federal Reserve allow covered companies to use internal pricing models to calculate the net mark-to-market loss impact of an issuer default, applying a zero percent recovery rate assumption, to all instruments and positions in the trading book? Under this approach, gains and losses would be estimated using full revaluation to the greatest extent possible, and simply summed. For derivatives products, all pricing inputs other than those directly related to the default of the issuer would remain constant. Similar to the proposed approach, only single-name and index credit default swaps, total return swaps, or equity derivatives would be included in this valuation. Would such a models-based approach better reflect traded credit exposures? If so, why?*

See our comments in Part II.B.

- Question 57.** *Are there additional non-compliance circumstances for which some cure period should be provided?*

See our comments in Part III.C.

- Question 58.** *Is the 90-day cure period appropriate and is it appropriate to generally prohibit additional credit transactions with the affected counterparty during the cure period? If not, why not?*

See our comments in Part III.C.

- Question 59.** *Is the scope of the exemption for direct claims on, and the portions of claims that are directly and fully guaranteed as to principal and interest by, the United States and its agencies appropriate? If not, explain the reasons why in detail and indicate whether there are alternatives the Federal Reserve should consider. Are there other governmental entities that should receive an exemption from the limits of the proposed rule?*

The scope of the exemption for claims that are directly and fully guaranteed as to principal and interest by the United States and its agencies should be clarified to apply to Federal Family Education Loan Program securities where the underlying loans are U.S. government-guaranteed but the security itself is not.

See our comments in Part II.C, footnote 12, and Part D.II, footnote 55.

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Question 60. *Should other credit exposures be exempted from the limitations of the proposed rule. If so, explain why?*

The Associations believe that the Proposed SCCL Rules represent an overly broad and inappropriate expansion of Section 165(e), for example, the coverage of high-quality non-U.S. sovereigns and individuals. In addition, we believe an exemption is appropriate for CCPs as discussed in Part II.F.

Proposed Risk Management Rules (Subpart E) – Risk Management¹

The importance of effective risk management has long been recognized by financial regulators and the industry. In 2006, then Federal Reserve Governor Susan Bies noted that “[a]t the Federal Reserve, we believe that all banking organizations need good risk management.”² An even earlier report by the industry-sponsored Committee on Sponsoring Organizations of the Treadway Commission (COSO) proposed an integrated framework for enterprise-wide risk management, which has been a model for many companies.³

Recent market events have caused financial regulators and the industry to focus even greater attention on risk management. For example, the Senior Supervisors Group, which includes financial supervisors from each of the major industrialized countries, has issued two reports that assess risk management practices during and after the global banking crisis.⁴ These reports are referenced in the Preamble.⁵

Dodd-Frank imposes additional risk management requirements on certain BHCs and nonbank financial companies supervised by the Federal Reserve. Section 165(b) of Dodd-Frank directs the Federal Reserve to establish enhanced risk management standards for covered institutions. Further, Section 165(h) of Dodd-Frank requires all BHCs with more than \$10 billion in assets and all nonbank financial companies supervised by the Federal Reserve to establish a risk management committee of the Board of Directors, and it directs the Federal Reserve to issue rules implementing that requirement. The Proposed Risk Management Rules and the governance provisions in the Proposed Liquidity Rules have been published in response to these statutory directives.

The Associations acknowledge the importance of effective enterprise-wide risk management, and support the intent of the Proposed Risk Management Rules and governance provisions of the Proposed Liquidity Rules. Indeed, the companies covered by these rules already have expended significant resources to enhance sound risk management and control functions. Nonetheless, the Associations are concerned that some of the provisions in these rules are overly prescriptive and potentially counterproductive.

Our chief concern is that the Proposed Risk Management Rules and the governance provisions in the Proposed Liquidity Rules would place operational responsibilities on a company’s board and risk committee that would interfere with the ability of the board and risk committee to exercise effective supervision of the company. As such, these rules would produce results contrary to their

¹ Capitalized terms used but not defined in this Annex have the meanings assigned to them in the Comment Letter to which this Annex is attached.

² Governor Susan Schmidt Bies, “A Bank Supervisor’s Perspective on Enterprise Risk Management,” Enterprise Risk Management Roundtable, North Carolina State University, Raleigh, North Carolina (Apr. 28, 2006).

³ COSO Enterprise Risk Management – Integrated Framework (2004).

⁴ *Observations on Risk Management Practices during the Recent Market Turbulence* (Mar. 6, 2008), and *Risk Management Lessons from the Global Banking Crisis of 2008* (Oct. 21, 2009).

⁵ 77 Fed. Reg. at 622.

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purpose. We also have concerns related to the structure of the risk committee and the role of the chief risk officer.

We make several recommendations below to address our concerns with the Proposed Risk Management Rules. Our recommendations would establish a clearer distinction between the role of a board and its committees and the role of management. They also would replace some of the overly prescriptive features of the Proposed Risk Management Rules with some general directives that we believe would be equally or even more effective in promoting sound risk management. Our recommendations addressing our concerns with the governance provisions in the Proposed Liquidity Rules are discussed in Parts II.B and II.C of *Annex B*.

We believe that with our proposed changes, the Proposed Risk Management Rules would establish risk management standards that are more stringent than the regulatory requirements applicable to companies not covered by the rules. For the first time, all covered companies would be required, by regulation, to have a board committee chartered to address risk management and that committee would be responsible for approving a comprehensive risk management framework for the company. Additionally, for the first time, larger BHCs and nonbank financial companies subject to supervision by the Federal Reserve would be required, by regulation, to have a chief risk officer who is charged with general risk management responsibilities.

This Annex is divided into seven parts. Part I is an executive summary; Part II addresses the functions of the risk management committee; Part III addresses the structure of the risk management committee; Part IV addresses the role of the chief risk officer; Part V addresses the relationship between these rules and other supervisory standards; Part VI addresses the use of risk management as a trigger in the early remediation framework; and Part VII addresses certain specific questions posed by the Federal Reserve in the Preamble.

I. Executive Summary

The Associations' key recommendations and concerns with respect to the Proposed Risk Management Rules are as follows:

- The Proposed Risk Management Rules blur the distinction between the proper oversight role of the board and management's responsibility for day-to-day operations in several areas. The Proposed Risk Management Rules should consistently preserve the distinction between a board's oversight role and management's operational role. Otherwise, boards and board committees will be overwhelmed with duties that impair their ability to provide independent, effective and objective supervision to the company. The risk management committee should approve and oversee risk management policies developed and recommended by management. Similar issues are raised by the corporate governance provisions of the Proposed Liquidity Rules.
- Effective risk management requires the oversight of the board and the involvement of various board committees. The final rules should explicitly acknowledge the Board of Directors' authority to allocate the oversight of certain, specific risk management responsibilities to appropriate board committees, such as an audit, credit or finance committee. Absent such a clarification, the Proposed Risk Management Rules could result in the duplication of risk management oversight functions and lead to less effective risk management.

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- The definition of “risk management expertise”, as applied to the risk committee, should be replaced with a definition patterned after the SEC’s definition of an “audit committee financial expert”. Moreover, an effective risk committee can benefit from members with diverse backgrounds, including senior operational and managerial roles with nonbanking firms, who could provide useful and effective input into operational, strategic and reputation risks. We recommend that only one member of the risk committee be required to have “risk management expertise” as that term is appropriately defined. We also recommend that only the chair of the risk management committee be required to be independent. Although an independent chair can help ensure that the committee is sufficiently independent of management and committed to compliance with its charter, the deliberations of the committee may be enhanced by management and other non-independent directors with a sound understanding of the risks facing the company.
- The chief risk officer should not be required to have “risk management expertise” as defined under the Proposed Risk Management Rules. Instead, management and the board should be able to determine what combination of skill, experience and education is appropriate for the chief risk officer given the company’s culture, business, strategy and risk profile.
- The Proposed Risk Management Rules should not mandate dual reporting by the chief risk officer to the risk committee, or require the chief risk officer to report directly to the chief executive officer. Although we believe the chief risk officer should have clear access to, and regular meetings or contact with, the risk committee and chief executive officer, no single corporate governance model is appropriate for all organizations, and dual reporting would impair effective risk management by complicating the relationship between management and the board.
- The Proposed Risk Management Rules provide for the chief risk officer to provide direct oversight of a granular list of responsibilities and fail to acknowledge that the chief risk officer works with, and through, the individual business and staff functions in the company. These rules should instead be less granular in design and acknowledge the primary role of business units and corporate staff in risk management.

II. Functions of Risk Management Committee

- A. The risk management committee should not be charged with operational responsibilities. It should be directed to approve risk management policies that are material to the enterprise-wide risk profile of the company and that are recommended by management and to hold management accountable for implementing the policies. Collectively, these policies would constitute the company’s risk management framework.**

The Proposed Risk Management Rules provide that the risk management committee should document, review and approve the company’s enterprise-wide risk management practices.⁶ The Proposed Risk Management Rules further provide that the committee shall oversee the operation of a risk management framework that is commensurate with the company’s capital structure, risk profile,

⁶ Section 252.126(c).

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complexity, activities and size, and that this framework include: (i) risk limitations for each business line; (ii) policies and procedures for risk management governance, risk management practices, and risk control infrastructure; (iii) processes and systems for identifying and reporting on risks and risk management deficiencies; (iv) monitoring compliance with the company's risk limit structure and policies and procedures related to risk management governance, practices and risk controls; (v) effective and timely implementation of corrective actions to address risk management deficiencies; (vi) specification of management and employees' authority and independence to carry out risk management responsibilities; and (vii) integration of risk management control objectives in management goals and the company's compensation structure.⁷

This detailed mandate blurs the distinction between the oversight role of the board and board committees and the operational role of management. One of the fundamental features of corporate governance is the distinction and balance between the role of a company's Board of Directors and the company's management. It is generally recognized that the board is responsible for oversight of a company, and management is responsible for the day-to-day operations of the company. This distinction and balance is embedded in state law,⁸ federal corporate law,⁹ and international standards,¹⁰ as well as prior guidance issued by the Federal Reserve.¹¹ It permits a board to stand above and apart from the day-to-day operations of the company and thereby bring a broader strategic and policy perspective, as well as independent judgment, to the company.

To preserve the appropriate distinction between the board and board committees and management, we recommend that Section 252.126(c) of the Proposed Risk Management Rules not require the committee to approve risk management "practices", including the features of the risk management framework listed in Sections 252.126(c)(1) – (7). The term "practices" may be interpreted to reach each and every activity that a company undertakes to identify, measure, monitor and control risk. Such a requirement would overwhelm the committee, and impair its ability to focus on the most important existing or emerging risks facing the company and "look at the big picture" from a more

⁷ Sections 252.126(c)(1)-(7).

⁸ Delaware courts, for example, have equated a director's duties with a responsibility to exercise oversight of the company, and have found that directors cannot be held liable for a failure to exercise their duties absent "a sustained or systematic failure of the board to exercise oversight." See *In re Caremark International Inc. Derivative Litigation*, 698 A. 2d 959, 971 (Del. Ch. 1996). Also, in *Schoonejongen v. Curtiss-Wright Corp.*, 143 F. 3d 120 (3rd Cir. 1998) the court noted that "[T]he ability to delegate is the essence of corporate management, as the law does not expect the board to fully immerse itself in the daily complexities of corporate operation."

⁹ SEC Regulation S-K, Item 407(h) requires proxy statements to "disclose the extent of the board's role in the risk oversight of the registrant..." (emphasis added).

¹⁰ "The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's ... risk strategy...", Principles for Enhancing Corporate Governance, Basel Committee on Banking Supervision, October 2010, page 7 (emphasis added).

¹¹ "Boards of directors are responsible ...for establishing clear policies regarding the management of key risks...", Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles, SR 08-8 (October 16, 2008) (emphasis added).

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balanced perspective. Even a more limited interpretation, however, would still perpetuate a confusion between the responsibilities of the board and those of management.

We further recommend that the risk management committee be directed to approve only those risk management “policies” that are material to the enterprise-wide risk profile of the company that are developed by management. Collectively, these policies would constitute the company’s risk management framework.

We believe that such policies should include the following:

- Policies governing the identification and control of emerging risks;
- Policies governing key risk parameters, tolerances and limitations;
- Policies governing the company’s risk management governance structure;
- Policies governing risk compliance monitoring and corrective actions to address risk management deficiencies;
- Policies governing the authority and independence of employees engaged in risk management; and
- Policies governing the integration of risk management in the company’s goals and compensation structure.¹²

In addition to the approval of these policies, the risk management committee should be expected effectively to challenge the recommendations of management and to hold management accountable for the implementation of the policies.

B. The governance provisions of the Proposed Liquidity Rules should not impose operational responsibilities on the board or the risk committee.

In addition to the overall risk management framework discussed above, the Proposed Liquidity Rules impose detailed liquidity risk management responsibilities on the board and/or the risk committee of the board. Examples of the types of specific responsibilities that would be imposed upon the board or the risk committee include: the board must establish liquidity risk tolerance annually, and must conduct a semi-annual review of the company’s compliance; the risk committee or a subcommittee of the risk committee must review and approve liquidity costs, benefits and risks of each new business line and each significant product line; the risk committee or a subcommittee of the risk committee annually must review each significant business line and product for unanticipated liquidity risk; and the risk committee or a subcommittee of the risk committee must review data related to

¹² As noted below in Part III.A., the *Interagency Guidance on Sound Incentive Compensation Policies* provides that the board, itself, or a compensation committee of the board, should have primary responsibility for overseeing the incentive compensation framework for a covered company. Consistent with that guidance, we expect that in most circumstances the risk committee would seek to oversee the integration of risk management principles into the company’s compensation framework through appropriate interactions with the full board or its compensation committee.

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liquidity risk compliance. Some of these obligations go well beyond the oversight function of the board and a board committee. *See* Parts II.B and II.C of *Annex B* for a more complete discussion of our concerns with the governance provisions in the Proposed Liquidity Rules and our recommendations for addressing those concerns.

III. Structure of the Risk Management Committee

- A. The Proposed Risk Management Rules should acknowledge a board’s responsibility to allocate risk management oversight responsibilities to various committees. Otherwise, the rules could result in the duplication of risk management oversight functions and lead to less effective risk management.**

The Proposed Risk Management Rules require the maintenance of an enterprise-wide risk committee by each publicly-traded BHC with more than \$10 billion in assets, each BHC with more than \$50 billion in assets, and each nonbank financial company designated for supervision by the Federal Reserve under the terms of Section 113 of Dodd-Frank.¹³

The Associations support the maintenance of a board committee that oversees enterprise-wide risk management. One committee of the board, working in coordination with other committees and the board, as a whole, should have the responsibility for looking at risk across the entire company. Section 252.126(a), however, may be interpreted to place sole responsibility for risk management within this committee. Effective risk management is not an isolated function within a particular board committee.

Effective risk management requires the oversight of the board and the involvement of various board committees. For example, where applicable, the credit committee of a board typically has responsibility for overseeing credit risk and the finance committee typically has responsibility for overseeing interest rate risk and liquidity risk. Additionally, audit committees of public companies have certain responsibilities related to risk management. The rules of the New York Stock Exchange require audit committees to address the company’s policies on risk assessment and risk management.¹⁴ Audit committees also may have primary responsibility for monitoring and overseeing risk associated with a covered company’s consolidated financial statements and related internal controls (including those applicable under the Sarbanes-Oxley Act and the Federal Deposit Insurance Corporation Improvement Act of 1991). Furthermore, consistent with Federal Reserve guidance, compensation committees may have primary responsibility for overseeing risks associated with a covered company’s incentive compensation arrangements.¹⁵

¹³ Section 252.126(a). For purposes of this requirement, the term “enterprise-wide risk committee” would be defined in Section 252.125(g) to mean a board committee that “oversees the risk management practices of such company’s worldwide operations.”

¹⁴ NYSE Listing Company Manual Section 303A.07(b)(iii)(D). The commentary to this requirement reads, in part, as follows: “While it is the job of the CEO and senior management to assess and manage the listed company’s exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company’s major financial risk exposures and the steps management has taken to monitor and control such exposures.”

¹⁵ *See Interagency Guidance on Sound Incentive Compensation Policies*, 75 Fed. Reg. 36396, 36402 (June 25, 2010).

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Given the important role various board committees may perform in the oversight of risk management, the Associations recommend that Section 252.126(a) not only direct a board to establish a risk committee that oversees risk on an enterprise-wide basis, but also acknowledge the board's authority to allocate the oversight of certain, specific risk management responsibilities to appropriate board committees. If the primary purpose of the enterprise-wide risk committee is to oversee enterprise-wide risk management practices of a company, then Section 256.126(a) should specifically permit the committee to aggregate information received from other board level committees addressing specific risks (e.g., the audit committee or credit committee).

Absent such a clarification, the risk management committee could be expected to duplicate risk management oversight functions performed by other board committees. Such a result would complicate the governance of risk management and could lead to less, not more, effective risk management. The enterprise wide-risk committee should, however, maintain appropriate lines of communication with other board committees that have primary responsibility for overseeing other material risks to the company. Those lines of communication should assist the risk committee, as well as other board committees with risk responsibilities, to assess the potential impact of the combination of, or inter-linkages between, risks under the primary oversight of separate committees.

Finally, in the Preamble, the Federal Reserve asks how it can ensure that the risk committee has sufficient resources to carry out its proposed oversight role.¹⁶ We agree that effective risk management requires a combination of trained personnel and systems. We also believe, as discussed above, that the risk committee should be required to approve a policy on the company's risk management governance structure, and that policy could require the allocation of sufficient resources for the risk management function.

B. Covered companies should be given the flexibility to determine how to structure the enterprise-wide risk management committee.

The Proposed Risk Management Rules require that the risk committee maintained by BHCs with more than \$50 billion in assets and nonbank financial companies supervised by the Federal Reserve not be housed within another board committee or be part of a joint committee.¹⁷ In other words, large BHCs and nonbank financial companies supervised by the Federal Reserve must maintain "stand alone" risk management committees. This requirement places form over function.

The Board of Directors of large BHCs and nonbank financial companies subject to supervision by the Federal Reserve should be given sufficient flexibility to determine how to structure the enterprise-wide risk management committee based upon the company's business strategy and risk profile. In order to give companies this flexibility, we recommend that Section 252.126(b)(5)(i) be deleted. We note, moreover, that it is common practice for a risk committee at the holding company level to also serve as the risk committee for subsidiaries, such as subsidiary banks, where such a risk committee is needed. This practice can be quite helpful in assisting the risk committee of both the parent holding company and the subsidiary bank in understanding, monitoring and evaluating the risks facing the relevant organization, including the risks arising from the activities of affiliated entities. Holding company risk committees and subsidiary risk committees will often have overlapping

¹⁶ Preamble, Question 67.

¹⁷ Section 252.126(b)(5)(i).

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membership with meetings that are held simultaneously. We do not believe that proposed Section 252.126(b)(5)(i) was intended to prohibit the use of joint *risk* committees by a covered company and its significant subsidiaries and respectfully request that this be made clear in any final rule.

C. The board committee responsible for enterprise-wide risk management should be chaired by an independent director, but other members of the committee need not be independent.

The Proposed Risk Management Rules require that the board committee responsible for enterprise-wide risk management be chaired by an independent director.¹⁸ For purposes of this requirement an independent director would be defined to mean an individual who: (i) is not an officer or employee of the company; (ii) has not been an officer or employee of the company during the preceding three years; (iii) is not an immediate family member of such an individual; and (iv) is classified as independent under SEC Regulation S-K, Item 407(a)(17 C.F.R. 229.407(a)).¹⁹

We support the requirement for an independent chair of the risk committee. An independent chairperson who sets the agenda for the committee and guides its deliberation can help to ensure that the committee is sufficiently independent of management and committed to compliance with the charter of the risk committee.

We also support the proposed definition of independence. The definition is consistent with existing SEC standards and is similar to the standard applicable to public companies listed on the New York Stock Exchange.²⁰ Consistency with these existing standards will enhance compliance and avoid confusion and conflict.

In the Preamble, the Federal Reserve asks if the regulation should include additional qualifications for independence,²¹ and if more than one member of the enterprise-wide risk committee should be independent.²² Given the consistency with other standards for independence, we see no need for the regulation to include additional qualifications for independence. Nor do we see a need to require additional members of the risk committee to be independent. Although many companies may choose to include more than one independent member, participation on the risk committee by management and other non-independent directors can enhance the deliberations of the committee because these individuals will have a sound understanding of the risks facing the company.

¹⁸ Section 252.126(b)(3).

¹⁹ Section 252.125(i).

²⁰ New York Stock Exchange Listed Company Manual, Section 303A.02.

²¹ Preamble, Question 61.

²² Preamble, Question 62.

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- D. As applied to the risk committee, the definition of “risk management expertise” should be patterned after the SEC’s definition of “audit committee financial expert”. Also, only one member of the risk management committee should be required to have such expertise.**

The Proposed Risk Management Rules require that at least one member of the risk committee have “risk management expertise” commensurate with “the company’s capital structure, risk profile, complexity, activities, size, and other appropriate risk related factors.”²³ For purposes of this requirement, risk management expertise would be defined as (i) an understanding of risk management principles and practices, and (ii) experience in developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing risk controls.²⁴

In addition to this requirement, the Federal Reserve states in the Preamble that “a risk committee’s members generally will have an understanding of risk management principles and practices... [and] should also have experience developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing risk controls...”²⁵ Also, in the Preamble, the Federal Reserve asks if it should specify minimum qualifications, including educational attainment and professional experience, for risk management expertise on a risk committee.

The Associations support a requirement for one member of the risk committee to have risk management expertise. It is not realistic, however, to require a risk expert to have experience in the “monitoring and testing” of risk controls. This language suggests that an individual must have experience with the compliance or audit function of a banking organization to qualify as having “risk management expertise”. Such a requirement would be unduly limiting and could well prevent well qualified individuals with substantial risk management experience from performing the functions contemplated by the Proposed Risk Management Rules. Moreover, the practices related to the monitoring and testing of risk controls are still evolving and relatively few individuals have direct experience with such practices.

We also are concerned that, as proposed, Section 225.125(l) places an emphasis on risk management experience within a banking organization, as opposed to other types of organizations. Insurance companies, securities broker-dealers and other financial institutions are exposed to many of the same types of risk as covered companies, and individuals with substantial risk management experience at nonbank financial companies should not automatically be prejudged as lacking “risk management expertise”. Indeed, individuals with such backgrounds would provide an informed, but less insular, management perspective to the committee’s deliberations. This is also important given that banking organizations already have difficulty locating qualified individuals who are willing and able to serve on the board, particularly given limitations on having interlocking directors under the Federal Reserve’s Regulation L and corporate fiduciary issues that may arise when a director serves on boards of banking organizations that compete in the same market. We note, moreover, that the “risk management expertise” of any individual (including an individual with experience with a nonbank

²³ Section 252.126(b)(2).

²⁴ Section 252.125(l).

²⁵ 77 Fed. Reg. at 624 (Jan. 5, 2012).

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financial company) would have to be commensurate with the company's capital structure, risk profile, complexity, activities, size and other appropriate risk related factors.²⁶

Given these concerns, the Associations recommend that, for purposes of the risk management committee, the Federal Reserve replace the proposed definition of risk management expertise with a definition patterned after the SEC's definition of an "audit committee financial expert".²⁷ This would require that the "risk management expert" have an understanding of risk management, an ability to apply the principles of risk management, and experience in applying those principles. This approach also would acknowledge that such attributes could have been acquired through experience as a risk officer for an organization or within a business unit, experience supervising a risk officer, or experience overseeing overall risk management at a banking organization, depository institution, or other financial company.

Finally, we are quite concerned about the commentary in the Preamble, which suggests that all members of the risk committee have risk management expertise. Such a bias would exclude individuals who could bring an informed perspective on key risk issues to the committee. For example, individuals who have had senior operational and managerial roles with nonbanking firms could provide useful and effective input into operational, strategic, and reputation risks. We urge the Federal Reserve to acknowledge that a risk committee composed of a variety of individuals, with different operational and managerial experiences, can help the committee identify and address the various types of risks facing a company.

IV. Chief Risk Officer

A. Management and the board should have the authority to determine the qualifications of the chief risk officer.

The Proposed Risk Management Rules require the chief risk officer to have risk management expertise commensurate with the company's capital structure, risk profile, complexity, activities and size.²⁸ Also, the Federal Reserve has asked if it also should specify minimum qualifications for the chief risk officer.²⁹

²⁶ Section 252.126(b)(2).

²⁷ 17 C.F.R. 407(d)(5). An audit committee financial expert is a person who has: (i) an understanding of generally accepted accounting principles and financial statements, (ii) the ability to assess the general application of such principles in connection with accounting for estimates, accruals and reserves, (iii) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities, (iv) an understanding of internal control over financial reporting, and (v) and understanding of audit committee functions. SEC Regulation S-K, 407(d) further specifies appropriate education and experience through which such attributes shall have been gained, such as experience as a principal financial or accounting officer or auditor, or experience actively supervising such a person or other relevant experience.

²⁸ Section 252.126(d)(1).

²⁹ Preamble, Question 68.

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As noted above, we believe that the “risk management expertise” required of a member of the risk committee should be aligned with the SEC’s definition of an “audit committee financial expert”. In the case of the chief risk officer, however, we believe that management and the board should be able to determine what combination of skill, experience, and education is appropriate for the chief risk officer given the company’s culture, business strategy and risk profile. Management and the board are in the best position to understand the company and decide what skill set is most appropriate for the company. We also disagree with the Federal Reserve’s expectation, as expressed in the Preamble, that risk management skills gained in particular business line may not be appropriate for another business line or an organization engaged in a diverse set of activities.³⁰ Although the risks associated with different financial businesses may vary, the basic principles of risk management can be transferrable between different types of financial businesses and organizations, and somewhat varied experience can often introduce additional helpful objectivity into an organization’s risk management process. Accordingly, we recommend that Section 225.126(d)(1) be revised to delete the reference to “risk management expertise”, and that no minimum qualifications be specified for the chief risk officer, other than that the individual’s qualifications are commensurate with the company’s capital structure, risk profile, complexity, activities, and other risk-related factors.

If the Federal Reserve does not adopt this recommendation, then, at a minimum, the definition of risk management expertise, as applied to the chief risk officer, should be modified to remove the requirement that such expertise include “monitoring and testing risk controls” and should acknowledge that individuals with risk management experience at nonbank financial companies may have “risk management expertise”. As discussed above, those standards would place unnecessary and overly prescriptive limits on the pool of individuals who have “risk management expertise”.

B. The chief risk officer should not be subject to a mandatory dual reporting requirement or required to report directly to the chief executive officer.

The Proposed Risk Management Rules require that the chief risk officer report directly to both the risk committee of the board and the chief executive officer of the company.³¹ Close interaction and full and frank communication between the chief risk officer and the risk committee is important for effective risk management. We do not believe, however, that it is appropriate for the Proposed Risk Management Rules to mandate that the chief risk officer be subject to a dual reporting requirement to the risk committee. Dual reporting would have the effect of separating the chief risk officer from a company’s senior management team and complicate the relationship between management and the board. As such, it would have the unintended consequence of impairing, rather than enhancing, risk management. We believe that the objectives of the Proposed Risk Management Rules would be better achieved by providing that the risk management governance policies of a covered company require the chief risk officer to have clear access to the risk committee and meet with the committee on a regular basis, including, as appropriate, in executive sessions with the committee.

We also acknowledge that the chief risk officer should be part of the senior management team for a company. However, we believe that the Proposed Risk Management Rules should not require that the chief risk officer report directly to the chief executive officer. The chief risk officer should have clear access and regular contact with the chief executive officer, but no single

³⁰ 71 Fed. Reg. at 625.

³¹ Section 252.126(d)(3).

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corporate governance model is appropriate for all organizations. We recommend that individual companies be given sufficient flexibility to establish reporting arrangements based upon their business strategies and risk profiles.

C. The Proposed Risk Management Rules should acknowledge the role of business units and corporate staff in risk management.

The Proposed Risk Management Rules provide that the chief risk officer would oversee “directly” the following responsibilities on an enterprise-wide basis: (i) allocating delegated risk limits and monitoring compliance with such limits; (ii) implementation of, and ongoing compliance with, policies and procedures related to risk management governance, practices, and risk controls as well as monitoring compliance with such policies and procedures; (iii) developing appropriate processes and systems for identifying and reporting risks and risk management deficiencies, including emerging risks, on an enterprise-wide basis; (iv) managing risk exposures and risk controls within the parameter of the company’s risk control framework; (v) monitoring and testing the company’s risk controls; (vi) reporting risk management deficiencies and emerging risks to the enterprise-wide risk committee; and (vii) ensuring that risk management deficiencies are effectively resolved in a timely manner.³²

This list of responsibilities includes matters not appropriately assigned to risk managers. Specifically, the development of processes and systems for identifying and reporting risks is often a function of information technology groups (with appropriate input from other areas), and the monitoring and testing of the company’s risk controls is a function of the audit or finance group. These are important functions, but are more properly managed by other parts of an organization.

Additionally, the requirement that the chief risk officer “directly” oversee these functions fails to acknowledge that the chief risk officer works with, and through, the individual business units and staff functions in the company. Individual business units within a company have a primary role in managing risks in their businesses, including identifying risks, setting risk limitations, and monitoring risk exposures. It is the business units that are most closely involved in the day-to-day operations of the lines of business, and must translate risk management policies into operational practices and procedures. The chief risk officer should have a sufficient degree of autonomy from the business units, but have sufficient seniority within the company to oversee the decisions of the business units and be able effectively to challenge risk decisions that affect the business units.

Given the foregoing concerns, the Associations recommend that Section 252.126(d)(4) be revised to be more general in design, yet comprehensive in nature. Specifically, we recommend that the chief risk officer be required to perform the following duties:

- Oversee the development of the risk management policies that constitute the company’s risk management framework;
- Guide senior management in their risk management responsibilities;
- Bring a risk-focused perspective to strategic planning, including the identification of emerging risks;

³² Sections 252.126(d)(4)(i)-(vii).

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- Provide central oversight of the company's risk management organization and risk management functions;
- Review and have input upon the risk management functions of the business units and staff functions; and
- Report, as appropriate, to the company's board and risk committee.

V. The Relationship Between the Proposed Risk Management Rules and Other Standards

A. The Proposed Risk Management Rules should be harmonized with risk management standards imposed by other financial regulators.

The Associations recognize that the risk management standards required under Section 165 of Dodd-Frank must be more stringent than the standards applicable to nonbank financial companies and BHCs that are not subject to Section 165. Subsidiaries and affiliates of a covered company, however, may be subject to standards imposed by other regulators. For example, the OCC imposes extensive risk management standards on a national bank that may be the largest subsidiary within a BHC structure.³³ Therefore, we urge the Federal Reserve to harmonize, and avoid conflict, with risk management standards imposed by other financial regulators.

B. The Federal Reserve and other financial regulators should avoid the imposition of the enhanced risk management standards to smaller institutions that are not subject to the Proposed Risk Management Rules.

As noted above, the prudential standards required under Section 165 of Dodd-Frank are intended to be more stringent than the standards applicable to institutions that pose little, if any, risk to the financial stability of the United States. We urge the Federal Reserve, and other financial regulators, to be mindful of this statutory distinction and not impose these more stringent standards on smaller institutions that are not covered by the Proposed Risk Management Rules. Smaller institutions, by their very nature, have more streamlined and simpler governance structures than large institutions, and should not be held to the same standards as large institutions.

VI. Early Remediation

One of the proposed triggers for early remediation is a company's "compliance" with the enhanced risk management and risk committee requirements outlined above.³⁴ In the earlier parts of this Annex and *Annex B* we have recommended some changes to the Proposed Risk Management Rules and the Proposed Liquidity Rules to clarify the role and responsibilities of the board, the risk

³³ See Comptroller's Handbook for Large Bank Supervision, January 2010.

³⁴ A company may be subject to Level 1 early remediation if it exhibits "weakness" in meeting the enhanced risk management and risk committee requirements. Level 2 early remediation may be required if a company demonstrates "multiple deficiencies" in meeting the enhanced risk management and risk committee requirements. Finally, Level 3 early remediation may be triggered if a company is in "substantial noncompliance" with the enhanced risk management and risk committee requirements.

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committee, and senior management (including the chief risk officer). Those changes not only would enhance compliance with the rules, but also should facilitate supervisory review of compliance.

Nonetheless, we are concerned that an assessment of a firm's compliance with risk management requirements could be quite subjective, and this could present significant problems for a company under the Proposed Early Remediation Rules.

To address that concern, we recommend, in *Annex F*, that the Federal Reserve establish a materiality threshold for the application of risk management compliance in connection with the Proposed Early Remediation Rules. Such a threshold would ensure that immaterial non-compliance with the risk management standards is not a basis for early remediation.

VII. Responses to Specific Questions.

We have set forth below responses to, or cross-references to discussions in this *Annex D* of, certain specific questions raised by the Federal Reserve with respect to the Proposed Risk Management Rules.³⁵

Question 61. *Should the Federal Reserve consider specifying by regulation additional qualifications for director independence? If so, what factors should the Federal Reserve consider in establishing these qualifications?*

See our comments in Part III.C.

Question 62. *Would it be appropriate for the Federal Reserve to require the membership of a risk committee to include more than one independent director under certain circumstances? If so, what factors should the Federal Reserve consider in establishing these requirements?*

See our comments in Part III.C.

Question 63. *Should the Federal Reserve consider specifying by regulation the minimum qualifications, including educational attainment and professional experience, for risk management expertise on a risk committee?*

See our comments in Part III.D.

Question 64. *What alternatives to the requirements for the structure of the risk committee and related requirements should the Federal Reserve consider?*

See our comments in Part III.A – D.

Question 65. *What is the appropriate role of the members of the risk committee in overseeing enterprise-wide risk management practices at the company and is that role effectively addressed by this proposal?*

³⁵ As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

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See our comments in Parts II.A and III.A – B.

Question 66. *Is the scope of review of enterprise-wide risk management that this proposal would require appropriate for a committee of the board of directors? Why or why not?*

See our comments in Parts II.A and III.A – B.

Question 67. *How can the Federal Reserve ensure that risk committees at companies have sufficient resources to effectively carry out the oversight role described in this proposal?*

See our comments in Part III.A.

Question 68. *Should the Federal Reserve consider specifying by regulation the minimum qualifications, including educational attainment and professional experience, for a CRO? If so, what type of additional experience or education is generally expected in the industry for positions of this importance?*

See our comments in Part IV.A.

Proposed Stress Test Rules (Subparts F and G) – Supervisory and Company-Run Stress Test Requirements¹

As evidenced by the Supervisory Capital Assessment Program (“SCAP”) and the subsequent Comprehensive Capital Analysis and Review (“CCAR”) process, the Associations agree that credible and robust stress tests can be invaluable tools for capital planning, provide important information to market participants and serve to enhance the stability of the financial system as a whole.

Nevertheless, we have a number of concerns and recommendations regarding certain aspects of the NPR’s implementation of the stress test requirements of Section 165(i) of Dodd-Frank. Our comments are centered around four main areas: (i) aspects of the stress test process itself, including the need for greater transparency into the Federal Reserve’s models for implementing the supervisory stress tests and more comprehensive guidance with respect to exactly what standards will be used to analyze the company-run stress tests; (ii) the content and scope of stress test results disclosure; (iii) the need for coordination among the multiple and overlapping stress test requirements applicable at multiple levels within the same consolidated banking organization pursuant to the Proposed Stress Test Rules and the concurrent OCC² and FDIC³ proposed stress test regulations; and (iv) the importance of consistency in the probability and severity of the supervisory stress scenarios in light of the interplay between annual supervisory stress tests and the Federal Reserve’s capital plan guidance creating an effective minimum capital requirement that can change from year to year as the stress test scenarios change.

Part I of this *Annex E* summarizes our comments on the Proposed Stress Test Rules in an Executive Summary; Part II focuses on the stress test process and our recommendations with respect thereto; Part III sets forth our thoughts and suggestions concerning the disclosure of stress test results; Part IV centers around the need for coordination among overlapping stress test requirements and the Federal banking agencies to avoid burdensome duplication; Part V addresses certain aspects of the interplay between annual supervisory stress test results and related capital requirements; Part VI sets forth our requests for clarification concerning certain aspects of the Proposed Stress Test Rules; and Part VII references our responses to certain of the specific questions posed in the Preamble to the NPR.

I. Executive Summary

As detailed further below, the Associations strongly believe that:

- The design of the supervisory models, techniques and underlying assumptions to be used as part of the stress test process should be transparent and subject to public consultation and input

¹ Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

² OCC’s *Annual Stress Test Notice of Proposed Rulemaking*, 77 Fed. Reg. 3408 (Jan. 24, 2012) (the “OCC Stress Test NPR”, and the proposed rules set forth in the OCC Stress Test NPR, the “Proposed OCC Stress Test Rules”)

³ FDIC’s *Annual Stress Test Notice of Proposed Rulemaking*, 77 Fed. Reg. 3166 (Jan. 23, 2012) (the “FDIC Stress Test NPR” and the proposed rules set forth in the FDIC Stress Test NPR, the “Proposed FDIC Stress Test Rules”).

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before adoption and implementation for purposes of the Proposed Stress Test Rules. This will avoid prolonged “blackout” periods for equity offerings.

- The Federal banking agencies should work collectively effectively to minimize the duplicative burden of the multiple and overlapping stress test requirements of the Proposed Stress Test Rules and the OCC’s and FDIC’s respective stress test rules, including by consistently using the same supervisory stress test scenarios and models for purposes of the supervisory and the company-run stress tests and formulating common inter-agency information reporting requirements.
- The CCAR 2012 disclosure template should generally be used for disclosure of both supervisory and company-run stress tests under Section 165(i) of Dodd-Frank and the Federal banking agencies’ respective proposed stress test rules, at least for covered companies with consolidated assets of \$50 billion or more.
- Under no circumstances should the Federal Reserve disclose, or should covered companies be required to disclose, base case stress test results or other information that could be used effectively to reverse-engineer earnings guidance or other quarter-by-quarter results under either the supervisory or company-run stress test requirements of the Proposed Stress Test Rules.
- Publication of summary results under the adverse scenario (as opposed to the severely adverse scenario) should not be required, except in situations where the covered company’s results under the severely adverse scenario indicate it would fail to meet the 5% minimum common equity requirement, for purposes of either the annual supervisory and company-run and mid-year company-run stress tests.
- The company-run stress tests to be performed under the Proposed Stress Test Rules should be deemed to fully satisfy the separate stress test requirement of the Capital Plan Rule in order to minimize further potential inconsistencies and duplicative burdens on covered companies.
- In order to ameliorate the negative effects of what in reality is a variable or floating minimum capital requirement created by the interaction of the Proposed Stress Test Rules and the Capital Plan Rule, the Federal Reserve and the other banking agencies should adopt a uniform approach for identifying supervisory stress scenarios (which would apply absent exigent circumstances) so that changes from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be. An example would be using consistent severity and minimum probability of occurrence benchmarks.
- The completion of stress testing and related supervisory evaluation process should not hinder or otherwise delay covered companies’ ability to take necessary strategic capital actions not otherwise set forth in previously approved capital plans.

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II. Concerns and Recommendations Regarding the Stress Test Process

A. The design of the models used as part of the stress test process should be transparent and subject to an appropriate public consultative process.

1. Well in advance of implementation by the Federal Reserve, there should be greater transparency into the details and mechanics of the models to be used in conducting the annual supervisory stress tests and evaluation of banks' proposed capital plans.

The macro-economic assumptions of the supervisory stress scenarios required by Section 165(i) of Dodd-Frank and the Proposed Stress Test Rules are but one component of the stress test process.⁴ Equally important are the models, methodologies, techniques and underlying assumptions the Federal Reserve will use to calculate each covered company's "projected losses, revenues and other factors affecting capital"⁵ when applying the stress scenarios to a particular covered company's portfolio and planned capital actions. The results of the supervisory stress test are important for several reasons, not in the least for purposes of the Capital Plan Rule and the effective 5% floating capital requirement discussed in Part V below. As such, we believe it is crucial that covered companies possess the requisite information to understand fully the models and their underlying assumptions and methodologies by which the Federal Reserve will conduct the supervisory stress tests and any weaknesses and limitations inherent in such models (particularly as applied to the idiosyncratic business and risks of an individual covered company) well in advance of the next round of supervisory stress tests and capital plan reviews. Banks' understanding of the Federal Reserve's modeling assumptions (e.g., how the hypothetical timing of credit losses and magnitude assumptions regarding operational risk factors such as mortgage securitization put-back liabilities) is quite important not only in the stress testing context, but, perhaps more fundamentally, in how banks consider and develop their capital plans pursuant to the Capital Plan Rule. The more transparent the Federal Reserve and other agencies are in describing and disclosing the methodologies and assumptions underlying the models they use for supervisory stress tests, the more effective they will be in their supervision of capital adequacy.

The absence of this information places substantial strain on publicly-traded BHCs seeking to sell common equity securities during the stress test process. BHCs may find it difficult to market common stock at a time when the company's capacity to pay dividends is subject to key unknown factors. In effect, this could create a multi-month blackout period, which could have a pro-cyclical impact in times of high market volatility.

A substantial number of the covered companies that were subject to the CCAR 2012 process felt that they lacked sufficient information concerning the supervisory models and methodologies to fully understand, analyze and reconcile the Federal Reserve's results, which, in certain instances were materially different from those generated by the banks' models under the same supervisory scenario. Such differences in results are by necessity a result of the Federal Reserve and covered companies applying different models and assumptions to the same macro-economic scenarios. We strongly believe that the lack of adequate transparency into the supervisory models will have

⁴ 77 Fed. Reg. at 629.

⁵ *Id.*

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negative on-going consequences for covered companies' capital planning and stress testing processes as banks will be unable to predict with any degree of accuracy how the Federal Reserve will model the banks' losses under the specific stress scenarios. Simply put, covered companies will not be able to engage in effective capital planning if the models and methods employed in supervisory stress testing remain an opaque "black box". We do not believe it is appropriate for covered companies' capital planning and distribution decisions to be governed by models and methodologies that have never been subject to any prior review and input by them.

Moreover, because Section 165(i) mandates "summary" disclosure of company-run stress test results (see Part III below), without an understanding of the models and underlying assumptions used by the Federal Reserve, covered companies will find it challenging to explain differences in their own stress test results and those run by the Federal Reserve. The largely inexplicable disclosure of these differences would only serve to heighten the "black box" effect and lead to market confusion concerning annual (and even semi-annual) stress test results.

We strongly disagree with any suggestion that transparency into the supervisory models and their underlying assumptions would somehow enable banks to "game" the system or otherwise lead to turning the capital planning and stress testing processes into mechanical compliance exercises as opposed to encouraging covered companies to develop and improve their own risk management and capital planning functions. The Proposed Stress Test Rules require company-run stress tests the results of which will be reviewed by the Federal banking regulators. We believe that the company-run stress test process is the proper supervisory forum for ensuring that the Capital Plan Rules and the Proposed Stress Test rules encourage and result in enhanced risk management and capital planning processes by covered companies. The Federal Reserve and the other Federal banking agencies already possess a wide array of tools as part of their examination and supervisory powers to ensure that this will indeed be the case. As a policy matter, the reason for banks to "fail" the stress tests and therefore face objections to their proposed capital distributions should be because they do not have sufficient capital, not because they do not understand the Federal Reserve's models and underlying assumptions. It is simply unfair to ask a bank to pass a test – and manage towards the standards of that test – if the parameters are largely unknown or otherwise opaque. Doing so is functionally similar to establishing a minimum risk-based capital ratio, but then not publishing the rules explaining how banks are to calculate their risk-based assets for complying with the ratio.

Although the Associations commend the Federal Reserve's publication of the CCAR 2012 supervisory methodologies "frequently asked questions" document⁶ and the announcement of the formation of the Model Validation Council as well as the up-coming stress testing best practices symposium,⁷ we continue to strongly urge that the Federal Reserve provide full and detailed explanations of methodologies, models, techniques and underlying assumptions the Federal Reserve will use well in advance of the next round of supervisory stress tests and capital plan reviews. In this regard, we respectfully submit that the Federal Reserve should provide much more detailed and specific guidance concerning its models and related methodologies than was previously published in connection

⁶ Federal Reserve, "*Frequently Asked Questions: Supervisory Methodologies in CCAR 2012*" (Apr. 20, 2012) ("**CCAR 2012 Supervisory Methodologies FAQs**").

⁷ Press Release, Federal Reserve, *Fed announces stress test advisory council, publishes FAQs on CCAR 2012* (Apr. 20, 2012).

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with the results of CCAR 2012.⁸ Aspects of CCAR 2012 stress testing methodology related information published heretofore by the Federal Reserve have been useful and instructive, but the models themselves continue to be described only in fairly general terms, with important methodological particulars being left open or vague. It is this continued lack of meaningful detail and specificity that furthers the problematic supervisory stress testing “black box”. To the extent that such disclosure would involve details and other information that the Federal Reserve believes would constitute confidential supervisory information that would not be appropriate for public disclosure, we believe such details could nevertheless be provided on a confidential basis by the Federal Reserve to covered companies as part of the normal supervisory process. Such information would be subject to the strong protections already provided by the Federal Reserve’s rules on disclosure of confidential supervisory information.⁹ Although such information may have some value after completion of the supervisory stress tests, we believe only detailed prior disclosure will be effective in eliminating the “black box” aspects of the supervisory stress tests.

2. The Federal Reserve should engage in an appropriate public consultative process and be open to input in the design of the models to be used for purposes of the supervisory stress tests and the Capital Plan Rule.

The design of models to predict losses and timing of losses on a wide variety of loan portfolios, including mortgages, home equity lines of credit, commercial and industrial loans, commercial real estate, and credit card and other consumer loans, provisions, revenue, losses and timing of losses on securities portfolios, and trading losses given particular macro-economic scenarios is an inherently difficult process, where there can be more than ample room for reasonable disagreement concerning assumptions, techniques, and methodologies. There is a similar range of views as to both the potential and timing of operational losses, such as litigation. The Associations respectfully request that, before implementing or materially modifying a particular set of models for purposes of the supervisory stress tests and the Capital Plan Rule, the Federal Reserve should provide a detailed description of the models in the form of consultative “white papers”, and give covered companies and other appropriate parties an opportunity to provide their views concerning the mechanics of such models either directly or through normal supervisory channels. While the recently announced Model Validation Council and the stress testing best practices symposium are first steps, we believe that the foregoing recommended public consultative process would be most constructive if conducted with the benefit of banks having the opportunity to first preview and analyze the detailed information concerning the models set forth for such purposes in such “white paper” and thereby making the supervisory stress test and Capital Plan Rule processes more effective and enhancing their utility from a supervisory perspective. As appropriate, these consultative “white papers” could supplement more granular information provided covered companies through the supervisory process to facilitate their actual stress testing and capital planning activities.

⁸ See CCAR 2012 Supervisory Methodologies FAQs; see also Federal Reserve, *Comprehensive Capital Analysis and Review 2012: Methodology and Results for Stress Scenario Projections* (March 13, 2012). Aspects of this publication were useful and instructive, but the models used in CCAR 2012 themselves are not disclosed or described, except in the most general terms.

⁹ See 12 C.F.R. § 261.20(g).

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B. The Federal banking agencies should provide more comprehensive guidance with respect to the standards by which the company-run stress tests will be analyzed.

The Associations recognize that the Preamble and the Proposed Stress Test Rules do provide some specific information concerning timing and other concrete process mechanics, as well as some level of guidance with respect to the methods and standards by which the Federal Reserve and the other banking agencies will evaluate the company-run stress tests.¹⁰ Such guidance is, however, general in nature and, in certain instances, is at a fairly high level of abstraction. The guidance that has been provided heretofore lacks specificity as to how exactly and under what specific standards the Federal Reserve and other banking agencies intend to review the results of company-run stress tests, including whether the Federal banking agencies plan to use the supervisory stress models to examine the mid-year company-run stress tests.¹¹ We believe that the Federal banking agencies should provide to covered companies, either formally through the relevant adopting releases or more informally through the supervisory and examination process, additional guidance concerning, among other things, the standard of review and analysis process with respect to the company-run stress tests prior to implementation of such rules pursuant to Section 165(i) of Dodd-Frank. The Associations believe such additional guidance will be crucial to enable covered companies to better implement the company-run stress test process by aligning their processes and procedures to regulatory expectations.

C. The completion of the stress testing and related supervisory evaluation process should not hinder or delay covered companies' ability to take necessary strategic capital actions not otherwise set forth in previously approved capital plans.

In connection with CCAR 2012 at least, the Federal Reserve appears to have taken the informal position that a covered company may not seek to change its outstanding capital plan, including with respect to dividends and stock buy-backs, throughout the stress test process. This could prove problematic since, pursuant to the Proposed Stress Test Rules, the annual supervisory stress test process potentially runs from mid-November to early April of the next year.¹² The annual company-run stress test process has a similar time line.¹³ In addition, there is also the mid-year company-run stress test process which would run effectively from mid-May to mid-October of each year for over \$50 billion covered companies.¹⁴ The inability of covered companies to respond, with any degree of promptness and for prolonged periods of time, to changes in market conditions will unnecessarily restrict timely and otherwise proper strategic decisions. Thus, the Associations believe that covered companies should, subject to proper prudential regulatory consultation, be able to take capital actions not otherwise contemplated or approved in a previous capital plan and related stress test process in response to changing market conditions or other opportunities during periods in which stress testing is otherwise pending.

¹⁰ See, e.g., 77 Fed. Reg. at 627-629.

¹¹ See, e.g., 77 Fed. Reg. at 632.

¹² 77 Fed. Reg. at 627-628.

¹³ *Id.* at 631.

¹⁴ *Id.*

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D. The Federal banking agencies should provide the supervisory stress test scenarios and model related information by October 15 of each year.

Covered companies will be required to submit the results of their company-run stress tests to the Federal banking agencies by January 5 of each year.¹⁵ Similarly, covered companies subject to the Capital Plan Rule must submit their capital plans, taking into account stress test results under the supervisory scenarios as discussed above, by January 5 of each year.¹⁶ Assuming publication of the stress scenarios by mid-November as set forth in the Preamble, covered companies will have only approximately six weeks to complete a great amount of work in respect of the stress testing and capital planning processes during the same period which also overlaps with normal year end and financial closing activities and the seasonal holidays. Moreover, as the CCAR 2012 process demonstrated, there may be an initial period when the relevant scenarios have been released, but where covered companies and the Federal banking agencies must work together to clarify ambiguities in the supervisory scenarios, thus effectively decreasing the time to actually perform the required stress testing and capital planning under the Proposed Stress Test Rules and the Capital Plan Rule, respectively. In light of the foregoing, we respectfully urge that the supervisory stress scenarios and the model and underlying assumption related information requested in Part II.A.1 above be provided not later than October 15 of each year in order to give covered companies the necessary time to complete the substantial amount of work involved without undue burden. This time frame for release of the supervisory stress scenarios is consistent with the time frame proposed by the OCC in its stress test rule.¹⁷

E. The Proposed Stress Test Rules should include a formalized “reconsideration”-type process through which covered companies can raise any concerns they may have regarding the results of the supervisory stress tests and the evaluation of the company-run stress tests prior to the publication of stress test results.

The supervisory and company-run stress tests are, by their very nature, highly complex undertakings, the results of which will be dependent on numerous assumptions and other factors. Thus, there will be the potential of legitimate and reasonable disagreement between a covered company and the Federal banking agencies concerning the results of the supervisory stress test. The Associations believe that the Proposed Stress Test Rules should include a more formalized “reconsideration”-type process through which covered companies can raise any concerns they may have in a timely manner prior to the publication of stress test results. The publication of potentially erroneous stress test results could quickly lead to situations where market perceptions trump reality and investors unfairly punish the applicable covered company. Such negative capital markets consequences may not be fully ameliorated by the publication of an after-the-fact correction. We respectfully submit that a “reconsideration” process would also serve to increase the reliability of stress test results and evaluation process by allowing for a safety-valve in the case of specific situations which may not otherwise fit within the normal parameters of the process, or more prosaically, to simply correct mathematical or other errors. A more formalized “reconsideration” system, as opposed to informal regulatory discussions, will provide more certainty and ensure that any disagreements between covered

¹⁵ Section 252.146(a).

¹⁶ 12 C.F.R. 225.8(d)(1)(ii).

¹⁷ See OCC Stress Test NPR, 77 Fed. Reg. at 3411.

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companies, regardless of size, are resolved promptly and efficiently. Such reconsideration process should be based on the procedures set forth in Section 225.8(e)(3) of the Capital Plan Rule.¹⁸

F. The effectiveness of the company-run stress test rule for covered companies with assets over \$10 billion but below \$50 billion should be moved to 2014.

Under the Proposed Stress Test Rules, the company-run stress test requirements would be immediately applicable to all covered companies and over \$10 billion covered companies.¹⁹ While many over \$50 billion covered companies previously participated in SCAP and CCAR, covered companies with over \$10 billion but less than \$50 billion in consolidated assets will need to develop internal processes and procedures, hire or repurpose staff and expertise, and develop appropriate systems, in each case, in order to be able to fully comply with the requirements of the Proposed Stress Test Rules. Assuming that a final rule will be promulgated in the second quarter of 2012, such entities will only have approximately four-and-a-half months to prepare for the arrival of the supervisory stress scenarios for the annual company-run stress tests for 2013. We believe this timing will be unduly burdensome and will not give such institutions adequate time to properly implement their preparations in order to run the required stress tests since these institutions are, by definition, smaller in size and lack prior experience with SCAP and CCAR and therefore have less readily available resources to dedicate to fulfilling the mandate of Section 165(i) of Dodd-Frank absent prior experience with SCAP and CCAR. The Associations respectfully urge the Federal banking agencies to move the effective date of the Proposed Stress Test Rules for covered companies between \$10 and \$50 billion in assets to January 5, 2014.

G. The effectiveness of the mid-year company-run stress test should be moved to 2013.

The comment period for the Proposed Rules ends on April 30, 2012. Even assuming, *arguendo*, a relatively brief period between the end of the comment period and the adoption and publication in the Federal Register of the final stress test rules, there will be very little time for covered companies subject to the mid-year company-run stress test to develop the required company-generated scenarios, conduct the stress test and submit results by July 5 of this year. The Associations believe that the supervisory goals of the mid-year company-run stress tests would be better served by moving the effectiveness of the implementation of this requirement until July 5, 2013 in order for subject covered companies to have sufficient time to be well prepared to run such stress tests and thereby deliver a better product for evaluation by the Federal banking agencies.

¹⁸ We do not believe the 12 C.F.R. §225.8(e)(3) process (which contemplates reconsideration within 10 days *after* Federal Reserve objection to a proposed capital plan) is an adequate remedy because, as discussed above, the mere publication of potentially erroneous stress test results could in and of itself be harmful to the covered company.

¹⁹ Section 252.141(a)(2).

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III. Disclosure of Stress Test Results

- A. The CCAR 2012 disclosure template should be used for disclosure of the results of the severely adverse scenario for purposes of both supervisory and company-run stress tests under Section 165(i) of Dodd-Frank and the Proposed Stress Test Rules at least for covered companies with consolidated assets of \$50 billion or more.**

The Associations agree that the form and content of the CCAR 2012 disclosures “have struck about the right balance between providing useful information to investors, counterparties and the public, on the one hand, and protecting proprietary information the release of which might result in competitive harm to firms, on the other,”²⁰ by ensuring that disclosure of stress test results does not result in effectively providing earnings guidance concerning base case scenarios or other information that would enable reverse-engineering of base case or quarter-by-quarter results. Furthermore, the CCAR 2012 disclosure template is consistent with the Sections 165(i)(1) and (2) respective requirements of publication of only a “summary of the results” of the stress tests required thereunder. As such, we strongly urge that the Federal banking agencies generally adopt the template used in reporting the CCAR 2012 results for purposes of publication of both the results of supervisory stress tests conducted by the Federal Reserve and the annual and semi-annual stress tests conducted by covered companies with consolidated assets of \$50 billion or more – e.g., publication of the results of only the “severely adverse” supervisory scenario for the annual supervisory and company-run stress tests and the company-generated “severely adverse” scenario for the mid-year company-run stress test, as applicable.

More particularly, under no circumstances should the Federal Reserve disclose, or should covered companies be required to disclose, base case stress test results or other information that could be used to effectively reverse-engineer earnings guidance or other quarter-by-quarter results under either the supervisory or company-run stress test requirements of the Proposed Stress Test Rules. To do otherwise would be the equivalent of requiring covered companies to frequently provide earnings guidance and detailed profit and loss forecasts for the following nine quarters and would create significant and unnecessary risks for banks and the banking sector. Differences between actual results and the expectations set forth in any baseline disclosures could create significant and unnecessary risks to the safety and soundness of banks and potentially lead to exposure to other liabilities under the securities laws or otherwise. Such disclosures could become “checklists”, and covered companies that failed to deliver short-term results consistent with the “checklists” could face significant volatility, spiraling negative perceptions and sentiment among investors and customers and the sudden loss of liquidity from a loss of confidence among depositors and counterparties. From a safety and soundness perspective, these required disclosures would likely incentivize covered companies to prioritize the achievement of short-term results to meet “checklist” expectations over more appropriate longer-term risk management and sustained long-term results. In light of the foregoing, we strongly urge the Federal Reserve and the other Federal banking agencies to avoid expanding the successful disclosure template of CCAR 2012 for purposes of the Proposed Stress Test Rules.

Publication of summary results under the adverse scenario (as opposed to the severely adverse scenario) should not be made or required to be made, except in situations where the covered

²⁰ See Governor Daniel K. Tarullo, Remarks to the Federal Reserve Bank of Chicago Annual Risk Conference: Developing Tools for Dynamic Capital Supervision, at 9 (Apr. 10, 2012) (*transcript available at <http://www.federalreserve.gov/newsevents/speech/tarullo20120410a.pdf>*).

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company's results under the severely adverse scenario indicates it would fail to meet the 5% minimum common equity requirement, for purposes of either the annual supervisory and company-run and mid-year company-run stress tests. As a general matter, the publication of the adverse scenario would not provide any useful additional information for market participants since, by definition, the severely adverse scenario subsumes the merely adverse scenario. However, publication of the results under the adverse scenario where an institution fails the severely adverse scenario would be beneficial in revealing additional information concerning the ability of the subject institution to withstand negative economic circumstance that could be useful to market participants and enhance the stability of the financial system more broadly.

In addition to the data set forth in the CCAR 2012 template, we support the requirement for covered companies to disclose a high-level description of the scenarios used and their key variables (for the mid-year company-run stress tests), as well as a general description of the models and methodologies used to generate the stress test results for the company-run stress tests.²¹ However, consistent with the CCAR 2012 template, we do not believe quarter-by-quarter data disclosure over the planning horizon pursuant to Section 252.148(b)(4) of the Proposed Stress Test Rules is justified or would serve any particular purpose since the aggregate losses, provisions and capital levels (and the lowest period results) are the relevant data points for market participants in order to determine an institution's relative strength in the face of the severely adverse stress scenario.

IV. Coordination Among Multiple Overlapping Stress Test Requirements and Regulatory Agencies

A. **The Federal banking agencies should work collectively to effectively minimize the duplicative burden of these multiple and overlapping stress test requirements on BHCs and subsidiary depository institutions.**

Under Section 165(i)(1) of Dodd-Frank and the Proposed Stress Test Rules, BHCs with over \$50 billion in assets are subject to the supervisory stress test. Pursuant to Section 165(i)(2) and the Proposed Stress Test Rules,²² BHCs with over \$10 billion in assets are required to conduct company-run stress tests; the mid-year company-run stress tests are applicable only to the over \$50 billion covered companies. The company-run stress test requirement is also separately applicable to depository institutions having over \$10 billion in assets, whether national banks, state member banks or state non-member banks.²³ With respect to depository institutions, the Federal Reserve would supervise company-run stress tests for state member banks under the Proposed Stress Test Rules, the OCC would supervise stress test under its own proposed rule pursuant to Section 165(i)(2) of Dodd-Frank for national banks, and the FDIC would do so for state non-member banks.²⁴ Over \$50 billion BHCs are also subject to the technically separate stress test requirements under the Capital Plan Rules.

²¹ Sections 252.148(b)(1)-(3).

²² The stress requirements are also applicable to nonbank financial companies supervised by the Federal Reserve.

²³ Sections 252.141, 142.

²⁴ Proposed OCC Stress Test Rules, Section 46.3; Proposed FDIC Stress Test Rules, Section 325.203.

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When these various statutory and regulatory requirements are aggregated, an institution consisting on a consolidated basis of, for example, an over \$50 billion BHC, a wholly-owned subsidiary national bank and a wholly-owned subsidiary state non-member bank, each with over \$10 billion in assets, would therefore appear to be subject to at least five²⁵ technically separate stress test requirements supervised by three different Federal banking agencies. While we recognize that this result appears to be, at least in part, mandated by the statutory language of Section 165(i) of Dodd-Frank, the Associations are deeply concerned that these multiple overlapping stress test requirements, if not properly implemented and coordinated among the relevant agencies, will lead to a great degree of burdensome duplication and will add little marginal utility from a policy and supervisory perspective, particularly regarding BHCs where the subsidiary depository institutions represent, either singly or in the aggregate, a large percentage of the consolidated assets of the BHC. Moreover, we believe that this is true even where the subsidiary depository institutions represent a smaller percentage of the consolidated assets of a BHC parent given the codification of the Federal Reserve's "source of strength" doctrine as part of Dodd-Frank.²⁶ In either case, the stress test results for the parent BHC must, by logical and practical necessity, include data concerning its subsidiary depository institution(s).

We appreciate the statements of the various Federal banking regulatory agencies to the effect that they will work together to coordinate the various stress test processes among the Federal Reserve, the OCC and the FDIC.²⁷ The Associations applaud this intention and respectfully urge the alignment of the aggregate stress testing process by robust coordination of its various aspects, including information gathering, public disclosure requirements, reporting forms, etc., across agencies so as to promote efficient use of covered company and supervisory resources and therefore minimize burdensome and inappropriate duplication of efforts, including that:

- the Federal banking agencies coordinate their stress test related activities through the Federal Financial Institution Examination Council (the "FFIEC") (or another appropriate joint supervisory forum) and develop inter-agency forms, policies and procedures, assumptions, methodologies and criteria with respect to the stress tests mandated by Section 165(i) of Dodd-Frank;
- the final rules governing such Section 165 stress test be adopted through joint interagency rulemaking in order to provide covered companies clear and coordinated guidance from all three relevant agencies; and
- with respect to depository institution subsidiaries which represent a large percentage of the consolidated assets of a parent covered BHC, the Proposed Stress Test Rules' requirement be met by submission of the BHC's company-run stress results together with a brief addendum

²⁵ For these purposes, we have not taken into account the stress testing requirements of the Proposed Liquidity Rule discussed in *Annex B*.

²⁶ See Section 616(d) of Dodd-Frank.

²⁷ See *e.g.*, 77 Fed. Reg. at 632; FDIC Stress Test NPR at 3168; OCC Stress Test NPR at 3409, 3412. We particularly support § 46.8 of the Proposed OCC Stress Test Rules, which provides that a covered company's disclosures will satisfy the disclosure requirement under the annual stress test under Section 165(i)(2) for any subsidiary national bank of the covered company with \$10 billion or more in assets, unless the OCC informs the bank otherwise.

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describing any material idiosyncratic circumstances or issues that are applicable only to such depository institutions' subsidiaries from a stress test perspective.

B. The information reporting requirements for purposes of the Stress Test Rules should be designed to and implemented as to avoid duplication.

Covered companies will be required to submit a variety of data to the Federal Reserve for purposes of the supervisory stress tests. The format and contents of such data have yet to be determined.²⁸ In connection with the company-run stress tests, the Federal Reserve may "require companies to provide other information on a supplemental basis"²⁹ in addition to the submission of stress test results. In addition, covered companies may also be subject to information reporting requirements under the Capital Plan Rules. There will likely be a great degree of overlap between information reporting requirements for purposes of stress tests to be run at different levels of a consolidated organization and to be reported to different Federal banking agencies.

The Associations respectfully submit that information reporting requirements for purposes of the Proposed Stress Test Rules (and their OCC and FDIC counterparts) should be designed to avoid duplication and should be substantially similar to the data content, forms and templates required under the Capital Plan Rules to the greatest extent possible. Moreover, the Federal banking agencies should develop, possibly under the auspices of the FFIEC, an interagency data repository and related interagency forms to avoid needless duplication of data reporting and information gathering. Finally, covered companies should not be required to separately and duplicatively report data mandated by Forms FR Y-14A/Q/M, for example, for purposes of the Proposed Stress Test Rules.

C. The Federal banking agencies should be consistent in their use of the same supervisory stress test scenarios and models for purposes of each of the supervisory stress tests and the annual company-run stress tests.

The Associations are concerned that both the FDIC and the OCC NPRs appear to leave open the possibility that different supervisory stress scenarios may be provided by the OCC or FDIC for purposes of the depository institutions' stress tests than what is used for purposes of the Federal Reserve's supervisory stress test and annual company-run stress tests for over \$50 billion BHCs.³⁰ Most covered companies consist on a consolidated basis of a BHC and at least one subsidiary depository institution. Using one set of supervisory stress scenarios at the BHC level and a different set of supervisory stress scenarios at the subsidiary depository institution and, if results under both scenarios were disclosed, would be needlessly burdensome and would likely result in the public disclosure of divergent results which would be both confusing and of little value to investors and other market participants. In addition, to the extent, as discussed below, the Federal banking agencies use their own models to evaluate the annual (for entities not otherwise subject to the supervisory stress test) and mid-year, as applicable, company-run stress test results, such models and their application should be consistent among the Federal banking agencies. We do not believe there is any analytical or policy

²⁸ 77 Fed. Reg. at 628-629.

²⁹ *Id.* at 631.

³⁰ See OCC Stress Test NPR at 3411; FDIC Stress Test NPR at 3168.

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justification for different results with respect to projecting income, loan losses or allowances, for example, when the Federal Reserve analyzes a BHC's consolidated company-run stress test versus when the OCC or the FDIC evaluates the company-run stress test conducted by the BHC's over \$10 billion depository institutions.

Thus, we strongly urge the Federal banking agencies to collectively and consistently use the same set of supervisory stress scenarios and models for all purposes under Section 165(i) of Dodd-Frank.

D. The company-run stress tests to be performed under Section 165(i) of Dodd-Frank should be deemed to fully satisfy the separate stress test requirement under the Capital Plan Rule.

The Capital Plan Rule requires that a covered company perform a stress test based on at least one scenario developed by the BHC, as well as under the Federal Reserve's supervisory stress scenarios.³¹ This requirement appears duplicative with the annual separate company-run stress requirement of Section 252.143 of the Proposed Stress Test Rules. More importantly, covered companies subject to the Capital Plan Rule are also generally subject to the mid-year stress test requirements of Section 252.144 of the Proposed Stress Test Rules. As such, the separate company-derived stress test scenario requirement of Section 225.8(d)(2)(i)(A) of the Capital Plan Rule appears superfluous, at best, in light of the Proposed Stress Test Rules since the mid-year stress test requirement can serve to fulfill any perceived supervisory need for a stress test based on company-generated scenarios, and indeed, is more comprehensive in this regard as it contemplates not just one but three company scenarios. Therefore, we urge that the Federal Reserve deem the three company-run stress tests to be performed under Section 165(i)(2) of Dodd-Frank and the Proposed Stress Test Rules to fully satisfy the separate company-generated stress scenario and stress test requirement under the Capital Plan Rule.

V. Stress Test Results and Capital Requirements

A. The design and severity of the supervisory stress scenarios should be consistent and properly cabined in light of the interplay between annual supervisory stress tests and the Federal Reserve's Capital Plan Rule creating an effective minimum capital requirement that can change from year to year as the stress test scenarios change.

As discussed further below, the Associations urge the Federal banking regulators to adopt a uniform approach for identifying supervisory stress scenarios in order to, as much as possible, minimize volatility of capital requirements from year to year in light of the interplay between Proposed Stress Test Rules and the capital plans mandated by Capital Plan Rule, which, in effect, create difficult to plan for variable or floating minimum capital requirements.

³¹ 12 C.F.R. § 225.8(d)(2)(i)(A).

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1. The interplay between annual supervisory stress tests and the Federal Reserve's capital plan guidance creates effective minimum capital requirements that change from year to year as the stress scenarios change.

Under the Proposed Capital and Leverage Rules, all covered companies will become subject to the Federal Reserve's Capital Plan Rule, which requires, among other things, stress testing as part of each covered company's yearly capital plan to be submitted to the Federal Reserve. The Preamble states that the Federal Reserve "expects that a covered company will integrate into its capital plan, as one part of the underlying analysis, the results of the company-run stress tests conducted in accordance with section 165(i)(2) of [Dodd-Frank]."³² Furthermore, "[t]he results of those stress tests, as well as the annual supervisory stress test conducted by the [Federal Reserve] under section 165(i)(1) of Dodd-Frank, will be considered in the evaluation of a covered company's capital plan."³³ Pursuant to Adopting Release for the Capital Plan Rule, "the stress scenarios that [the Federal Reserve] provides...will be consistent with the stress scenarios it will provide for firms for stress tests they conduct under Section 165 of [Dodd-Frank]."³⁴ Most significantly, the Federal Reserve has taken the position that, under the Capital Plan Rule, "covered companies would be required to demonstrate to the [Federal Reserve] their ability to maintain capital above existing minimum regulatory capital ratios and above a tier 1 common ratio of 5% under both expected and stressed conditions..." or else face limitations on capital distributions such as dividends and share buy-backs.³⁵ In light of significant negative consequences for banking institutions that are unable to make capital distributions due to regulatory concerns, we believe this position effectively creates a new *de facto* minimum regulatory capital requirement for covered companies. Moreover, in order to build in a margin of safety, many institutions will likely find it necessary to hold capital well in excess of the 5% stressed minimum in order to have a margin of safety. As discussed in greater detail in *Annex B*, this results in the "more stringent" capital requirements mandated by Section 165(a) of Dodd-Frank.

Unlike regulatory capital floors pursuant to the Federal Deposit Insurance Act (the "FDIA") and related regulations' "prompt corrective action" provisions and under the Basel III requirements, the amount of capital required by this effective 5% minimum will necessarily depend on the severity of the various assumptions underlying the applicable stress scenarios, which, under the Capital Plan Rule and the Proposed Stress Test Rules, will likely change each and every year. In essence, this will create a "floating" minimum capital requirement for covered companies that will be different each year depending on what macroeconomic and other variables the Federal Reserve deems appropriate to use for purposes of the stress scenarios.

³² 77 Fed. Reg. at 599.

³³ *Id.* at 599; *see also id.* at 626.

³⁴ 76 Fed. Reg. at 74635.

³⁵ 77 Fed. Reg. at 599; *see also* Capital Plan Rule Adopting Release, 76 Fed. Reg. at 74636-74637.

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- 2. This floating minimum capital requirement will make it challenging for covered companies to develop and implement appropriate medium and long-term capital planning as a practical matter.**

The severity of the supervisory severely adverse scenario may fluctuate significantly from year to year as was the case when comparing the 2011 CCAR to the 2012 CCAR. While the severity of the stress severely adverse scenario may fluctuate, the 5% Basel I Tier 1 common threshold is consistent. A significant change in the severity of the severely adverse scenario from year to year could result in a bank passing the stress test with a sizeable margin over the 5% threshold in one year and then failing the stress test the following year even if its risk profile has not changed. Essentially, this creates a moving target for the amount of capital that banks need to hold each year as a result of the fluctuations in the severity of the supervisory defined stress scenarios. While the Associations agree that stress tests provide important information to the market participants, we respectfully submit that ever changing effective minimum capital requirements based on changing stress scenarios could serve to undermine the credibility of the stress tests as well as market confidence in banking institutions as investors and other market participants may have difficulty making meaningful evaluations of covered companies' prospects and future actions when minimum capital requirements effectively float from year to year.

- 3. The Federal Reserve and the other banking agencies should adopt a uniform approach for identifying supervisory stress scenarios (which would apply absent exigent circumstances) so that changes from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be.**

The Associations believe that the foregoing problems inherent in capital requirements that are effectively floating can be ameliorated by the Federal Reserve and the other banking agencies, absent exigent circumstances, adopting a uniform approach for identifying stress scenarios so that changes in these scenarios from year to year do not unnecessarily make floating capital requirements more volatile than they otherwise need be. For example, a consistent set of severity and minimum probability of occurrence benchmarks in the design of the supervisory stress scenarios could be used so that risk factor moves in the adverse and the severely adverse stress scenarios are generally anchored to statistical probabilities of occurrence ceilings of no more than once in five years (i.e., a 20% probability of occurrence case) and no more than once in 20 years (i.e., a 5% probability of occurrence case), respectively. Thus, while the specific macro-economic variables of the adverse and severely adverse scenarios could change from year to year, their severity (and therefore the impact on the floating capital requirements) could be calibrated to the probability of occurrence ceiling. We respectfully submit that such a uniform approach would serve to reduce volatility and provide greater predictability in the amount of capital that covered companies will be required to hold pursuant to the floating capital requirement resulting from the Capital Plan Rule and the Proposed Stress Test Rules and therefore serve to improve the ability of such institutions to engage in more meaningful medium-to-long term capital planning as a practical matter. Moreover, this greater degree of predictability (especially when coupled with greater transparency as per Part III.A above) should serve to enable investors and other market participants to make better and more consistent evaluations of the strength of financial institutions and thereby enhance systemic stability as the degree of potentially artificial volatility in capital requirements as a result of the design of regulatory stress scenarios is reduced.

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B. At a minimum, the Federal banking agencies should subject the stress scenarios to appropriate public consultation and input prior to their use.

Since, as described above, the stress scenarios will, in effect, dictate how much capital covered companies will be required to hold in any given year, such stress scenarios should not be the product of pure regulatory fiat but rather be subject to an appropriate degree of public consultation and input in order to help ensure that the chosen stress scenarios for any given year are neither so outlandish as to create meaningless results far outside the realm of the possible nor ignore real risks present in the broader national and global economy at the relevant time. The Associations believe that such public consultation and input with respect to the scenario creation process will serve to provide to the Federal banking agencies important outside perspective regarding the relevant issues involved and, as with the models to be used for purposes of the supervisory stress test, therefore enhance the utility of stress testing from a supervisory perspective. We respectfully submit that an informal public consultative process would be more appropriate and efficient than a formal agency rulemaking procedure.

VI. Other Issues

A. Requests for clarification.

The Associations appreciate the efforts of the Federal banking agencies to address the various requirements of Section 165 of Dodd-Frank. Nevertheless, there are certain aspects of the NPR and the Proposed Stress Test Rules, including how they interrelate with other rules (e.g., the Proposed Liquidity Rule), that we urge the Federal banking agencies to clarify when the final Section 165 rules are adopted. More particularly:

- What are the Federal banking agencies' concrete supervisory expectations regarding covered companies' "broader stress testing activities"³⁶ other than as required by Section 165, the Proposed Stress Test Rules and the Liquidity Rule?
- Exactly how will the results of the annual and mid-year company-run stress tests be used from a supervisory and prudential perspective?
- What is the practical relationship between the use of models and supervisory judgment in determining the results of the supervisory stress tests for purpose of the Proposed Stress Test Rules and the Capital Plan Rules?

VII. Responses to Specific Questions

Below please find our responses or cross references to our responses above, as applicable, with respect to stress-test specific questions posed in the Preamble.³⁷

³⁶ 77 Fed. Reg. at 630.

³⁷ As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

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Question 70. *Are the timing requirements of this proposal sufficient to allow a covered company or nonbank covered company to prepare, collect, and submit to the Federal Reserve the information necessary to support the supervisory stress test? If not, what alternative timing should the Federal Reserve consider?*

Please see Parts II.D, F and G above.

Question 71. *What is the potential burden on covered companies stemming from the requirements to submit internal data to support the supervisory stress tests?*

Please see Part II.B above.

Question 72. *What alternative models or methodologies for estimating a covered company's losses and revenues should the Federal Reserve consider?*

Please see Parts II.A and B above.

Question 73. *What are the benefits and drawbacks associated with company-specific disclosures? What, if any, company-specific items relating to the supervisory stress tests would present challenges or raise issues if disclosed, and what is the nature of those challenges or issues? What specific concerns about the possible release of a company's proprietary information exist? What alternatives to the company-specific disclosures being proposed should the Federal Reserve consider?*

Please see Part III above. In addition, we note that the considerations involved with respect to stress test related disclosure issues for non-U.S. BHCs and nonbank financial companies supervised by the Federal Reserve may very well be different. We respectfully reserve the right to comment further on these topics as the Section 165 regulatory process evolves regarding non-U.S. BHCs and nonbank SIFIs.

Question 74. *What alternative to the public disclosure requirements of the proposed rule should the Federal Reserve consider? What are the potential consequences of the proposed public disclosures of the company-run stress test results.*

Please see Part III above.

Question 75. *Is the proposed timing of stress testing appropriate, and why? If not, what alternatives would be more appropriate? What, if any, specific challenges exist with respect to the proposed steps and timeframes? What specific alternatives exist to address these challenges that still allow the Federal Reserve to meet its statutory requirements? Please comment on the use of the "as of" date of September 30 (and March 31 for additional stress tests), the January 5 reporting date (and July 5 for additional stress test) the publication date, and the sufficiency of time for completion of the stress tests.*

Please see Parts II.D, F and G above.

Question 76. *Does the immediate effectiveness of the proposed rule provide sufficient time for an institution that is covered at the effective date of the rule to conduct its first annual*

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stress test? Would over \$10 billion companies, in particular, have sufficient time to prepare for the first annual stress test, under either the proposed initial or proposed ongoing applicability rules?

Please see Parts II.G and F above. In addition, even for institutions that were subject to CCAR 2012 and are subject to the Capital Plan Rule on a consolidated basis, implementing company-run stress tests at the depository institution subsidiary level may proven challenging in the required timeframe in light of the fact that many such institutions manage their business on an business-line as opposed to legal entity by legal entity basis. Covered companies may need additional time to develop the systems and infrastructure that would allow them perform stress tests broken down with respect to a specific depository institutions subsidiary even though they are able to perform holding company consolidated stress tests. Thus, the Associations respectfully urge that Federal banking agencies delay the implementation of the depository institution specific stress tests where the BHC otherwise covered company under the Proposed Stress Test Rules until January 4, 2014.

Proposed Early Remediation Rules (Subpart I) – Early Remediation Framework¹

The Associations support the overall objective of Section 166 of Dodd-Frank, which is to require the Federal Reserve to put into place an early remediation regime for large BHCs and nonbank SIFIs in financial distress in order to minimize the probability that the covered company will become insolvent and the potential harm of such insolvency on U.S. financial stability.

As described below, however, the Associations have certain concerns about the Proposed Early Remediation Rules. The Associations respectfully submit that a successful early remediation regime would, in general, apply only to firms subject to genuine financial or management weaknesses, impose individually-tailored conditions and restrictions on those firms, and facilitate a prompt exit from the regime when such firms return to health. The early remediation regime should be designed to help firms overcome weaknesses and protect the stability of the financial system as a whole. The early remediation regime should not subject firms to conditions or restrictions that are interminable or overly broad or impede firms' ability to return to health. A poorly designed early remediation system will exacerbate firms' financial or management weaknesses and destabilize the financial system.

The Associations also believe that any notices, determinations and regulatory actions taken under the early remediation regime should be treated as non-public confidential supervisory information, for the reasons discussed below.

In addition to the specific concerns that follow, the Associations recommend that the early remediation regime be viewed in context with the numerous regulatory reform efforts that are concurrently underway. We see the various strands of the Section 165 enhanced prudential standards coming together through the early remediation regime, and as such, we believe that the elements should all work together, not at cross-purposes. Dodd-Frank eliminated certain categories of regulatory capital, imposed new limitations on certain asset classes and required a general move to the clearing of derivatives; the U.S. banking agencies are preparing proposed rules to implement Basel III; and the Financial Stability Board has endorsed the imposition of a "G-SIB" surcharge on the world's largest banking entities, including most of the "Major Covered Companies" under the Proposed SCCL Rules. The early remediation regime is not an isolated response to the financial crisis. The Associations respectfully submit that the Federal Reserve should proceed cautiously when putting the early remediation regime into place, recognizing the many related measures that have been or will be adopted to otherwise reduce systemic risk in the financial system.

Part I of this Annex summarizes our comments on the Proposed Early Remediation Rules; Part II provides, for ease of reference, a brief summary of the early remediation triggers and resulting actions; Parts III–VII detail our specific recommendations and concerns; and Part VIII sets forth our responses to certain of the specific questions posed in the NPR.

I. Executive Summary

We are concerned that the sensitivity of the automatic triggers of the Proposed Early Remediation Rules and the lack of discretion left to the banking supervisors to determine appropriate

¹ Capitalized terms used in this Annex and not otherwise defined are used with the meanings assigned to them in the Comment Letter to which this Annex is attached.

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remediation actions, including the inability to calibrate any such actions to the nature of the applicable triggering event, create the risk that entry into the early remediation regime by a firm will precipitate its further deterioration rather than address and strengthen its shortcomings. In particular, we believe that:

- The Proposed Early Remediation Rules should rely on discretionary supervisory judgments rather than mandatory triggering events;
- Regulatory flexibility is particularly important at Level 2, when initial remediation steps are being taken;
- Stress tests, the results of which are a function of the severity of hypothetical scenarios, should not be a trigger for early remediation; if they are to be used as a trigger, they should not trigger remediation requirements higher than Level 1;
- Automatic triggers may become self-fulfilling prophecies, and market indicators in particular are susceptible to manipulation and may be volatile for reasons unrelated to financial and management weaknesses; in particular, triggering a credit default swap-based indicator could quickly exacerbate liquidity stresses;
- Risk management, risk committee and liquidity requirements should be subject to a materiality threshold for triggering early remediation;
- Required remediation unrelated to the triggering event may harm healthy operations and impair the ability to remediate the problem; and
- Inflexible restrictions on executive compensation could work at cross-purposes with the broader goals of the early remediation regime by harming the company's ability to attract new management or retain skilled and experienced managers that did not contribute to the company's decline.

We also recommend that:

- Early remediation regimes, triggers and requirements employed by different regulatory agencies be harmonized to avoid incongruous outcomes, and in particular, the interplay of stress testing, capital planning and early remediation triggers should be carefully examined, as should the interplay of the early remediation regime with prompt corrective action ("PCA");
- Companies subject to the early remediation regime should be promptly released from applicable restrictions and requirements when restored to appropriate managerial or financial health; and
- All notices, determinations and regulatory actions taken in the early remediation regime should be treated as non-public confidential supervisory information.

II. Summary of Proposed Early Remediation Rules

The Federal Reserve's proposed rules to implement Section 166 of Dodd-Frank would establish an early remediation regime for BHCs with \$50 billion or more of consolidated assets and any

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U.S. nonbank financial company designated by the FSOC for oversight by the Federal Reserve (collectively, “**Early Remediation Covered Companies**”). Under the Proposed Early Remediation Rules, Early Remediation Covered Companies would potentially be subject to any of four levels of early remediation: Heightened Supervisory Review (Level 1), Initial Remediation (Level 2), Recovery (Level 3) and Resolution Assessment (Level 4). The restrictions on, and oversight over, Early Remediation Covered Companies rise significantly with each level of the early remediation regime.

A. Level 1: Heightened Supervisory Review.

Level 1 is triggered when there are signs of financial distress or material risk management weaknesses such that further decline of the company is probable. A largely discretionary standard, Level 1 review is triggered if:

- the covered company is well-capitalized, but the Federal Reserve determines that the company’s capital structure, capital planning processes or amount of capital held is not commensurate with the level and nature of risks to which it is exposed;
- there is non-compliance with the Federal Reserve’s capital plan and stress testing rules;
- there are signs of weakness in meeting the enhanced risk management, risk committee, or liquidity risk management requirements under the rules; or
- the median value of any market indicator exceeds the applicable threshold for the breach period (market indicators such as expected default frequency, marginal expected shortfall, market equity ratio, option-implied volatility, credit default swap and bond spreads are to be published separately).

In the event Level 1 is triggered, the Federal Reserve would be *required* to produce a report on the elements evidencing deterioration within 30 days and to determine whether the institution should be elevated to a higher level of remediation.

B. Level 2: Initial Remediation.

Level 2 is triggered if:

- risk-based capital and leverage ratios fall to adequately-capitalized levels;
- the results under the severely adverse scenario pursuant to supervisory stress tests reflect a Tier 1 common risk-based capital ratio of less than 5%; or
- there are multiple deficiencies in meeting the enhanced risk management, risk committee, or liquidity risk management requirements under the rules.

In the event Level 2 is triggered, certain mandatory remediation actions will result, including:

- restrictions on capital distributions, acquisitions and asset growth;

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- a requirement for the covered company to enter into a non-public memorandum of understanding with the Federal Reserve to establish an action plan for improving its financial condition; and
- a requirement to obtain prior Federal Reserve approval to acquire a controlling interest in any company.

In addition, the Federal Reserve may impose limitations or conditions on conduct or activities.

C. Level 3: Recovery.

Level 3 is triggered if:

- risk-based capital and leverage ratios fall to under-capitalized levels;
- the results under the severely adverse scenario pursuant to supervisory stress tests reflect a Tier 1 common risk-based capital ratio of less than 3%; or
- there is substantial noncompliance in meeting the enhanced risk management, risk committee, or liquidity risk management requirements under the rules.

In the event Level 3 is triggered, certain mandatory remediation actions will result, including:

- a prohibition on asset growth and capital distributions;
- a prohibition on any acquisitions, establishment of offices or engaging in new business lines;
- limits on executive compensation; and
- a requirement that the covered company enter into a written agreement or other form of formal enforcement action with the Federal Reserve that would specify that it must raise capital and take other actions to improve capital adequacy, and may require divestiture.

In addition, the Federal Reserve may require management changes, restrict transactions with affiliates, impose limitations or conditions on conduct or activities, or impose additional requirements on a case-by-case basis.

D. Level 4: Resolution Assessment.

Level 4 is triggered if risk-based capital and leverage ratios fall to significantly under-capitalized levels. If the threshold is triggered, the Federal Reserve will consider whether to recommend that the covered company be placed into resolution under Title II of Dodd-Frank (the “**Orderly Liquidation Authority**”). Such recommendation would be one of the “three keys” required to invoke the Orderly Liquidation Authority, to which the FDIC and the Treasury Secretary would also have to agree.²

² Section 203 of Dodd-Frank.

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III. Key Concerns Regarding Triggering Events and Regulatory Discretion

A. The Proposed Early Remediation Rules should rely on discretionary supervisory judgments rather than mandatory “triggering events”.

The Proposed Early Remediation Rules include certain “triggering events” which, when reached, would automatically result in an Early Remediation Covered Company becoming subject to a new, or heightened, level of the early remediation regime. There are four sets of triggering events: (1) capital and leverage triggering events, calculated based on regulatory capital and leverage standards; (2) stress test triggering events, determined with respect to capital planning requirements imposed by the Federal Reserve and stress tests conducted pursuant to other sections of the NPR; (3) risk management standards, triggered by a determination by the Federal Reserve of “manifested signs of weakness”, “multiple deficiencies”, and “substantial noncompliance” in management areas; and (4) market indicators.³

The Associations have concerns about the use of mandatory “triggering events” at all levels in the Proposed Early Remediation Rules. The Associations respectfully submit that a more appropriate approach would be for the Federal Reserve to make early remediation determinations based on discretionary supervisory judgments, in light of all of the facts and circumstances, taking into consideration non-determinative quantitative and qualitative factors. The use of market indicators as mandatory triggers, rather than as merely informative factors, is particularly troublesome, for the reasons discussed below.

The Associations support an early remediation regime that allows the Federal Reserve to intervene early at an Early Remediation Covered Company that is showing signs of material financial or management distress. We believe that it is important that the early remediation process be used to create a virtuous cycle that quickly identifies a troubled covered company, and then allows regulators and management to work together to strengthen the institution, rather than creating a vicious cycle where the early remediation requirements of the regulators precipitate a death spiral at the covered company in distress, and the regulators find themselves with no discretion to take countervailing actions to prevent the precipitous decline.

While we agree with the goals of the early remediation proposed rule, it is important that the early remediation process also allow for regulatory tailoring and discretion to act as required by a specific situation, both in terms of triggers and in terms of regulatory action within each level of remediation review. As the early remediation proposed rule itself recognizes, there is a risk that certain triggers, if misapplied or misused, could exacerbate funding or market pressures at the affected covered company, rather than providing for early remediation of such issues. Therefore, we believe that providing regulators the authority to intervene early at Early Remediation Covered Companies is better than requiring regulatory action upon triggering events. Such regulatory discretion is especially important given the wide range of institutions potentially subject to the Proposed Early Remediation Rules.⁴

³ Section 252.163.

⁴ For those institutions just within the \$50 billion threshold, there is a significant risk that a heavy-handed application of the Proposed Early Remediation Rules could put such firms at a significant disadvantage to their slightly smaller competitors.

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Further, in order to be truly effective, the triggers should avoid, where possible, the use of fixed numeric standards; as the Federal Reserve recognizes, the use of a single fixed standard gives rise to risks of both “false positives” (remediation for a firm without material weaknesses) and “false negatives” (lack of remediation for a firm whose financial condition has indeed deteriorated), therefore forcing a covered company into an inappropriate level of remediation, a problem that regulators familiar with the institution would be able to avoid with more discretion. The use of more flexible triggers would also facilitate the conformance of the early remediation framework with any revised capital and leverage standards (such as Basel III) as they are incorporated into U.S. regulation—conformance which the Federal Reserve indicates it expects to monitor,⁵ and which the Associations endorse.

B. Flexibility is particularly important at Level 2.

This regime should give regulators flexibility to tailor remediation requirements to circumstances, particularly in Level 2 Initial Remediation, so that regulators could choose among one or more specified actions but would not be required to implement all of them. Such flexibility in choosing steps for Initial Remediation would let regulators avoid actions that are inappropriate given the cause or severity of distress or that could exacerbate funding or market pressures. A dynamic process should exist that allows institutions to exit remediation stages when conditions improve.

C. Stress test results should not trigger early remediation requirements, or at least should not trigger requirements higher than Level 1.

The Proposed Early Remediation Rules would place a firm into Level 2 early remediation if the results of the supervisory stress tests in any quarter of the planning horizon reflect a Tier 1 common risk-based capital ratio of less than 5%.⁶ If the results of stress tests are even lower, a firm can be placed into Level 3 early remediation.⁷ The planning horizon under the supervisory stress tests must be at least nine quarters.⁸ Although they can be useful tools, the supervisory stress tests necessarily involve imperfect assumptions about market conditions, and the Associations believe that a single quarter of projected financial weakness under the Federal Reserve’s most adverse stress scenarios should not be a trigger of early remediation action.

We do not believe it is appropriate for the results of the supervisory stress tests to trigger any level of early remediation requirements, given the statutory requirement that heightened remediation requirements be linked to the declining financial condition of a covered company. A covered company’s stress test results are a function of the severity of the hypothetical scenarios, not the actual financial condition of the covered company.

If stress tests are nevertheless to be used as an early remediation trigger, the Associations respectfully submit that, in light of the serious consequences of Level 2 or Level 3 early remediation and the imperfect assumptions underlying forward-looking stress tests, that the failure to

⁵ 77 Fed. Reg. at 634.

⁶ Section 252.163(b)(2).

⁷ Section 252.163(b)(3).

⁸ Section 252.132(g).

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meet the required capital ratio under the severely adverse scenario pursuant to supervisory stress tests should trigger Level 1 early remediation requirements, rather than Level 2 or Level 3 early remediation requirements. We believe the remediation actions under Level 1 are more appropriate in the event the stress test requirements are not met, because they allow the Federal Reserve to monitor a firm on the basis of failing to meet the requirements of the stress test, rather than mandating actions based on hypothetical assumptions. We also note that it is unnecessary for stress test results to trigger the full range of Level 2 or Level 3 early remediation, as the Capital Plan Rule already imposes significant restrictions on covered companies that do not meet the 5% Tier 1 common requirement on a post-stress basis.⁹

Further, the Proposed Early Remediation Rules, particularly the stress test triggers, should be better coordinated with the Proposed Capital and Leverage Rules. Under those requirements, firms are already subject to Federal Reserve action if their Tier 1 capital falls below mandated thresholds, making a similar set of remediation actions under the Proposed Early Remediation Rules both superfluous and burdensome.

D. Automatic triggers may become self-fulfilling prophecies, and market indicators, in particular, are susceptible to manipulation.

In an early remediation system based on automatic, publicly-disclosed thresholds, firms may find that depositors and counterparties abandon or turn against them if regulatory capital or leverage levels temporarily fall close to, but still above, “triggering event” levels, or if market indicators near applicable thresholds. An automatic trigger system may inadvertently impair the ability of an Early Remediation Covered Company to take appropriate restorative capital actions because market participants assume the firm will inevitably become subject to the early remediation regime. An early remediation regime without automatic triggers, or with triggers that are not public, would reduce the risk of self-fulfilling death spirals.

If placement into the early remediation regime is based on automatic triggers, counterparties or market participants may deliberately take actions that have the effect of temporarily triggering an Early Remediation Level. Market indicators such as spreads on single-name credit default swaps or equity securities prices, for example, could be manipulated. To the extent triggers are not automatic or are not publicly-disclosed, the risk of manipulation would be mitigated.

The Associations also have serious concerns about the use of automatic early remediation triggers based on changes in indicators like credit default swap spreads and the prices of equity securities that can be quite volatile and may arise from circumstances unrelated to financial and management weaknesses, including investors’ perceptions of sector- or region-wide strength, potential merger or acquisition activity and analysts’ expectations of earnings. In addition, many smaller Early Remediation Covered Companies have a limited number of market indicators and the trading volume in their securities (or instruments based on such securities) may be smaller than for other covered companies, increasing the potential for manipulation or “false positives”. While the Federal Reserve has not yet published the initial indicator list, market indicator thresholds, and breach period,¹⁰ the

⁹ See 76 Fed. Reg. 74631, 74647 (Dec. 1, 2011).

¹⁰ Section 252.163(e)(2).

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Associations expect that the market indicators for these smaller Early Remediation Covered Companies will primarily be the equity securities of such firms.

E. Risk management, risk committee and liquidity requirements should be subject to a materiality threshold for triggering early remediation.

The Associations recommend that, to the extent weaknesses in meeting the risk management, risk committee and liquidity requirements form a basis for triggering early remediation, there should be a materiality threshold for triggering early remediation requirements. Immaterial non-compliance with the risk management, risk committee and liquidity requirements should not result in the early remediation regime being invoked. In addition, the evaluation of risk management for purposes of the early remediation regime should not be inconsistent with current supervisory examinations of risk management at BHCs, and in no event should the results of the evaluation under the early remediation regime be more severe than the results in the examination process.

IV. Appropriateness of the Required Remediation under the NPR

The Associations have concerns about the appropriateness of the required remediation under the Proposed Early Remediation Rules. As proposed, an Early Remediation Covered Company may become subject to early remediation restrictions or requirements as a result of reaching a single “triggering event”. Once placed within the regime, however, the firm is subject to the entire panoply of restrictions and requirements, irrespective of whether they are related to the triggering event that caused the firm to be placed into the regime. For instance, a deficiency in meeting the risk committee requirements could by itself result in restrictions on a firm’s asset size and future acquisitions, even if the deficiency were unrelated to financial or growth issues.

A. Required remediation unrelated to the triggering event may harm healthy operations and impair the ability to remediate the problem.

Subjecting Early Remediation Covered Companies to restrictions or requirements unrelated to an actual triggering event may unnecessarily impair the healthy operations or activities of the firm, which could, in turn, harm the ability of the firm to improve its overall financial or managerial health. If firms are required, or find it necessary under securities laws, to disclose their early remediation status, the application of the full panoply of early remediation requirements and restrictions based on a discrete triggering event may have substantial market effects or even, in severe cases, inaccurately signal to the market that a firm is in an irreversible decline. In addition, given the range in size, risk profile and activities of Early Remediation Covered Companies, a one-size-fits-all approach fails to recognize meaningful distinctions among firms that, if properly evaluated, would result in tailored early remediation restrictions and requirements.

Consistent with the Associations’ view that placement within the early remediation regime should involve regulatory decision-making and discretion, the Associations respectfully submit that, in the case of each firm placed within the early remediation regime, the Federal Reserve should determine the appropriateness of the restriction or requirement under the applicable early remediation level before imposing such restriction or requirement. This tailored approach would ensure that any Early Remediation Covered Company experiencing financial or management weaknesses is placed within a carefully designed regulatory framework that will best manage the firm’s particular problems and protect the financial system.

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B. Absolute and inflexible compensation restrictions would work at cross-purposes with the broader goals of the early remediation regime.

In addition, we are concerned that the absolute prohibition on the payment of bonuses to, or any increase in the compensation of, senior executive officers or directors in the Level 3 early remediation would work at cross-purposes with the broader goals of the early remediation regime. In contrast to other similar regulatory measures, there is no exception in the Proposed Early Remediation Rules to this prohibition (even with regulatory approval) to allow a company to attract new management that may be brought in to help address the issues which have caused the firm to be in early remediation.¹¹

In addition, there is no level of culpability required to be shown in order for the prohibition to apply. In other contexts, firms are having to show how they will keep key management in place at times of distress;¹² moreover, other rules would apply to clawback bonus compensation from culpable executives of a firm which did not remediate and failed.¹³ Accordingly, we believe that this remedial requirement under the Proposed Rules does not support the goals of the early remediation regime, and could, in fact, contribute to a firm's decline rather than promoting the restoration of the firm's financial health.

V. Coordination With Other Prudential and Supervisory Regimes and Existing Regulatory Tools

Early remediation regimes, triggers and requirements employed by different regulatory agencies should be harmonized to avoid incongruous outcomes. The NPR notes that the early remediation regime is intended to "supplement rather than replace the Federal Reserve's other supervisory processes with respect to covered companies" and that the Federal Reserve may use other supervisory authority to cause a covered company to take remedial actions. It is currently unclear how the existing supervisory process is intended to interact with the early remediation regime, especially given the overlap in certain of the triggers (capital requirements, stress testing) with the current supervisory process.

A. The interplay of stress testing, capital planning and early remediation triggers needs to be carefully examined.

Other provisions of the NPR impose stress testing requirements on Early Remediation Covered Companies. The Proposed Stress Test Rules require both supervisory stress tests, firm-run stress tests and separate liquidity stress tests.¹⁴ Each set of stress tests involves analyses of regulatory

¹¹ See the FDIC's Orderly Liquidation Final Rule, which notes that directors and senior executives hired to turn the firm around are presumed not to be substantially responsible for the firm's eventual failure. 12 C.F.R. § 380.7(b)(3).

¹² E.g., the Federal Reserve and the FDIC's Resolution Plan Final Rule, which requires strategic planning for the rapid and orderly resolution of covered companies in the event of material financial distress or failure. 76 Fed. Reg. 67323 (Nov. 1, 2011).

¹³ See the FDIC's Orderly Liquidation Final Rule regarding recoupment of compensation from senior executives or directors materially responsible for a firm's failure. 76 Fed. Reg. 41626 (July 15, 2011).

¹⁴ See Proposed Rules, Subparts F and G.

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capital, leverage or liquidity measures, as applicable, over a forward-looking planning period,¹⁵ and firms must submit the results of firm-run stress tests to the Federal Reserve for evaluation.¹⁶ As explained in the commentary to the Proposed Early Remediation Rules, the stress test requirements “are designed to work in tandem with the Board’s capital plan rule. . . .”¹⁷ In combination, stress tests and capital planning are intended to guide the future activities, capital actions and liquidity management of firms over defined planning periods.

Stress tests help regulators and firms anticipate firms’ future capital, leverage or liquidity problems before they develop, but stress tests necessarily involve imperfect assumptions about the future conditions and actions of firms, counterparties and the broader economy. Such imperfect assumptions should not be used to subject firms to punitive regulatory measures before financial weaknesses actually appear. The early remediation regime, in contrast, prescribes a set of specific regulatory responses to verified financial or management weaknesses. The early remediation regime is necessarily reactive, because other regulatory tools address forward-looking stress scenarios and capital planning and because it would be inappropriate to subject firms to burdensome early remediation requirements and restrictions without clear evidence of actual weaknesses. The Associations have concerns, however, that the early remediation triggering events, by incorporating the Federal Reserve’s assessments of Early Remediation Covered Companies’ capital planning,¹⁸ may result in the Federal Reserve finding that a firm has breached a triggering event based upon the firm’s projected capital actions or economic conditions.

The Associations have two concerns about this interplay of stress tests and capital planning with the early remediation regime. First, as noted above, firms may be subject to early remediation actions based on imperfect assumptions about future developments or economic conditions. The Associations respectfully submit that firms’ regulators have other suitable tools, including capital requirements, to respond to the possibility of weaknesses in the firms’ prospective capital, liquidity or risk management processes. A firm should not become subject to a mandatory early remediation action unless and until a firm has demonstrated actual financial or management weaknesses.

Second, as discussed more fully below, the stress testing regime in the NPR involves public disclosures.¹⁹ The Associations have concerns that if the early remediation regime incorporates stress testing or capital planning elements into early remediation triggering events, market participants may be able to predict or discover early remediation actions against specific firms by scrutinizing stress test disclosures. Perceptions that a firm may in the future, or has already, become subject to an early remediation action could precipitate the very financial weaknesses that capital planning, stress tests and the early remediation system are intended to prevent. Accordingly, the Associations respectfully submit

¹⁵ Section 252.133 (supervisory stress tests); Section 252.145 (firm-run stress tests); Section 252.52 (liquidity stress tests).

¹⁶ Section 252.146.

¹⁷ 77 Fed. Reg. at 626, *citing* 12 C.F.R. § 225.8.

¹⁸ Section 252.163(a)(1).

¹⁹ Section 252.148.

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that early remediation triggers should not be dependent on, or otherwise linked to, forward-looking stress tests or capital planning.

B. The interplay of the prompt corrective action regime and the early remediation regime needs to be carefully examined.

Separate from Dodd-Frank and the NPR's provisions, insured depository institutions in the United States may become subject to PCA if their capital ratios decline below established benchmarks.²⁰ While the existing PCA framework has been criticized for inadequately protecting the financial health of banking entities and the financial system as a whole,²¹ PCA remains an important tool available to regulators to address banks' financial distress and the risk of losses to the FDIC's Deposit Insurance Fund.

The Associations respectfully submit that the early remediation framework should generally serve to augment PCA standards and processes. In addition, early remediation should not be used to promote industry reorganization. While the PCA framework may require revisions, PCA appropriately focuses on institution-specific weaknesses. Early remediation should likewise be used to address specific financial or management issues at Early Remediation Covered Companies, and should not be used to effect industry-wide reorganizations.

VI. Exit from the Early Remediation Regime

Under the Proposed Early Remediation Rules, a firm placed under the early remediation regime remains subject to the regime until "the Board provides written notice to the covered company that its financial condition or risk management no longer warrants application of the requirement."²² The Proposed Early Remediation Rules do not otherwise describe the process of exiting from the early remediation regime.

As discussed above, a successful early remediation regime would ensure that Early Remediation Covered Companies, when restored to appropriate managerial or financial health, are promptly released from the restrictions and requirements of the regime. Such a quick exit would ensure that firms are able to perform their normal range of market activities, thus fostering healthy credit markets and economic growth. In light of these objectives, the Associations are concerned that the Proposed Early Remediation Rules do not provide adequate clarity concerning the process for existing the regime.

We believe that once a firm has addressed the issue that triggered the application of the Early Remediation Rules for two consecutive quarters, the firm should be released from the application

²⁰ 12 U.S.C. § 1831o(e).

²¹ See, e.g., United States Government Accountability Office, "Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness," June 2011, <http://www.gao.gov/assets/330/320102.pdf>; Financial Stability Oversight Council, "Report to the Congress on Prompt Corrective Action," December 2011, <http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%20PCA%20Report%20FINAL.PDF>.

²² Section 252.164(c).

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of the sanctions. Such a clear exit rule would also encourage firms to act quickly to remediate rather than disputing the triggering event.

VII. Public Disclosure Issues

Neither the Proposed Early Remediation Rules nor the accompanying release discusses public disclosure issues related to the early remediation regime. The Associations respectfully submit that all notices, determinations and regulatory actions taken in the early remediation regime should be treated as non-public confidential supervisory information.

As discussed above, one danger of an improperly designed or administered early remediation regime is that signals of weakness can become self-fulfilling prophecies. A firm with moderate financial or management weaknesses may face sudden pressure if its counterparties interpret an early remediation action as signaling the decline of the firm. The goal of the early remediation regime should be to arrest and reverse weaknesses at firms, not propel firms toward collapse. Public disclosure of an early remediation action could further weaken any firm subject to the regime.

Finally, the Federal Reserve has already taken actions in other areas to increase large banking entities' disclosure obligations. Under the Proposed Stress Test Rules, for instance, all Early Remediation Covered Companies (and many smaller banking entities) must publish summaries of their annual stress test results.²³ Market participants will be able to use such summaries, as well as other information provided in securities filings, to make appropriate assessments about Early Remediation Covered Companies' financial health and stability. As with bank examination reports, firms should not be required to disclose the substance of early remediation determinations.

VIII. Responses to Specific Questions²⁴

Question 78: *The Federal Reserve recognizes that liquidity ratios can provide an early indication of difficulties at a covered company and seeks comment on the costs and benefits of including a quantitative liquidity trigger in the early remediation regime. If the Federal Reserve were to include a quantitative liquidity trigger in the regime, what quantitative liquidity trigger should be used and how should it be calibrated?*

See our comments in Part III.A.

Question 80: *The Federal Reserve seeks comment on the proposed mandatory actions that would occur at each level of remediation. What, if any, additional or different restrictions should the Federal Reserve impose on distressed covered companies?*

See our comments in Part IV.

Question 81: *The Federal Reserve seeks comment on the proposed risk-based capital and leverage triggers. What alternative or additional risk-based capital or leverage triggering events,*

²³ Section 252.148(b).

²⁴ As noted in footnote 6 to the Comment Letter, the Associations are not addressing the concerns of, or specific questions posed by the Federal Reserve in the Preamble relating to, nonbank covered companies.

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if any, should the Federal Reserve adopt? Provide a detailed explanation of such alternative triggering events with supporting data.

See our comments in Part III.A.

Question 82: *What additional factors should the Federal Reserve consider when incorporating stress test results into the early remediation framework? Is the severely adverse scenario appropriately incorporated as a triggering event? Why or why not?*

See our comments in Part III.C.

Question 84: *The Federal Reserve seeks comment on the proposed approach to market-based triggers detailed below, alternative specifications of market-based indicators, and the potential benefits and challenges of introducing additional market-based triggers for levels 2, 3, or 4 of the proposed early remediation regime. In addition, the Federal Reserve seeks comment on the sufficiency of information content in market-based indicators generally.*

See our comments in Part III.D.

Question 85: *Should the Federal Reserve include market indicators described above in the early remediation regime? If not, what other forward-looking indicators should the Federal Reserve include?*

See our comments in Part III.D.

Question 86: *Are the indicators outlined above the correct set of indicators to consider? Should other market-based triggers be considered?*

See our comments in Part III.D.

PRIOR SUBMISSIONS

Referenced in

**THE ASSOCIATIONS'¹ COMMENT LETTER REGARDING THE
NOTICE OF PROPOSED RULEMAKING IMPLEMENTING ENHANCED
PRUDENTIAL STANDARDS AND EARLY REMEDIATION REGULATIONS
UNDER DODD-FRANK 165/166**

April 27, 2012

¹ The "Associations" refers to The Clearing House Association L.L.C., the American Bankers Association, the Financial Services Forum, The Financial Services Roundtable and the Securities Industry and Financial Markets Association.

DOCUMENT	TAB
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LETTERS

I

Letter from the American Bankers Association to the Honorable Susan S. Bies, dated April 28, 2005.....	1.
Letter from the American Bankers Association to the Basel Committee on Banking Supervision, dated April 15, 2010, regarding the Consultative Document entitled <i>International Framework for Liquidity Risk Measurement, Standards and Monitoring</i>	2.
Letter from The Clearing House Association L.L.C. to the Basel Committee on Banking Supervision, dated April 16, 2010, regarding the Consultative Document entitled <i>International Framework for Liquidity Risk Measurement, Standards and Monitoring</i>	3.
Letter from the Global Financial Markets Association, <i>et al.</i> to the Basel Committee on Banking Supervision, dated April 16, 2010, regarding the Basel Committee on Banking Supervision’s consultative proposals to strengthen global capital and liquidity regulations.....	4.
Letter from The Clearing House Association L.L.C. to Timothy F. Geithner, <i>et al.</i> , dated November 5, 2010, regarding various reforms of capital and liquidity regulation as applied to U.S. banks.....	5.
Letter from the American Bankers Association to the Basel Committee on Banking Supervision, dated August 26, 2011, regarding the Consultative Document entitled <i>Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement</i>	6.
Letter from the Global Financial Markets Association to the Basel Committee on Banking Supervision, dated August 26, 2011, regarding the Consultative Document entitled <i>Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement</i>	7.

DOCUMENT	TAB
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<p>Letter from The Clearing House Association L.L.C. and Institute of International Bankers to the Basel Committee on Banking Supervision, dated August 26, 2011, regarding the Consultative Document entitled <i>Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement</i>.....</p>	8.
<p>Letter from The Clearing House Association L.L.C. to Timothy F. Geithner, dated November 2, 2011, regarding its study entitled <i>Assessing the Liquidity Coverage Ratio</i>.....</p>	9.
<p>Letter from The Clearing House Association L.L.C., <i>et al.</i> to the Board of Governors of the Federal Reserve System, <i>et al.</i>, dated February 7, 2012, regarding the notice of proposed rulemaking regarding alternatives to credit ratings for debt and securitization positions.....</p>	10.

STUDIES AND WHITE PAPERS



<p>The Clearing House Association L.L.C., <i>“How much capital is enough?” Capital Levels and G-SIB Capital Surcharges</i> (Sept. 26, 2011)</p>	1.
<p>The Clearing House Association L.L.C., <i>Assessing the Liquidity Coverage Ratio</i> (Nov. 2, 2011)</p>	2.
<p>The Clearing House Association L.L.C., <i>The Basel III Liquidity Framework: Impacts and Recommendations</i> (Nov. 2, 2011)</p>	3.
<p>The Clearing House Association L.L.C., <i>Understanding the Economics of Large Banks</i> (Nov. 7, 2011)</p>	4.

Letters – Tab 1



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April 28, 2005

The Honorable Susan S. Bies
Governor
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Sue:

Thank you again for participating in the inaugural meeting of ABA's Enterprise Risk Management Working Group. Our members valued the opportunity to discuss the variety of issues covered by our agenda. We hope you found the exchange informative. Your insights and observations contributed greatly to our subsequent internal discussions.

As we promised, we are following our discussion with this letter to provide insights about a particular trend in supervisory oversight – that of forcing management's role onto an already overburdened board of directors – and to offer our recommendations for taking steps to redress it.

Observations of a Trend – The Blurring of Management and Board Responsibilities

Prominent among the issues considered at our meeting was the apparent trend that regulators require an increasing level of detailed involvement of boards in fundamental management responsibilities. With each new guidance and embedded in virtually all the recent examinations, is a blurring of the distinction between senior management and the board. While well-intentioned, this regulatory trend diverts the attention of directors from providing strategic leadership and oversight to their institutions by getting them too involved – at times unnecessarily or unproductively – in an increasing amount of operational and other business-related detail. Requiring too high a level of detail is counterproductive to the goal of enhancing effective corporate governance of banks and bank holding companies.

We have collected examples of required actions from members' recent examination reports that illustrate this trend. We have included an attachment that demonstrates that these instances are not isolated, but occur frequently across regulators and regions. Here are some "Matters Requiring Board Attention" that are representative of the problems encountered by our members.

- ❑ **“Reduce/minimize cash transaction processing errors to ensure currency transaction reports are accurate.”** This is clearly management’s job.
- ❑ **“Files on the X and Y drives must be reviewed and access assigned to employees based on need.”** Conceding the substantive appropriateness of this security recommendation, it is a management issue.
- ❑ **“We recommend that [bank] develop structure around the processes dealing with the development, receipt and implementation of major assumptions: deposit elasticities, core deposit maturities, prepayment assumptions. Such assumptions should receive regular approval by the board or board designated committee”** What expertise will directors possess that would allow them to regularly approve these items? The Board’s role is to ensure that management puts a governance process in place so that experts evaluate such assumptions and provide transparency.
- ❑ **“Violations were noted regarding the font size of disclosures contained in various credit card application disclosures.... The board must ensure that management revises the application/brochures to comply with regulatory requirements.”** Technical compliance violations should not belong at the board level unless management has refused to address the issue in a timely fashion.

A board should have a policy or approved process in place that articulates bank management and audit function responsibilities for correcting adverse exam findings. Requiring assorted violations to be elevated to the board on an *ad hoc* basis circumvents this mechanism and absorbs time that should have been used by the board to address important enterprise risk issues.

As further illustration, directors are being asked to approve technical policies that are truly in the domain of management. Directors often question how they can be expected to add value by approving technical policies. They believe that this is why management with the requisite technical expertise is employed by the company.

New Supervisory Guidance Is Exacerbating This Trend.

Unfortunately, the development of new supervisory guidance has further exacerbated the tendency of examiners to blur distinctions between board and senior management responsibilities. A reading of the Basel II interagency guidance on operating risk and retail or corporate credit risk reveals that 40 of the 58 references to a bank’s board occur when describing a duty or expectation in conjunction with management, as in “IRB systems need the support and oversight of the board and senior management...” or “the board of directors and management would be responsible for maintaining effective internal controls over the [bank’s] information systems....” Although some of the Basel guidance draws a distinction between levels of reporting, too little discussion is contained in these pieces that distinguish

between the roles intended for management and those intended for the board. Consequently, using the conjunctive “board and senior management” will only encourage examiners’ tendency to blur distinctions between the two when writing future remedial recommendations.

In addition to Basel-related guidance, we see this trend reflected in other sources of supervisory oversight such as anti-money laundering compliance and information security oversight. Even expressions of modest board involvement characterized as “informing” the board imposes on directors a duty of familiarity assigned by supervisory fiat rather than derived from internally-derived risk management analysis and judgment.

This Trend Threatens to Hinder Effective Corporate Governance

This trend of rising supervisory expectations for board involvement in senior management matters has significant adverse implications for effective corporate governance. First, the independence of the board may be compromised. Second, management has a finite amount of time with board members. If a substantial portion of that time is spent reviewing materials that are best handled by management, then there is less time available for important risk issues that the board needs to understand. This comment is not just coming from management; we are hearing it from frustrated directors as well.

Third, the over-specification of board responsibilities tends to convert board service into a compliance exercise of ticking off a checklist of regulatory chores rather than a broad principle-driven dynamic interaction that develops strategic direction and performance expectations tailored to the particular bank and its market. There must be latitude for directors to define their interface with management, giving due consideration to economic circumstances, regulatory standards and complexity of the bank’s operations.

Recommendations to Address the Problem

Because these trends have serious implications for corporate governance if uncorrected, we recommend that the banking agencies take the following initiatives in this area:

First, we recommend that the agencies conduct a study of examination reports to evaluate whether examiners are appropriately distinguishing management from board obligations in their exam findings, conclusions and recommendations. In addition to sampling exam reports, we recommend interviewing examiners, field managers, review examiners and senior supervisory personnel to understand better why they choose to mandate specific board attention or action in situations that are usually management responsibility. Is agency guidance being misinterpreted, or are examiners drawing inferences about agency intentions for board participation that are going uncorrected by agency internal supervision?

Our second recommendation grows from the first: to have the agencies inventory the sources of existing regulatory obligations that examiners rely upon to support their prescriptions that directors undertake more managerial-type responsibilities. An appreciation for the source and scope of these obligations is a necessary predicate to reassessing the burdens accompanying the supervisory expectations that have accumulated over time.

Finally, our third recommendation is for the Federal Reserve and other agencies to take a leadership role in convening a “Corporate Governance in Banking Forum” to foster dialogue focusing on differentiating the roles and supervisory expectations for directors versus senior executives under the enterprise risk management paradigm. Most examiners, through no fault of their own, have never had experience in a real corporate board setting. As a result, their point of view tends to be less practical and more academic. Our bankers can provide insights to help bridge this gap and still preserve good corporate governance. This might be accomplished as part of enhanced training for examiners on the role of the board in today’s corporate governance environment. The ABA stands ready to assist in these efforts.

Conclusion

ABA’s Enterprise Risk Management Working Group believes that principle-based ERM holds the key to enabling management and the board to conduct the business of banking in the most efficient and effective manner. We look forward to working with you and your colleagues in making our common aspirations for enterprise risk management and effective governance in the banking industry a reality.

Sincerely,

A handwritten signature in black ink, appearing to read "James D. McLaughlin". The signature is fluid and cursive, with a large initial "J" and "M".

James D. McLaughlin

Examples in Which Regulatory Actions Blur Management and Board Responsibilities

The following excerpts come from examination reports and supervisory correspondence illustrating the trend of examiners to require greater involvement in the operational detail of the institution. Those excerpts that do not specifically reference the “board” were nonetheless listed under exam recommendations labeled as “matters requiring board attention.” In all cases, the institution in question was considered well-managed.

“Appropriate assumptions are critical to the success of IRR modeling. These assumptions should be consistent with the company’s experience, and should be approved as needed by the board of directors or a board designated committee”

“We recommend that [bank] develop structure around the processes dealing with the development, receipt and implementation of major assumptions: deposit elasticities, core deposit maturities, prepayment assumptions. Such assumptions should receive regular approval by the board or board designated committee...”

“For those assumptions that change more frequently, such as mortgage prepayments, it would be sufficient for the board to approve the process by which such estimates are generated ...”

“Management.....needs to create a workout policy to ensure accuracy and consistency in the commercial credit workout process. The policy must be reviewed and approved by the Board of Directors.”

“During the review it was noted that inconsistencies exist in the signature process of [Problem Asset Reports (PAR)]. Additionally, PAR’s did not meet frequency guidelines. Management and the board of directors need to ensure that PAR guidelines are utilized to provide adequate monitoring of classified and criticized credit relationships.”

“The board must assure that a uniform and systematic approach is maintained for the documentation of the underwriting decision made in extending credit card loans to small businesses.”

“Violations were noted regarding the font size of disclosures contained in various credit card application disclosures... The board must ensure that management revises the applications/brochures to comply with the regulatory requirements.”

“Ensure that policies, procedures and guidelines are consistent and clearly communicated.”

“Files on the X and Y drives must be reviewed and access assigned to employees based on need.”

“...monitor integration of the automated AML system to ensure timely implementation of comprehensive suspicious activity monitoring processes across all business lines.”

“Reduce/minimize cash transaction processing errors to ensure currency transaction reports
 (“CTRs”) are accurate.”

Letters – Tab 2

April 15, 2010

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

Re: Consultative Document: *International Framework for liquidity risk measurement, standards and monitoring*

Ladies and Gentlemen:

The American Bankers Association¹ (ABA) welcomes the opportunity to comment on the consultative document (CP) published by the Basel Committee on Banking Supervision (Committee or BCBS), *International Framework for liquidity risk measurement, standards and monitoring*. We share the Committee's goals of further elevating the resilience of internationally active banks to liquidity stresses across the globe, as well as increasing international harmonization of liquidity risk supervision. We are broadly supportive of quantitative liquidity standards, the implementation of which could be coordinated through the college of supervisors framework, in order to enhance the consistency of liquidity regulation across jurisdictions. We are, however, concerned with the potential macroeconomic and market impacts of adoption of the CP in its present form, especially when combined with other BCBS initiatives and those advanced in other fora, including the Financial Stability Board, the accounting standards setters, and national legislatures and sectoral regulators.

Overall, we believe that the parameters and assumptions set forth in the CP are excessively conservative and would create a significant funding gap that will exacerbate, not reduce, liquidity risk and, consequently, systemic risk. We support the goal of the Committee to improve liquidity resilience but believe that a major recalibration of the CP is necessary to achieve this goal.

We urge greater attention to the impact of the underlying assumptions in the CP and the unintended consequences that may result therefrom, only one of which may be to force banking-like activities into segments of the financial services industry not subject to comparable standards – and thereby frustrate the efforts toward harmonization of standards. There are also serious issues regarding workability and impairment of the ability of banks to manage their finances in the most efficient and safe manner. Specifically, we believe that the assumptions underlying the ratios are fundamentally flawed and should be revised substantially. The liquidity standards expressed in the CP reflect “worst case” market conditions. Indeed, we believe that the assumptions

¹ “The American Bankers Association represents banks of all sizes and charters and is the voice for the nation’s \$13 trillion banking industry and its two million employees.”

underlying the net stable funding ratio are more severe than actual experience in stressed “tail event” liquidity conditions such as in the 2007-2008 period. These assumptions would likely give rise to an unwarranted and unsubstantiated liquidity “shortfall” that could undermine seriously market confidence.

Moreover, an assessment of the liquidity position of a firm needs to be broader than an assessment of two ratios that may not capture adequately the funding capabilities and vulnerabilities of all banks, nor appropriately accommodate the diversity within the industry. The net stable funding ratio and the liquidity coverage ratio should be used as two tools as part of the overall assessment of a firm’s liquidity position and processes. The standardized assumptions that underlie these ratios mean that the measures would not be truly comparable across banks as a result of different business models or activities, geographies, and levels of market participation.

We appreciate the effort of the Committee to conduct a quantitative impact study (QIS) to assess the effect on banks of the Committee’s initiatives. However, we are cognizant of the data and operational challenges that are posed by such a study and urge a flexible approach that does not view the QIS results as definitive evidence to support the calibration of liquidity standards and metrics. Indeed, the availability of funding liquidity can vary significantly by jurisdiction and we question whether a uniform calibration of liquidity standards and metrics is appropriate. We urge the BCBS to make public the research that supports the cash outflow run-off rates and the funding haircuts proposed in the CP for the liquidity coverage ratio and the available stable funding factors and required stable funding factors proposed for the net stable funding ratio. We encourage the Committee to allow the industry to examine the analysis conducted and offer comment.

The Committee should consider carefully how to phase-in new liquidity standards, taking into account the impact of those changes on the market during various stages of implementation. Adopting changes to prudential standards without proper phase-in can be extremely disruptive to national and international markets, especially during times of stress. We strongly encourage a measured approach and continuous monitoring of the impact of changes to the prudential standards for liquidity in order to minimize unintended consequences and market disruptions.

We are pleased that the Committee has recognized the need to take account of jurisdiction-specific considerations with respect to run-off factors. However, we believe that other parameters may also have to be adjusted to take into consideration national differences. The Committee should also consider carefully differences in banking operations across jurisdictions, including differences as to what constitutes a liquid asset, differences in market haircuts for funding sources, the required stable funding factors, and the parameters used to establish stressed market conditions. Moreover, banks in the same jurisdiction may warrant the use of very different parameters. A more flexible approach is appropriate to determine whether a bank has adequate short-term and longer-term funding liquidity sources, in light of the bank’s overall liquidity risk management program.

Macroeconomic and Market Impacts of the CP

The potential macroeconomic and market impacts of adoption of the CP raise significant concerns, especially when combined with the potential impact of other BCBS initiatives and those advanced in other fora, including the Financial Stability Board, the accounting standards setters, and national legislatures and sectoral regulators. We believe that insufficient attention has been given to the potential cumulative impact of these various initiatives and the unintended consequences that may result therefrom.

These macroeconomic and market concerns are particularly acute at the current stage of the global economic cycle. A significant increase in holdings of liquid assets by banks could create market dislocations as banks would need to shift investments from consumer-, mortgage-, and business-related investments to sovereign instruments such as cash, central bank reserves, and government securities. This shift in investments would impair the recovery of the economy and make it very difficult for consumers and small businesses to obtain credit, to the detriment of national economies and the global economy. The cost of available credit could be expected to increase significantly with a lower supply.

Moreover, there is an additive effect when one considers other proposals that could constrain bank intermediation activities and growth. The BCBS has published for comment a consultative document on regulatory capital that would require significantly higher capital requirements through a much more limited definition of tier 1 capital, the phase-out of hybrid capital instruments, the inclusion of additional assets on banks' balance sheets as a result of accounting changes, and the need to maintain buffers in addition to minimum requirements. In addition, in a number of jurisdictions, consideration is being given to the imposition of taxes on banks to offset the cost of current interventions and/or to fund the cost of any future interventions. The proposals in the CP, when considered in concert with the heightened capital standards under consideration by the BCBS, proposals for tax schemes, and other proposals under consideration in various national and international fora, could have a significant negative impact on the ability of the global economy to recover from the current recession and on global growth rates for many years.² We strongly urge the Committee to utilize all available resources – including input from high-level policy makers – to study the potential cumulative impact on global growth of the CP and other initiatives. Only by studying this cumulative impact will the Committee be able to take appropriate steps to coordinate regulatory reforms based on a robust cost/benefit analysis of the cumulative impact and in a way that strengthens rather than damages the financial system.

The CP does not mention a specific date for implementation of revised liquidity standards, but it does quote the recommendation of the G20 that the BCBS and national authorities should develop and agree to by 2010 a global framework for

² In the United States, both private and public sector economists are projecting high levels of unemployment persisting at least through 2011.

promoting stronger liquidity buffers at financial institutions.³ We submit that developing and agreeing to a liquidity framework in this compressed timeframe, and given the need to coordinate a liquidity initiative with the regulatory capital and other initiatives underway, does not appear possible or practicable. We respectfully request that the Committee consider the cumulative impact of the CP and other proposals through the QIS process and provide the industry with the opportunity to contribute more effectively towards the data collection needed to product a robust QIS by extending the study through 2010. We also reiterate our encouragement of a gradual implementation and measured approach and continuous monitoring of the impact of changes to the prudential standards for liquidity in order to minimize unintended consequences and market disruptions.

In addition to the need for further study of the impact of the proposals in the CP, we would urge the Committee to consider carefully the timing of the implementation of any new requirements in light of economic conditions and the need for banks to make possibly significant changes to their liquidity risk management processes and management information systems. The Committee should seek the input of banks with respect to the timing of implementation and appropriate phase-in, transitional, and grandfathering arrangements once the QIS exercise has been completed. This may be best accomplished by publishing a second consultative document for public comment once the QIS has been completed and further details of the liquidity proposal have been agreed by the Committee.

With respect to individual banks, the cumulative impact of the CP and other initiatives likely would be higher costs of capital and lower returns that would make it more difficult to attract and retain investors, creating a banking sector that would be less resilient to future shocks. There is an acknowledged “announcement effect” that translates the tightening of bank prudential standards into lower ratings and share prices, even before those changes are implemented and despite the announcement of grandfathering or transitional provisions. For bank customers, both consumers and businesses, the cumulative impact would mean lower levels of lending and investment by banks, and a relative contraction of economic activity.

Our members have noted that the CP would require banks to maintain data at a level of granularity that generally is not available at the present time. As a result, banks would need to make considerable investments of time and resources to upgrade systems and processes at a time when they are faced with a number of competing calls for additional resources. The Committee should consider carefully the cost/benefit trade-off of imposing additional data requirements and the timing of any such requirements. The Committee should refrain from imposing requirements on a bank that would not be consistent with or contribute to the bank’s overall liquidity risk management program, consistent with the Basel Committee’s longstanding “Use Test.” For example, the focus on contractual cash flows is not meaningful or justified on a cost-benefit basis, as it would not be comparable across banks.

³ See Paragraph 4 of the CP.

Differences Across Jurisdictions

We are pleased to see that the Committee has recognized the need to take account of jurisdiction-specific considerations in Paragraphs 10 and 18 of the CP with respect to run-off factors. However, we believe that other parameters may also have to be adjusted to reflect national differences, most notably the definition of liquid assets, the available stable funding haircuts, the required stable funding factors, and the parameters used to establish stressed market conditions.

With respect to the cash outflow run-off rates, available stable funding haircuts, and required stable funding factors set forth in the CP, we question how these could be established by international agreement, given the acknowledged significant national differences in deposit behavior. We encourage the Committee to reconsider the approach of setting standardized run-off rates, haircuts, and factors for the liquidity coverage and net stable funding ratios in light of acknowledged national differences. Specifically, it would be more appropriate for individual banks to set these parameters, in coordination and consultation with their national regulators and consistent with overall principles. Banks are constantly developing new and improved models for funding liquidity; the use and further development of these models will enhance the management of liquidity risk. Standardized parameters are not only inaccurate for individual banks, they disincent good liquidity risk management and the development of more robust risk management techniques. Given the experience of the past several years, there is an opportunity to perform quantitative analysis to calibrate these factors better on a bank-specific basis.

In addition, we have the following specific comments on the CP:

- The definition of unencumbered, high quality liquid assets for purposes of calculating the liquidity coverage ratio is excessively narrow and too heavily relies upon the assumption of riskless sovereign instruments. This narrow definition, combined with prescriptive ratios, would cause banks to focus on the same funding sources and pricing incentives, thus increasing the likelihood of highly correlated “herd” behavior and the possibility of supply bottlenecks.
- The prohibition on commingling or using as hedges, collateral, or credit enhancements those liquid assets would raise serious operational problems for banks.
- The CP would impose overly aggressive cash outflow run-off rates for the liquidity coverage ratio akin to the Basel I credit risk weights. We believe that these run-off rates would prove to be inadequate and insufficiently granular for different types of funding sources just as the Basel I risk weights were found to be insufficiently granular for different types of assets.

- Similarly, the available stable funding haircuts and required stable funding factors would be inadequate and insufficiently granular for different types of funding sources. The proposed haircuts fail to acknowledge that securities collateral already is haircut in the margining process.
- The net stable funding ratio assumptions are too severe for a one-year stress event and exceed conditions that can be expected in severe liquidity stress “tail events.” These assumptions do not take into account banks’ ability to change strategies or business plans over a one-year period in response to a stress.
- A more reasonable assumption for the liquidity coverage ratio and the net stable funding ratio would be to recognize a “spectrum of liquidity” within the 30-day and one-year time periods, respectively.
- The assumption that the central bank would not provide support in a systemic shock runs counter to the long-standing role of banks as intermediaries and central banks as providers of liquidity and lenders of last resort.
- The assumptions underlying the liquidity ratios should be aligned in order to prevent a double counting of potential outflows. Moreover, these assumptions should be aligned with the assumptions set forth in the capital proposal.
- While metrics can be helpful “snapshots” of a bank’s current liquidity position, they should be considered in a holistic context in light of the bank’s overall liquidity risk management policies and processes.
- The assumption of no asset prepayments for purposes of the contractual maturity mismatch metric is excessively conservative and does not reflect banks’ actual experience over many years and across economic cycles.
- The 1 percent of total liabilities threshold for purposes of the concentration of wholesale funding metric is excessively conservative, especially if supervisors apply this metric more broadly to smaller banks.
- The proposed public disclosures likely would result in an incomplete picture of a bank’s true liquidity profile and confusing and misleading information as a result of the lack of comparability of disclosures across banks, potentially causing perverse and unjustified shocks to bank liquidity.

Definition of Liquid Assets

The definition of liquid assets in the CP⁴ includes cash, central bank reserves available in times of stress, marketable securities not issued by financial firms that are assigned a zero risk weight and for which deep markets exist, and government or central bank debt issued in the domestic currency. Consideration is being given to including high quality corporate bonds and covered bonds subject to haircuts and diversification criteria.⁵ We urge the Committee to disclose publicly the methodology used to compute the proposed haircuts in Paragraphs 36 and 37 of the CP so that the industry and other interested parties may study the analysis and provide comment as appropriate.

We have pointed out above the serious macroeconomic and market impacts that such a narrow definition of liquid assets would create. Specifically, the narrow definition of liquid assets, combined with prescriptive ratios, would cause banks to focus on the same sources of funding (e.g., sovereign debt) and pricing incentives, thus increasing the likelihood of highly correlated “herd” behavior, as well as exposing the overall banking system to significant funding shortages and bottlenecks – especially in times of overall system stress. The end result of this would be to constrain, not increase, banks’ overall funding liquidity.

In order to avoid the risk of highly correlated bank behavior that would increase overall systemic liquidity risk, the definition of liquid asset should be made flexible, as well as open-ended to encompass new products as they are developed. In addition to including corporate and covered bonds in the definition of liquid assets, which we strongly favor, we encourage the consideration of appropriate mortgage-related instruments, subject to appropriate haircuts that could be modified over time as conditions in the secondary market for those assets improve. The failure to include government-sponsored agency mortgage-backed securities in the definition of liquid assets could be detrimental to national markets and the housing sector. Moreover, a failure to include mortgage-related assets such as agency mortgage-backed securities could disincent banks’ holdings of these assets for prudent risk-mitigation purposes, such as to hedge interest rate risk.

We also urge the inclusion in the definition of liquid assets readily available funding from government-sponsored sources, such as the Federal Home Loan Banks and Federal Reserve Banks in the United States. We understand that banks in many of the Basel Committee jurisdictions have ready access to similar sources of funds in both business-as-usual and stressed conditions. The inclusion of these funds in liquid assets could be conditioned on the bank having in place all contractual arrangements needed to effect ready access to the funds.

We encourage the Committee to revisit the assumptions reflected in the proposal regarding the liquidity of the repo markets. The experience during the recent market disruptions was that the repo market remained active for a broad range of securities

⁴ See Paragraph 34.

⁵ See Paragraph 35.

beyond those defined as liquid in the proposal. During recent stress events, secured financing was not impacted significantly for U.S. and European investment grade corporate, U.S. and European equities, U.S. investment grade convertible debt, and investment grade private label collateralized mortgage obligations. For those assets that became more illiquid during the recent stress events, such as U.S. high-yield corporate debt, non-investment grade private label collateralized mortgage obligations, non-investment grade convertible debt, and emerging markets securities, the assumption of no liquidity is inappropriately conservative. Rather, we would encourage the Committee to use assumptions based on stress haircuts actually experienced during the 2007-09 period.

The asymmetric treatment of repurchase and reverse repurchase agreements and securities lending and borrowing transactions is inappropriate insofar as it assumes that borrowings are repaid contractually by the bank but that cash placed with counterparties is not repaid. In reality, if secured borrowing becomes limited, treasurers and finance desks will be recalling cash.

Prohibition on Commingling, Hedging or Use as Collateral or Credit Enhancements

Paragraphs 26 and 32 of the CP provide that the stock of high quality liquid assets that forms the numerator of the liquidity coverage ratio could not be pledged either explicitly or implicitly in any way to secure, collateralize, or credit enhance any transaction and could not be held as a hedge for any other exposure. We understand from our members that this limitation on the use of liquid assets would create considerable operational and management information systems capability issues. In many banks, individual business lines enter into collateral, credit enhancement, or hedging contracts as business and risk management needs dictate. While a centralized treasury function may track these contracts, it would be extremely cumbersome for business line executives to verify on a transaction-by-transaction basis whether a particular asset could be pledged or hedged. We encourage the Committee to reconsider the absolute prohibition on pledging or hedging. Instead, we suggest an approach where supervisors have the ability to assess the ability of a bank's stock of liquid assets to serve as a source of contingent funding, taking into consideration the composition of those assets and the risk management capabilities of the particular bank.

Cash Outflow Run-off Rates and Haircuts for Liquidity Coverage Ratio

The CP would impose cash outflow run-off rates for the liquidity coverage ratio akin to the Basel I credit risk weights.⁶ We believe that these run-off rates would prove to be inadequate and insufficiently granular for different types of funding sources just as the Basel I risk weights were found to be insufficiently granular for different types of assets and, ultimately, would prove inadequate both for supervisory and risk management purposes. Moreover, we believe the run-off rates proposed are unduly conservative,

⁶ Paragraph 41 et. seq.

even taking into account banks' experiences in the recent financial disruptions. In fact, available data demonstrates that the run-off rates actually experienced by banks immediately prior to failure are much lower than those proposed in the CP. Deposit trends from 121 bank failures from 2008 and 2009 show that deposits actually increased at banks in the third and fourth quarters prior to failure, decreasing by 1.3 percent in the second quarter prior to failure and 2.1 percent in the last quarter prior to failure. The greatest decline in deposits – that is, the greatest rate of run-off – of any bank in the last quarter prior to failure was 17 percent.⁷

In particular, the degree of deposit runoff assumed for custodial deposits, corporate deposits, and deposits from financial institutions with well established relationships are excessive. Experience during the recent market disruptions demonstrates that custodial and corporate deposits were resilient due to the stable, long-term nature of custodial deposits and strong underlying business relationships. A substantial proportion of financial institution deposits are associated with core businesses, such as payment and settlement and custodial accounts.

The CP provides a 10 percent draw down assumption for committed lines of credit to non-financial corporate customers and a 100 percent draw down assumption for committed lines to all other counterparties. This approach is insufficiently granular and does not reflect differences in draw downs across different types of firms during the recent market stress. In particular, we do not believe that this approach reflects accurately the liquidity profile of commitments to financial firms and would urge the reconsideration of assumptions related to financial firms and funds more along the lines of what is provided for non-financial corporate counterparties.

We strongly support an approach that would be agreed to by banks and their supervisors, utilizing banks' internal models and historical data to establish ranges of run-off factors that could be adjusted over time to account for changes in market conditions as well as idiosyncratic factors. Such an approach would have the benefit of greater accuracy and would contribute to more robust liquidity risk management methodologies and practices.

Available Stable Funding and Required Stable Funding Factors for Net Stable Funding Ratio

As is the case with standardized run-off rates for the liquidity coverage ratio, the available stable funding and required stable funding factors for the net stable funding ratio would be inadequate and insufficiently granular for different types of funding sources.⁸ The use of these factors would be an inappropriate reversion to a Basel I-type standard that would prove inadequate both for supervisory and risk management purposes. Again, we strongly support an approach agreed to by banks and their supervisors that would utilize banks' internal models and historical data to establish

⁷ Source: FDIC data through Q3 2009.

⁸ Paragraph 86 et. seq.

ranges of factors that could be adjusted over time to account for changes in market conditions as well as idiosyncratic factors.

The calculation of the net stable funding ratio does not consider adequately the availability of collateral. For example, an asset subject to a repurchase agreement would require 100 percent long-term stable funding even if the agreement is for a relatively short term and adequate and appropriate collateral is posted. This proposed treatment does not reflect market practices and would disincent greatly the use of repurchase agreements, which have been shown to be a stable and cost-effective source of funding. The available stable funding factor haircuts also fail to recognize that securities collateral is already subject to haircut in the margining process. A second layer of haircuts would be a double counting of a conservative approach.

The use of similar assumptions for the liquidity coverage ratio and the net stable funding ratio would be inappropriate. The short-term liquidity coverage ratio implies a level of stress associated with a firm that will no longer be viable on a stand-alone basis. The longer-term net stable funding ratio should reflect a lower level of stress associated with a longer term, less stressful event.

Net Stable Funding Ratio Assumptions

The assumptions underlying the net stable funding ratio are too severe as to be meaningful over a one-year horizon. Indeed, the assumptions are more severe than the experiences of banks during recent funding liquidity disruptions. A complete run-off of market-based funding is unrealistic except in the case of a bank failure. During the most recent market disruptions, wholesale funding markets remained available, albeit at shorter maturities.

Over a one-year horizon, banks have many other sources of liquidity beyond the narrowly prescribed definition of available stable funding⁹ that have served and can continue to serve as contingent liquidity sources. For example, over a one-year horizon, banks can plan for asset sales, curtail lending to shrink balance sheet size, and take other measures to improve liquidity through a range of liquidity risk management techniques. Moreover, banks should be granted full credit – that is, a required stable funding factor of zero percent – for scheduled amortizations and pre-payments on pooled investment securities with terms to maturity greater than one year, as these are stable and predictable cash inflows. The assumption of a total loss of funding from maturity term securitizations and asset-backed commercial paper is inappropriate and would reduce incentives for asset securitization, reduce the flow of liquidity to segments of the market, and potentially reduce economic activity.

We understand the concern of the Committee regarding the lack of liquidity in the securitization markets during the recent market disruptions. However, for purposes of a longer-term liquidity ratio, the lack of any credit for securitization exposures is unduly harsh, particularly for government agency-sponsored mortgage-backed securities. We

⁹ See Paragraph 86 of the CP.

would encourage the Committee to reconsider this aspect of the proposal and provide a prudent partial credit for these exposures, given the long history of the securitization markets as a source of liquidity to banks. The proposal reduces incentives to securitize assets, thus decreasing liquidity and, potentially, economic activity.

The impact of these excessively severe assumptions underlying the net stable funding ratio would be a significant impairment of banks' ability to serve their traditional intermediation functions and play their role in maturity transformation as a result of the need to maintain excessive amounts of short-term, liquid assets on the balance sheet. The ultimate impact, of course, would be a serious curtailment of the amount of credit available and a significant increase in the cost of that credit, both of which are detrimental to economic growth and development and the exit from a global recession.

Spectrum of Liquidity

The proposal fails to recognize that there is a "spectrum" of liquidity for assets over time, even under stressed conditions. Moreover, the range of assets that can be monetized over a one-year period is markedly broader than those that can be monetized over a short-term timeframe. The proposal should consider the range of marketability of different assets over time. To fail to do so would only increase funding liquidity risk, as banks would migrate to the same narrow range of assets to meet their funding needs. Moreover, the proposal should recognize banks' ability, particularly over a one-year timeframe, to change their funding activities and business models to take into account new market information and adjust their strategies accordingly.

A very narrow focus on sovereign issuances would also have a potential negative impact on the ability of corporate issuers to access the market, as banks would be reluctant to purchase corporate paper not considered "liquid" or would require a considerable premium in the form of dividends or interest to hold this paper. At the same time, given the need to hold high levels of liquid assets, banks would not have the capital to provide corporate funding through traditional bank loans. The macroeconomic implications of constraining corporate credit availability in this manner could have wide-ranging and unforeseen consequences to the broader economy.

Central Bank Support

The assumption that the central bank would not provide support in a systemic shock runs counter to the long-standing role of banks as financial intermediaries with a maturity transformation role in the economy and central banks as providers of liquidity and lenders of last resort. The proposal, as it currently stands, would place banks in an unprecedented role as insurers of financial stability, with consequences for banks' market perception of stability. It would also cause banks to step back from some of their intermediation activities, increasing the cost and reducing the availability of credit.

Alignment of Assumptions in the Liquidity and Capital Proposals

The CP double-counts potential liquidity and capital outflows. For example, under the CP, a bank would assume it has no access to liquidity facilities it has established for its benefit while, at the same time, assume that banks to which it has provided liquidity facilities would execute unscheduled draws on all such facilities.¹⁰ At a minimum, corporate committed facilities should be differentiated between those more likely to be drawn under stress – that is, leveraged finance, syndications, and bridge facilities – and those that have not seen increased draws under stress.

Moreover, the assumptions underlying the CP are misaligned with assumptions underlying the Committee's capital proposal.¹¹ For example, for purposes of calculating the leverage ratio, the bank would assume that liquidity facilities that it provides may not be cancelled.¹² However, if those facilities are provided to banks, those banks may not assume access to those funds.¹³ The overall impact of the proposals is double-counted when assumptions are misaligned.

Metrics Generally

While metrics can be helpful “snapshots” of a bank's current liquidity position, they should be considered in a holistic context in light of the robustness of the bank's overall liquidity risk management policies and processes. Metrics should also reflect how a particular bank measures and manages its liquidity risk in order to satisfy the “Use Test.” Metrics that do not reflect a bank's overall liquidity risk management program are not helpful, at best, and can be misleading.

We reiterate our view that the liquidity coverage ratio and net stable funding ratio are only two tools among many for managing liquidity risk. The measures are not comparable across banks as a result of different business models and activities, geographies, and degree of market participation, and efforts to make comparisons could be damaging to individual banks and the industry as a whole.

Prepayment Assumption for Contractual Maturity Mismatch Metric

Paragraph 97 of the CP would impose contractual cash flow assumptions on all asset flows for purposes of calculating the contractual maturity mismatch metric. Paragraph 98 would impose an assumption that liabilities do not rollover. These assumptions run counter to the historical and current experiences, even in extreme “tail events,” and would be dangerously misleading. The assumptions may also give rise to an incentive for banks to rely more heavily on wholesale funding, which is more likely to contain prepayment penalties that protect the bank from premature withdrawal.

¹⁰ Paragraph 22 of the CP.

¹¹ See Consultative Document: *Strengthening the resilience of the banking sector*, Basel Committee on Banking Supervision, December 2009.

¹² Paragraph 206 of the CP.

¹³ *Id.*

A contractually based metric is not meaningful in measuring liquidity mismatches either for a particular bank or across banks. A contractual metric does not reflect actual cash flows, nor does it capture the full range of contingencies and optionality inherent in many cash flows. Imposition of this metric would impose costs on banks with no realizable benefit and would not pass the Basel Committee’s “Use Test.”

In lieu of the proposed contractually based metric, we support strongly an approach that would utilize banks’ internal models and historical data to establish appropriate prepayment assumptions for various classes of assets. This approach would be more closely aligned to the actual experience of the bank, provide a more meaningful metric for both banks and supervisors, and would contribute to more robust liquidity risk management methodologies and practices.

Concentration of Funding Metric Threshold

Paragraph 107 of the CP defines a “significant counterparty” for purposes of the concentration of funding metric as a single counterparty or group of connected or affiliated counterparties accounting for in the aggregate more than 1 percent of the bank’s total liabilities. A 1 percent of liabilities threshold is also used for determining a “significant instrument/product” and a “significant currency.”¹⁴

While we fully support the Committee’s concerns about funding concentrations and encourage banks to have diverse sources of funding for both business-as-usual and stressed conditions, we believe that the 1 percent threshold would be inappropriately low for most banks and very difficult for smaller banks to meet.¹⁵ Instead of a “one-size-fits-all” threshold, an analysis of the bank’s liquidity position would be more appropriate. Consideration could be given, on a bank-by-bank basis, to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the bank’s size, complexity, and risk profile, including mismatch position. Ultimately, funding concentrations should be viewed in the context of the bank’s overall balance sheet composition.

Public Disclosures

The proposed public disclosures would result in an incomplete picture of a bank’s true liquidity profile that easily could be misinterpreted or misunderstood by recipients of such information. This misunderstanding could undermine confidence in a particular bank or in banks more broadly, without any appropriate basis for such lack of confidence.

As noted above, metrics can be helpful “snapshots” of a bank’s current liquidity position. However, they cannot be separated from disclosure of the bank’s overall liquidity risk management program and should be subject to a “Use Test” requirement. Banks

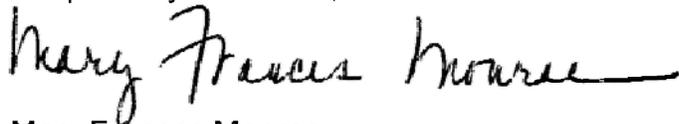
¹⁴ Paragraphs 109 and 111 of the CP, respectively.

¹⁵ The Committee would give national supervisors the discretion to apply the new liquidity standards to banks of all sizes pursuant to Paragraph 133 of the CP.

should be encouraged to make robust and complete disclosures of their liquidity positions and liquidity risk management programs, but the details of that disclosure should be left to the discretion of bank management.

We appreciate the opportunity to comment on the CP and would be pleased to answer any questions.

Respectfully submitted,

A handwritten signature in black ink that reads "Mary Frances Monroe". The signature is written in a cursive style with a long horizontal flourish at the end.

Mary Frances Monroe

Letters – Tab 3



Paul Saltzman
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April 16, 2010

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

Re: Proposals to Strengthen Liquidity Risk Measurement, Standards
and Monitoring

Ladies and Gentlemen:

The Clearing House Association L.L.C. (“*The Clearing House*”), an association of major commercial banks¹, appreciates the opportunity to comment on the Basel Committee’s December 2009 consultative document (the “*CD*”), *International framework for liquidity risk measurement, standards and monitoring* (the “*Proposals*”).²

The observation in Paragraph 1 is indisputable – “[t]he crisis illustrated how quickly and severely liquidity risks can crystallize and certain sources of funding can evaporate . . .”. Banks³ and their regulators must deal with this phenomenon. We endorse the Committee’s efforts to enhance the resilience of internationally active banks

¹ The member banks of The Clearing House are Bank of America, N.A., The Bank of New York Mellon, Capital One, N.A., Citibank, N.A., Deutsche Bank Trust Company Americas, HSBC Bank USA, National Association, JPMorgan Chase Bank, N.A., The Royal Bank of Scotland N.V., UBS AG, U.S. Bank N.A. and Wells Fargo Bank, National Association. The following members of our affiliate, The Clearing House Payments Company L.L.C., participated in the preparation of this letter and endorse its positions: Branch Banking and Trust Company, Comerica Bank, KeyBank, N.A., PNC Bank, N.A. and Union Bank, N.A.

² The Clearing House is submitting a separate letter commenting on the Committee’s capital proposals, *Strengthening the resilience of the banking sector* (the “*Capital Proposals*”). Additionally, a number of The Clearing House banks will submit their own comment letters on the Proposals and the Capital Proposals, including in many cases comments on aspects of the Proposals and Capital Proposals that particularly impact the operations of those banks.

Capitalized terms used herein and not otherwise defined are used with the meanings assigned to them in the CD. Paragraph references are to paragraphs in the CD.

³ We are using the term “*banks*” to mean both bank holding companies and depository institutions that are internationally active banking organizations.

to liquidity stress and, as part of those efforts, to develop clearer principles for the quantitative measurement of liquidity risk. As a conceptual matter, we support the application by banks of a short-term measure to address liquidity needs under an acute liquidity stress scenario, like the liquidity coverage ratio, or “*LCR*”, outlined in the Proposals. We also believe that banks’ analysis of their liquidity risk, and national regulators’ supervisory oversight of that risk, should take into account structural mismatches between short-term funding and longer-term assets, which the Proposals attempt to address with the Net Stable Funding Ratio, or “*NSFR*.”

We are deeply concerned, however, with the approach taken by the Committee in the Proposals and are committed to working with the Committee and our national regulators to develop sound and effective approaches to the measurement, analysis and supervision of liquidity risk that address what we believe are the weaknesses of the Proposals.

EXECUTIVE SUMMARY

A. Fundamental Concerns

Our principal concerns with the Proposals are in four areas.⁴

- Prescribed Ratios; Alternative Approaches. We continue to believe that a principles-based approach to liquidity risk management is the better approach. We are skeptical that the prescriptive approach of the Proposals can be adjusted to provide the best approach to the measurement, analysis and supervision of liquidity risk and urge the Committee to consider permitting national regulators much more flexibility in establishing funding parameters⁵ based on actual experience in their jurisdictions and permitting banks that have developed internal liquidity models (“*ILMs*”) for measurement and management of liquidity risk, and can demonstrate the efficacy of those models to the satisfaction of their national regulators, to use those models as an alternative to

⁴ By letter dated July 31, 2008, The Clearing House commented on the Committee’s initial release of its *Principles for Sound Liquidity Risk Management and Supervision*, ultimately issued in September 2008 (the “*2008 Principles*”). We noted in particular that the 2008 Principles avoided mandatory quantitative standards and urged the Committee not to require mandatory quantitative disclosures. Those two comments on the 2008 Principles are among our most basic concerns with the Proposals.

⁵ In the letter, we use the term “*funding parameters*” to mean the numerators and denominators in the ratios (for example, the haircuts on components of the numerator in the LCR, the run-off factors for the denominator in the LCR, the ASF Factors applied in calculating the numerator in the NSFR, and the RSF Factors applied in calculating the denominator in the NSFR).

the LCR and NSFR. If the Committee proceeds with prescribed ratios like the LCR and NSFR, it is exceedingly important that banks, regulators and market participants (analysts, investors, creditors and counterparties) recognize that those ratios are but two of many tools for measuring liquidity risk. We urge the Committee and national regulators not to focus on the LCR and NSFR so narrowly and prescriptively that banks are deterred from developing more advanced ILMs tailored to the particular nature of their own businesses and the evolving nature of liquidity risk.

Both the LCR and the NSFR have serious flaws. The LCR can be fixed more easily than the NSFR, however, most importantly by expanding the scope of high-quality liquid assets for purposes of the numerator in the ratio and adjusting the funding parameters used to determine net cash outflow in the denominator to reflect actual experience. Our concerns with the NSFR are more fundamental. We agree that structural mismatches between short-term funding and longer-term assets should be addressed as part of liquidity management and supervision. However, given its severe assumptions, the NSFR goes too far in eliminating those structural mismatches. It would fundamentally change the role of banks in maturity transformation.

- Disclosure. We are concerned that the required disclosure by banks of their LCR and NSFR percentages may destabilize some banks. In our view the better approach would be one where, if the Committee proceeds with a prescriptive LCR and NSFR as contemplated by the Proposals, banks' percentages under those ratios would not be publicly disclosed but, instead, would be recognized and accepted for what they are – just two of many tools used by national regulators and banks to evaluate and manage liquidity risk. Although we urge the Committee not to require disclosure, we are very concerned that, inevitably, irrespective of whether disclosure is required by national regulators, banks' ratios under the LCR and NSFR will become public. That likelihood makes it even more important that the ratios be properly and realistically calibrated. We believe that many of the funding parameters and assumptions underlying the LCR and NSFR are excessively conservative and need to be re-calibrated so that calculations under the ratios produce a more realistic picture of banks' liquidity positions.
- Macroeconomic Impact. We urge the Committee to give greater attention to the macroeconomic impacts of the Proposals, together with other legislative and regulatory initiatives (including the Committee's own Capital Proposals) that are substantially

changing the landscape for bank regulation and the definition and conduct of the banking business.

- Process and Timing. We urge the Committee to adopt a less accelerated timeline for finalization of definitive Proposals, and their implementation, that permits the Committee to more fully explain the analysis underlying the Proposals, particularly the research undertaken and data used in developing funding parameters, and allows regulators and banks to comment once they understand that analysis and can evaluate the impact of the ongoing quantitative impact studies, or “*QIS*.”

B. Recommendations on Specific Elements of Proposals

In order to assist the Committee in understanding our view that a principles-based approach to liquidity risk management will produce better results than the prescriptive approach of the Proposals, we have set forth in Part II.A under “Detailed Comments” our more specific concerns with the Proposals, summarized below.

1. Liquidity Coverage Ratio. As indicated above, as a conceptual matter, we support the application by banks of a short-term measure to address liquidity needs under an acute liquidity stress scenario, like the LCR. However, we are deeply concerned with certain aspects of the LCR. Our principal concerns with the LCR, discussed in Part II.A of our Detailed Comments, are with the excessively conservative assumptions in the stress scenario for the LCR, unsupported in our view by the experience of U.S. banks during the financial crisis; the definition of “high-quality liquid assets” for purposes of the numerator in the LCR, which we believe should be substantially expanded; run-off factors for both retail and wholesale deposits that assume much higher run-off in a number of areas than was experienced by our member banks during the financial crisis; the assumption that there is no rollover of repos or other short-term funding transactions, except for those supported or secured by high-quality liquid assets, which we feel is far too extreme; the asymmetry in the provisions addressing draw-downs of committed credit and liquidity facilities in the treatment of banks as borrowers and lenders; the failure to recognize liquidity provided by the Federal Home Loan Banks (“*FHLBs*”) in the United States; and certain other aspects of the funding parameters.

2. Net Stable Funding Ratio. Our principal concerns with the NSFR, discussed in Part II.B of our Detailed Comments, begin with its basic premise. Although we support the general goal of addressing excessive reliance on wholesale funding through regulatory oversight, we are skeptical that the best way to do that is with a highly prescriptive ratio applied in the same manner across institutions and jurisdictions over a single time horizon. The NSFR would directly affect the role of banks in maturity transformation—that is, intermediating the imbalances between short-term and long-term needs of borrowers and the availability of credit. We are concerned that the macroeconomic consequences of narrowing the role of banks in maturity transformation

are not understood.

In addition to that fundamental and conceptual concern with the NSFR, our other concerns include the scenario assumed for the NSFR, which is extremely conservative; the inclusion in the denominator of the NSFR of match-funded non-renewable loans with a maturity of one year or less, which do not present a structural funding mismatch and we believe should be excluded; the failure to take into account the likelihood of central bank support in an extended period of crisis; certain of the ASF Factors and RSF Factors which seem to us to be inconsistent with historical experience, including during the recent financial crisis, and unduly conservative; the treatment of intangible assets (which are assigned a 100% RSF Factor and we believe should be assigned a 0% RSF Factor); the failure to give any credit for outstanding borrowings from FHLBs or a bank's ability to drawdown under a facility with an FHLB; the assignment of a 0% ASF Factor to term securitizations and ABCP and a 100% RSF Factor to many of the assets underlying those term securitizations and ABCP programs, notwithstanding that they have shown themselves over a longer-term time horizon to be durable sources of funding; the asymmetric treatment of repos and reverse repos; and the asymmetry in the interplay between the LCR and the NSFR.

3. Monitoring Tools. We address, in Part II.C. of our Detailed Comments, concerns with several additional aspects of the Proposals, including the frequency of reporting, the definition of "significant counterparty" in Paragraphs 106 and 107, and operational challenges raised by the Proposals.

* * *

There is an inherent tension between greater liquidity and the capacity of financial institutions to serve the needs of their customers and the economy. The appropriate balance between the two must be assessed over the long term, and the recent financial crisis demonstrates that the balance requires adjustment. Nonetheless, the objective should be to achieve the best balance for long-term economic prosperity rather than to reject the concept of balance in favor of attempting to assure a risk-free financial system.

DETAILED COMMENTS

This letter discusses more fully in Part I our fundamental concerns referenced in the Executive Summary, above, and comments in Part II on specific aspects of the Proposals that are more granular and less broadly conceptual but illustrate our concern with the prescriptive approach of the Proposals. We hope that our comments will assist the Committee in developing balanced standards for revised Proposals that will assist financial institutions and their prudential regulators in managing liquidity risk.

I. Fundamental Concerns

A. Prescribed Ratios; Alternative Approaches

We endorse the Committee's efforts to enhance the resilience of internationally active banks to liquidity stress and, as part of those efforts, to develop clearer principles for the quantitative measure of liquidity risk. As a conceptual matter, we support the application by banks of a short-term measure to address liquidity needs under an acute liquidity stress scenario, like the LCR, and we believe that banks' analysis of their liquidity risk, and national regulators' supervisory oversight of that risk, should take into account structural mismatches between short-term funding and longer-term assets of the type the Proposals attempt to address with the NSFR (discussed further in Part I.B, below).

However, we are concerned that the level of prescriptiveness in the Proposals, with its very precise funding parameters for calculation of those ratios, is unsound. That approach is the equivalent of Basel I⁶ for capital. It fails to recognize differences among banks. In a number of cases it specifies funding parameters that are at odds with the experience of The Clearing House members, and we believe the banking industry more generally, including during the financial crisis. Among the most significant deviations between the Proposals and actual experience, in the case of the LCR, are the run-off factors for customer deposits – both retail and wholesale – and the assumed level of drawings on credit and liquidity lines, both of which factor into the denominator in that ratio. Moreover, some of the assumptions (with respect to both the components of the numerators and denominators in the ratios and the calibration of the funding parameters) are so unduly conservative that, collectively, they could push banks beyond sound liquidity management practices and into a zone where the resultant need to hold a mandated amount of narrowly defined high-quality liquid assets causes banks to cut lending and financial intermediation services. In addition, banks will be obligated to raise significant additional capital that they likely will have difficulty raising if the Proposals, together with the Capital Proposals and other regulatory initiatives, depress returns on equity of the international banking sector generally.

All The Clearing House banks have, and are continuing to refine based on the experience and learning of the last several years, internal models that they use to measure and evaluate their liquidity. We expect that other (and likely most if not all) internationally active banks are engaged in similar endeavors, and the Committee and national regulators of course are well aware of those endeavors. The quantitative measurement and financial modeling of liquidity risk is by its nature more institution-specific than the regulation of bank capital. Liquidity risk management depends on a

⁶ We are using the term “*Basel I*” to mean the Basel Committee’s 1988 risk-based capital framework titled *International Convergence of Capital Measurement and Capital Standards*. We are using the term “*Basel II*” to mean the Basel Committee’s June 2006 comprehensive new accord titled *International Convergence of Capital Measurement and Capital Standards – A Revised Framework*.

greater number of firm-specific variables than capital management, including business model, mix of business, market participation, and market status and access. As a consequence, there has been – and we believe, both as a matter of supervisory policy and sound management for individual banks, should be – less convergence around standardized approaches to measuring liquidity risk than approaches to other aspects of bank regulation, including capital, particularly with respect to the stability of funding over a longer-term horizon. Where the Proposals recognize the need to give national regulators some discretion to accommodate jurisdiction-specific considerations and differences⁷, they do not recognize or accommodate differences among banks within a jurisdiction or more generally. That is a significant departure from the historical approach to monitoring and regulating liquidity risk. National regulators historically have recognized, even in recent pronouncements, the reality that liquidity risk processes and systems are not reducible to prescriptive formulas.⁸

We urge the Committee to reconsider whether the level of international harmonization sought by and embodied in the Proposals – particularly in the standardized funding parameters – is the best approach. We believe that it is not and that a less prescriptive approach that is guided by principles enunciated by national regulators but that benefits from the knowledge and understanding that (i) national regulators have of banks and the banking business in their jurisdictions and (ii) individual banks have of their own businesses – a Pillar 2-type approach – will produce a better result. Under a less prescriptive and more principles-based approach, quantitative measures – whether the LCR and NSFR, if the Committee decides to proceed with those ratios, or other revised ratios after taking into account comments received and the results of the QIS – would not specify funding parameters. Instead banking regulations would leave the funding parameters used by each bank to its discretion, in discussion with its national regulator as a matter of supervisory oversight. This approach would also give banks some flexibility, in discussion with their national regulators, to determine the components of the numerators and denominators in the ratios.

The need for an alternative approach is particularly important in the case of the NSFR. A prescriptive approach is inherently more likely to include inappropriate funding parameters and produce undesired and problematic results over a longer-term time horizon.

⁷ See Paragraphs 10, 18, 39 and 91, for example.

⁸ The U.S. Department of the Treasury and the U.S. Federal bank regulatory agencies, in their revised *Interagency Policy Statement on Funding and Liquidity Risk Management* issued last month, 75 Fed. Reg. 13656, 13661 (March 22, 2010), commented on this several times, including in Paragraph 5 of the Policy Statement as follows:

“An institution’s obligations, and the funding sources used to meet them, depend significantly on its business, mix, balance-sheet structure, and the cashflow profiles of its on- and off-balance sheet obligations.”

We urge the Committee to permit banks that have developed ILMs for measurement and management of liquidity risk, and can demonstrate the efficacy of those models to the satisfaction of their national regulators, to use those models as alternatives to the LCR and NSFR. This would effectively be an “*enhanced Pillar 2*” approach, similar to the foundation and advanced internal ratings-based, or “*IRB*,” approaches to capital in Basel II. Under this approach, the Committee would adopt an LCR and NSFR as the foundation approach to liquidity measurement (perhaps including some guidance as to funding parameters), taking into account comments received on the Proposals and learning obtained through the QIS, but then also permit banks to propose and, if approved, instead use as an alternative ILMs tailored by each bank to its own business and experience, as the advanced approach to liquidity measurement. The liquidity rules of national regulators would specify minimum requirements for initial and ongoing use of ILMs proposed by individual banks taking into account their own circumstances and the unique aspects of their businesses, similar to the advanced IRB approach to capital in Basel II. The minimum requirements for use of ILMs likely would include the objectives that must be achieved by the internally developed ratios and the scope of components that must be covered by the numerators and the denominators in those ratios, but would permit flexibility to individual banks as to the components of the numerators and denominators and would not specify precise funding coefficients. The determination as to whether a particular bank could apply an internal approach would ultimately be made by its regulator after evaluating the bank’s proposed internal approach against these specified criteria.

If the Committee determines not to permit use of ILMs as an alternative to prescribed ratios at the outset, we urge the Committee nevertheless affirmatively to encourage banks, with language to that effect in the Proposals, to continue their ongoing endeavors to develop ILMs tailored to their individual businesses and to leave open the possibility that, at a future date, as the validity of liquidity risk management techniques become more demonstrable through testing, ILMs may in fact replace and not merely supplement prescribed ratios as liquidity measurement tools for some banks.

The more prescriptive the ratios ultimately adopted, the more important it becomes that relevant constituencies – market participants (analysts, investors, creditors and counterparties), banks and even regulators – recognize those ratios for what they are, only two of many tools for measuring and managing liquidity risk, all of which have an inherent degree of imprecision and none of which is equally appropriate for all financial institutions. We are very concerned that market participants, banks and regulators will place excessive importance on these ratios. The consequence could be to distort fundamental decisions by banks with respect to the businesses they choose to conduct, in particular with respect to financing broad elements of the economy. This may not be of significant concern in countries where lending is predominantly state directed or to large companies, but it is of far greater concern in countries where lending is more focused on smaller businesses and consumers who require more stable (*i.e.*, longer-term) financing. The mere fact that one bank has a higher LCR or NSFR than another bank, when viewed in the context of the totality of both banks’ businesses, does not necessarily support a conclusion that the second bank has more liquidity risk than the first bank. We are very

concerned that the Proposals will effectively force banks to manage their businesses to achieving LCR and NSFR percentages that place them comfortably within a zone mandated by the marketplace for their peer group, even if doing so does not produce the best decision-making, either with respect to liquidity risk management or the conduct of the bank's business more generally.

B. Disclosure

We urge the Committee not to require banks to disclose their percentages under liquidity ratios (whether the LCR and NSFR or other metrics that may be implemented). As discussed below, we are concerned with the consequences of public disclosure by banks of their percentages under the LCR and NSFR. In our view, could it be achieved, the better approach would be to not have public disclosure by banks of their LCR and NSFR ratios but, instead, use the LCR and NSFR only as supervisory tools – a component in the assessment by banks, national regulators and supervisory colleges to determine the adequacy of a bank's liquidity position and processes. Inevitably, the more standardized the funding parameters and other substance of the ratios, the less reliable are the ratios as tools to measure liquidity risk in a truly meaningful manner across different mixes of businesses, geography and market participation.

Considerations bearing upon the disclosure of liquidity ratios are very different from those bearing upon the disclosure of capital ratios. Calculations of capital ratios are largely numerical, deriving from financial statements. Liquidity measurement is substantially more complex. Liquidity measures do not derive from financial statements and depend for a particular bank upon its interactions with the market. As a consequence, liquidity ratios are useful as a tool for supervisory oversight, to be evaluated by regulators with discretion, but much less useful as a disclosure metric to be considered by depositors and market participants.

The risks associated with disclosure of LCR and NSFR ratios are both apparent and significant. Public disclosure may expose banks to market penalties for marginal differences in their ratios as compared to peers, even where the differences do not reflect meaningful differences in the banks' respective liquidity strength. In some cases disclosure may exacerbate any existing liquidity problems, potentially setting off a "death spiral" in which disclosure of the LCR or NSFR ratios for a bank with ratios below those of its peer banks makes obtaining funding more costly, if not impossible, which in turn amplifies underlying liquidity issues.

With that said, however, we are concerned that banks' LCR and NSFR percentages will end up being publicly disclosed even if disclosure is not mandated.⁹ The

⁹ We in fact considered whether the best approach would be to treat banks' percentages under the LCR and NSFR as confidential supervisory information that, like examination reports in the United States, banks would in fact be *prohibited* from disclosing. However, for the reasons addressed in this paragraph, we ultimately concluded that that approach simply is not practicable.

more prescriptive and standardized the LCR and NSFR, the greater the likelihood of public disclosure. Analysts are likely to model the LCR and NSFR ratios of banks they follow, necessarily making a variety of assumptions because much of the information necessary to calculate the ratios is not publicly available. Inevitably the analysts' modeling will be wrong, sometimes by significant amounts. Banks will feel compelled to make public more accurate disclosure in order to rebut mis-impressions arising from incomplete information available to analysts. Moreover, some banks may in fact choose to disclose their LCR and NSFR ratios as a competitive matter – because they believe their ratios demonstrate a strong liquidity position compared to their peers.

The likelihood of ultimate disclosure makes it even more critically important that the LCR and NSFR, as ultimately calibrated, be as accurate and realistic as possible. As indicated in the Executive Summary of this letter, we believe that the calibration in the Proposals is not realistic and includes funding parameters that are at odds with the experience of The Clearing House members generally and during the financial crisis. Our more specific comments in this regard are set forth in Part II. They include:

- the narrow definition of liquid securities to be included in the liquidity buffer under the LCR (Part II.A.2);
- the degree of run-off of wholesale deposits (Part II.A.4);
- the degree of access to wholesale funding markets (Part II.A.5);
- the scope of securities for which the repo markets remained open (Part II.A.5);
- the lack of recognition of the availability of secured funding through the FHLBs in the LCR (Part II.A.8) and of the stability of secured funding through the FHLBs in the NSFR (Part II.B.7); and
- the asymmetric treatment of repos and reverse repos in the NSFR (Part II.B.9).

C. Macroeconomic Impact

The potential macroeconomic effects of the Proposals, particularly when considered with other aspects of financial regulation reform, raise significant concern. The ongoing reform of bank regulation arising out of the financial crisis is exceedingly complex and has many components. Some, including the specific regulation of capital and liquidity, are within the recognized purview of bank regulators and can and should be addressed as a matter of regulation and supervisory oversight. Others – for example, resolution of systemically important institutions and broader frameworks for regulatory oversight – are the subject of legislation (or proposed legislation) in many jurisdictions, including the United States. Still others – for example, compensation practices,

limitations on powers and activities and the manner of funding resolutions of systemically important institutions – are being addressed both by bank regulatory agencies and legislators. Finally, certain other areas – accounting principles, for example – may be left to standards-setting organizations. All these components, however, irrespective of the relevant responsible authority, have a cumulative impact on banks and their role in the economy, and they cannot be considered in isolation.

The Proposals and the Capital Proposals, even considered without regard to other possible components of financial reform, must be considered and calibrated together, not in isolation. The Proposals are so conservatively formulated that they seem geared toward addressing capital concerns with robust liquidity. One example of that approach is the requirement in Paragraph 28 that, in order to be a high-quality liquid asset, the asset must “be easily and immediately converted into cash at little or no loss of value.” Why? Loss of value customarily would be analyzed in the context of its impact on capital, not liquidity. The financial crisis demonstrated that the market’s lack of confidence in the level of a bank’s capital (and the ability of that capital to absorb losses) can trigger a liquidity crisis for the bank. Insufficient liquidity itself was not the triggering event.

The Clearing House members believe it is essential that the Committee and national regulators, in refining the Proposals, evaluate their macroeconomic consequences, taking into account not merely the Proposals but also the broader scope of regulatory reform (including the Capital Proposals and the Committee’s July 2009 document titled *Revisions to the Basel II Market Risk Framework*) and the role of liquidity as one of many components of a sound financial system. Reform of liquidity regulation cannot be evaluated in isolation and, of course, will not be implemented in isolation.

We are very concerned, however, that the components of regulatory reform are being developed without the comprehensive evaluation of the consequences of all of those components, taken together, that is manifestly called for. Requiring financial institutions to maintain too great a stock of high-quality liquid assets (or defining too narrowly what qualifies as a high-quality liquid asset) poses risks that are equally as threatening to national economies as too low a stock of high-quality liquid assets (or too broad a definition), including reduced availability of credit, higher costs paid by consumers for loans and other banking services, potential disintermediation of activities historically conducted within banks to unregulated entities in the shadow banking system, reduced returns on equity for investors in financial institutions, related challenges for those institutions in raising additional capital, incentives for financial institutions to engage in activities or enter into transactions intended to maintain acceptable returns on equity of a type (and posing risks) not now contemplated, and more generally acting as an impediment to economic growth.

A significant increase in holdings by banks of a narrowly defined category of liquid assets inevitably will create market dislocations – as to both the availability and pricing of different types of assets – as banks shift investments from consumer-

mortgage-, and business-related loans to cash, central bank reserves and government securities. This shift will be most pronounced for those borrowers who require stable funding sources, in the form of longer-term funding. As a key example, the goal of certain countries to promote home ownership will be directly frustrated by liquidity ratios that discourage mortgage lending. The market dislocations will be significant both for the defined liquid assets and the assets not within the definition (and which encompass virtually all customary bank lending products). The effects become magnified when considered with other initiatives that may incentivize banks to reduce their balance sheets (including, for example, the Capital Proposals and the initiatives in the number of jurisdictions to impose a levy or tax on banks to offset the cost of current interventions and/or to fund the cost of any future interventions).

We do not purport to have a good grasp of the consequences on banks or economies of the combined impact of the Proposals, the Capital Proposals and other financial reforms. We doubt anyone has a good grasp at this point. However, we note in particular two consequences of the Proposals and Capital Proposals, taken together, that particularly concern us. First is a variety of disincentives for banks to fund banks. These include, for example, (i) in the LCR the exclusion of any bank instruments from high-quality liquid assets and the assumed 100% run-off of wholesale funding provided by banks, (ii) in the NSFR, the assignment of a 0% ASF factor to funding provided by banks and a 100% RSF factor to loans to banks, and (iii) in the Capital Proposals, the required deduction from common equity of holdings in common stock of financial companies outside the scope of consolidation (including in connection with underwriting and market-making activities).

Second, the Proposals and the Capital Proposals, taken together, include disincentives to mortgage financing that could have a very adverse – and potentially devastating – effect on the U.S. housing market. The aspects of the Proposals and Capital Proposals most central to that concern are (i) in the Proposals, (x) the exclusion of mortgages and mortgage-backed securities (either directly or indirectly as collateral for borrowings from Federal Home Loan Banks) from the definition of high-quality liquid assets in the LCR and (y) the assignment, in the NSFR, of a 0% ASF Factor to Federal Home Loan Bank borrowings collateralized with mortgages and a 100% RSF Factor to mortgages and mortgage-backed securities held on the balance sheet; and (ii) in the Capital Proposals, the requirement that mortgage servicing rights be deducted from common equity.

D. Process and Timing

The proposals are detailed and quantitative. At the same time, they present many funding variables and other concepts with little elaboration of the research, data and modeling used to derive them. This does not allow us or other constituencies to comment with the thoughtfulness that we could if we were able to consider the Committee's research in deriving the funding variables. Accordingly, we believe that the Committee should make public its research so that banks can take it into account in evaluating the Proposals.

A number of The Clearing House members are participating in the QIS process. The QIS responses are due on April 30, 2010, shortly after the April 16, 2010 date on which comment letters on the Proposals are due. The amount of data to be gathered by banks participating in the QIS process is substantial, and the granularity of that data differs from what most members collect on a regular basis today. Those banks that are participating have indicated that their understanding of the Proposals and consequences of their implementation is substantially enhanced by participation in the QIS process. Because those banks are preparing comment letters prior to finalization of their QIS responses, they have indicated (i) a need to more fully absorb the understandings they have gathered through the QIS process in commenting on the Proposals (both through The Clearing House and in preparing their own comment letters), and (ii) concern that, because the comment letters will be submitted before completion of the QIS, they will not be able to reflect adequately in comment letters the learning they are gaining through the QIS process. More generally, we believe that the banking industry as a whole must have access to the data provided through the QIS, in an aggregated format, in order to comment meaningfully on the Proposals.

Accordingly, The Clearing House believes it is *essential* that the Committee publish revised Proposals for additional comment, before issuing a final set of standards. In order to make the additional comment process useful, we urge the Committee to establish a 90-day comment period on revised Proposals. The revised Proposals, of course, need to take into account the results of the QIS. Equally important, banks need to be able to evaluate the revised Proposals taking into account the results of the QIS as well as a better understanding of the Committee's analysis in developing the initial Proposals and the funding factors.

II. **Recommendations on Specific Elements of Proposals**

We continue to believe that a principles-based approach to liquidity risk management, guided by principles enunciated by national regulators but that benefits from the knowledge and understanding that (i) national regulators have of banks and the banking business in their jurisdictions and (ii) individual banks have of their own businesses – a Pillar 2-type approach, will produce better result than the prescriptive approach of the Proposals. In order to assist the Committee in understanding our reasons for that view, we have set forth in this Part II more detailed observations regarding

(i) certain aspects of the LCR and the NSFR, (ii) the new monitoring tools and (iii) the operational challenges associated with implementation of the Proposals.

A. Liquidity Coverage Ratio

1. The Scenario – Paragraphs 22-24. Paragraph 24 describes the stress scenario for the LCR as “a minimum supervisory requirement.” Yet the scenario specified in Paragraph 22 is extremely conservative. It assumes, on an ongoing basis for every bank, that every adverse event observed as to a firm during the recent financial crisis applies to, and must continuously be addressed by, every firm. Even as a tool for supervisory oversight, let alone disclosure, we believe that some of its standards are excessively conservative and unsupported by the experience of U.S. banks during the financial crisis, in particular:

- the assumed levels of loss of unsecured wholesale funding, including the 100% assumed loss of unsecured wholesale funding provided by financial institutions (clause (c));
- the unavailability of the short-term repo market on, as a practical matter, all but government securities (clause (d)); and
- the assumed levels of draws on committed unused credit and liquidity facilities (clause (f)), implemented in paragraph 66, combined with an asymmetric assumption in paragraph 76 that banks will not be able to draw on their own committed credit facilities. This asymmetry demonstrates the extraordinary conservatism of the assumptions.

There is, of course, an inevitable trade-off between defining the severity of the scenario and tolerating the more severe macroeconomic consequences that are likely to result from assuming a more severe scenario (as acknowledged by the Committee in Paragraph 29). We urge the Committee, however, to consider whether the scenario specified in Paragraph 22 is unduly severe, particularly with respect to the components referenced above. We submit that it is appropriate to base certain regulatory requirements on a reasonable worst case, but that it is counterproductive to use, as the Proposals appear to, the worst case conceivable.

2. High-Quality Liquid Assets – Paragraphs 28, 29 and 34 through 37. We believe that the Proposals have defined too narrowly what constitutes a “high-quality liquid asset.” The Proposals have a strong bias in favor of sovereign debt, mandating a material increase in banks’ exposure to sovereign credit risk for incremental high-quality liquid assets at a time when sovereign credit quality is deteriorating. Shifting bank investments from the traditional array of assets toward a substantially increased focus on sovereign paper may assist some stressed sovereigns in raising debt, but it will affect the ability of corporate issuers to fund themselves.

Moreover, high-quality liquid assets is defined in the numerator of the ratio in a way that in many respects has little to do with liquidity. For example, as noted in Part I.C, Paragraph 28's requirement that an asset must be convertible into cash at little or no loss of value is a concept more relevant to capital than liquidity. We question whether that is the correct approach. The test for assets included in the numerator of the LCR should, insofar as liquidity is concerned, be focused on the ease with which they can be converted into cash (most importantly, the liquidity of the markets in which they trade). The Proposals themselves, by applying haircuts to the carrying amount of certain assets for the purpose of the numerator in the LCR, recognize the inconsistency between a "selling at no or little loss" test and a proper measure of liquidity. Presumably the haircuts are designed to reflect conservatively estimated losses.

Even if the "fundamental" and "market-related" characteristics of high-quality liquid assets described in Paragraph 29 were the relevant test, we believe those characteristics are found in a wider range of assets than those listed in Paragraph 34.

- *Obligations of Government-Sponsored Enterprises.* Paragraph 34 specifically excludes securities "issued by banks or other financial services entities," even where those securities are guaranteed by sovereigns (Paragraph 34(c)(iii)). We recommend including the obligations of government-sponsored enterprises ("GSEs") where there are deep and liquid markets for the obligations, subject to appropriate haircuts to be determined by national regulators. In the U.S., this would permit inclusion in high-quality liquid assets of debt of GSEs such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).
- *Corporate Bonds.* We support the inclusion of highly rated, liquid corporate bonds in the stock of high-quality liquid assets. Such bonds, especially when meeting the extensive criteria set forth in the Proposals (Paragraph 36), have the quality and liquidity to justify their inclusion in the numerator of the LCR.

We note that the criteria for qualifying corporate bonds, while obviously intended to correlate with safety and liquidity in times of financial crisis, include very specific quantitative tests for characteristics such as credit risk and historical bid-ask-yield spread. Furthermore, the proposed 20% and 40% figures for corporate bond haircuts are presented in the Proposals without elaboration or derivation and are, we believe, excessive. We believe that the Committee should disclose the models it has employed and the reasoning it has used to design these criteria and the associated haircuts, which are difficult to evaluate in a vacuum. The collective knowledge and experience of the constituencies commenting on the Proposals could be used to refine the treatment

of corporate bonds and potentially suggest other ways of tailoring their weighting more closely to the risk profiles of individual institutions.

- *Municipal Obligations.* We believe that obligations of municipalities (including state and local governments and other public-sector entities) should be given significant liquidity value in a 30-day time horizon. In the United States, municipal obligations generally maintained their value with a high degree of liquidity throughout the crisis.
- *Securities Issued by Banks or Other Financial Services Entities.* Clause (c)(iii) of Paragraph 34 excludes all securities issued by banks or other financial services entities. We believe that the exclusion is far too conservative. During the financial crisis, highly rated senior debt securities of many banks remained liquid and traded at prices that were at or near par.
- *Trading Portfolio Securities.* We believe that all securities carried in a trading portfolio should be includible in liquid assets for purposes of the numerator in the LCR. Under U.S. GAAP, securities in the trading portfolio have already been marked-to-market. Accordingly, liquidation of those securities should involve little or no additional loss.

3. Retail Deposit Run-Off – Paragraph 41. Paragraph 41 provides that certain “stable” retail deposits – which generally include funds deposited by natural persons and exclude other deposits – will receive at least a 7.5% run-off factor for purposes of calculating the LCR, and that other “less stable” retail deposits will be assigned a minimum run-off factor of 15%. Although this binary approach has the benefit of simplicity, it is by necessity arbitrary. As a general matter, we believe that such prescriptive minimum run-off factors are too conservative and do not reflect the experience of U.S. banks during the financial crisis. We anticipate our member banks, in their individual comment letters, will address their own experience with run-off factors as applied to specific types of deposits. One of general applicability, however, is deposits to the extent insured by the Federal Deposit Insurance Corporation (“FDIC”). Our experience uniformly was that deposits up to the insured amounts were exceedingly “sticky,” not warranting more than a nominal run-off factor.

The minimum run-off factors fail to take into consideration differences among banks or any relevant jurisdictional and activity-specific factors that may render these assumptions unrealistic. At the most basic level, banks clearly had very different experiences during the financial crisis, from runs on some banks to flight-to-quality inflows at other banks. The run-off experience of a bank is, of course, affected by its credit quality. But it is also affected by a variety of other factors that are difficult to measure in a uniform way, including differences across jurisdictions in business customs,

customer behavior and legislation, and the financial reliability of government insurance schemes.

Data gathered during the recent financial crisis should enhance banks' and regulators' ability to forecast run-off factors. That data is from one of the most stressed times in modern financial history. We urge the Committee to disclose the data it used in developing the run-off factors in the Proposals and to make use of data covering the period of the financial crisis in refinancing run-off factors for the LCR.

We urge the Committee to permit national regulators to establish the run-off factors for deposits and other liabilities of banks within their jurisdictions based on empirical data relevant to the jurisdiction. We are very skeptical that uniform international standards will reflect accurately actual experience.

Many banks have substantial databases that can be used to establish reliable run-off factors for many types of liabilities, including retail and wholesale deposits, that differ from the experience of other banks in the same jurisdiction. Accordingly, we also urge the Committee to give national regulators discretion to permit banks to use run-off factors that may be different from (and perhaps less) than those otherwise established as the "default" measures for the jurisdiction where the relevant bank has demonstrated to the satisfaction of its regulator, based on empirical evidence, that its proposed run-off factors are accurate.

4. Retail Deposit Bias – Paragraphs 41-55. The run-off factors assigned to funding sources other than retail deposits and certain wholesale deposits from small-business customers (Paragraphs 41 and 48) for purposes of calculating the LCR are very (and we believe unduly) punitive. Like other aspects of the Proposals, the prescribed run-off factors for non-retail deposits fail to account for any relevant jurisdictional, institutional and activity-specific features that may render the prescribed run-off factors for such deposits unrealistic and needlessly conservative, including, for instance, national deposit insurance schemes. In addition, this bias against non-retail deposits could severely impact the business models of banks with deposits primarily comprising non-retail deposits, the associated costs of which may result in such banks curtailing or eliminating various lending and financial intermediation services.

We urge the Committee and national regulators, in considering run-off factors for wholesale deposits, to consider the degree of operational business relationships a depositor may have with a financial institution. The Proposals require up to 100% run-off factors for wholesale clients, without regard to relationships resulting from, for example, trust, custody, or securities servicing business, that affect run-off experience. These relationships generate frictional cash that is a function of the business relationship. Usually depositors cannot shift contractual arrangements quickly to another provider. Shifts to alternative providers can involve significant technical and operational resources, and cannot occur quickly. The depth of the relationships does not vary if the depositor is a financial institution or nonfinancial corporation. Such deposit balances may be relatively stable even during periods of financial distress for this reason. We

propose run-off rates for deposits with such relationships to be based on historical data observed during periods of market stress, or benefit in a similar fashion, as nonfinancial corporations with an operational relationship.

5. Secured Funding Run-Offs, Including Repos – Paragraphs 57-59.

The assumption in Paragraphs 57-59 that there is no rollover of repos or other short-term funding transactions, except for those supported or secured by high-quality liquid assets, is far too extreme in our view. The repo markets remained very active during the financial crisis for a far wider scope of securities than the assets assigned a 0% outflow factor in the chart in Paragraph 59. We are aware of no empirical evidence to support a 100% loss of funding across every asset class that is not in the 0% category. The funding parameters reflected in Paragraphs 57-59 would only apply to a firm in, and perceived to be in, its final hours. In our view that standard is far too conservative for an industry-wide compliance metric even in the context of a severe financial crisis.

6. Haircuts on Collateral Securing Derivative Transactions –

Paragraph 63. The requirement in Paragraph 63 that collateral posted to secure derivative transactions be increased by 20% of the value of all posted collateral seems arbitrary to us and not supported by recent experience. Depending upon the nature of the posted collateral and the terms of the derivative contract, substantial haircuts are already being applied to most types of collateral other than government securities. We urge the Committee to re-examine, against available data sources, the appropriateness of the 20% funding parameter applied to collateral for these transactions.

7. Draws on Committed Credit and Liquidity Facilities and Lines of

Credit – Paragraphs 66 and 76. The assumptions regarding draw downs of committed credit and liquidity facilities are asymmetrical and exaggerated. Under Paragraph 66, a bank would have to assume that 100% of committed liquid facilities to non-financial corporate customers and 100% of committed credit and liquidity facilities to other legal entities, including financial institutions, are fully drawn down; however, pursuant to Paragraph 76, it would also have to assume that no credit, liquidity facilities or other contingent funding facilities may be drawn by it, including those provided by other financial institutions.

First, our member banks' experience during the financial crisis was that the proportion of committed amounts drawn on credit and liquidity facilities to corporate customers remained mostly unchanged from pre-crisis levels. Corporate customers simply do not make uneconomic decisions and borrow amounts (and incur a resultant negative carry) that they do not need.

Second, although we believe that lines of credit where the bank is the borrower should be discounted to a certain extent given that some lending banks may be unable to honor credit lines or decide that the benefits of renegeing on their commitments outweigh the costs of honoring them, we find the assumption that the expected availability of such lines of credit is \$0 excessively conservative. Even under conditions of acute financial distress, such an outcome is highly unlikely. Instead, we believe that

this value is best established through a supervisory process in which a supervisor, taking into account relevant jurisdictional and institution-specific factors, determines a value that attempts to reflect the likelihood that lines of credit will, or will not be, honored. In our view these factors should include, among others, an assessment of the contractual clauses in the lines of credit, the jurisdiction-specific consequences of failing to honor such lines of credit and historical data regarding the availability of such commitments in periods of financial distress.

8. Federal Home Loan Bank Borrowings. For many U.S. banks, lines of credit with the regional FHLBs are an important and reliable source of liquidity. The FHLBs are government-sponsored entities whose own borrowings are conducted on a consolidated basis through a combined funding office. Borrowings from the FHLBs are secured, and each FHLB specifies its own collateral requirements. Eligible collateral customarily includes a variety of assets, including mortgages and mortgage-related securities, that are much broader in scope than the high-quality liquid assets as defined for purposes of the LCR. The LCR as described in the Proposals does not give effect to the availability of FHLB borrowings. We believe it must; not doing so would arbitrarily eliminate a major and reliable liquidity source for U.S. banks. The Proposals could address this either by permitting banks to include as liquid assets in the numerator of the LCR those assets that may be pledged under existing lines of credit with an FHLB, applying the same haircut that the FHLB applies to the collateral, or recognizing undrawn and available amounts under FHLB facilities as cash inflows in Paragraph 77.

B. Net Stable Funding Ratio

1. NSFR Objective – Structural Funding Changes – Paragraph 78. We urge the Committee to reconsider the fundamental premise behind the NSFR. Paragraph 78 describes the objective of the NSFR as being to “incent [structural] changes in the liquidity risk profiles of institutions away from short-term funding mismatches and toward more stable, longer-term funding of assets and business activities.” Although we support the general goal of addressing excessive reliance on wholesale funding through regulatory oversight, we are skeptical that the best way to do that is with a highly prescriptive ratio applied in the same manner across institutions and jurisdictions over a single time horizon. For centuries, maturity transformation – that is, intermediating the imbalances between short-term and long-term needs of borrowers and the availability of credit – has been an essential economic and even societal function of banks. In setting their risk appetites, banks must balance an appropriate level of prudence against the desired level of maturity transformation.

The NSFR, if implemented as proposed, would create enormous market dislocations. One panelist, in comments at an April 7, 2010 forum hosted by the Federal Reserve Board to discuss the Proposals and the Capital Proposals, estimated that, in order to come into compliance with the NSFR, the 25 largest U.S. banks would need to raise between \$1.2 trillion and \$1.9 trillion of additional long-term debt, and the largest 20 European banks would need to raise approximately €1.3 trillion of long-term debt. Another panelist at the same forum commented that Swiss banks would need to increase

their holdings of sovereign debt by an amount that is greater than the current outstanding debt of Switzerland. We are concerned that the macroeconomic consequences of narrowing the role of banks in maturity transformation are not understood. Maturity transformation still needs to occur, whether facilitated by banks or by unregulated financial entities.

We are committed to working with the Committee and our national regulators to develop an appropriate approach to structural funding mismatches. Even if the basic approach of defining a ratio of the available amount of stable funding to the required amount of stable funding were ultimately determined to be the right approach, calibrating the ratio at 100% is the wrong calibration. We believe that this area requires substantially more thought and analysis to get to a sound result.

2. Severity of NSFR Scenario – Paragraph 83. The scenario underlying the NSFR is defined in Paragraph 83 in much more general terms than the scenario underlying the LCR, as defined in Paragraph 22. However, the funding parameters for purposes of those ratios seem to be equally conservative. We believe that the need for a more nuanced and flexible approach is even more important for the NSFR, as a longer-term measure, than for the LCR, as a measure designed to assure survival over a short-term period. Experience during the recent financial crisis shows that, notwithstanding its relatively long term, banks were able to take a number of actions to react to the crisis, discussed further below.

We believe that the Committee must lessen the severity of the assumptions used to determine the NSFR. In particular, even assuming a severe economic downturn, the complete unavailability of alternative funding sources seems unrealistic and inconsistent with past events. Indeed, even during the recent global financial crisis, banks were able to conduct asset sales, securitize, raise capital and take other similar measures to bolster liquidity. As currently drafted, the Proposals make no allowance for such alternative funding activities in deriving a bank's available stable funding (and thus its NSFR). We strongly believe that the NSFR should include a factor that could be applied to potential alternative funding measures a bank could take under the applicable stress conditions. The calibration of this factor could be undertaken in consultation with a bank's supervisor and take into account, among other factors, the quality of the bank's liquidity management over the past several years and the ability of comparable banks to undertake such alternative funding activities under stressed conditions of an extended duration.

In general, we believe that the Committee should avoid choosing funding parameters that embody the most pessimistic and conservative, virtually "end of the world," assumptions possible, but rather choose funding parameters with a view toward promoting sound liquidity risk management and measurement policies and practices over an extended period of stress for banks that are assumed to be reasonably well managed. Data gathered from the QIS should facilitate the identification of reasonable funding parameters based on experience from 2007 to 2009. Toward that end, we believe that the NSFR should account for potential alternative funding measures as outlined above.

3. Required Stable Funding Factors for Certain Loans of Maturity Less than One Year. Irrespective of the degree of prescriptiveness ultimately embodied in the NSFR, we believe that the NSFR generally should exclude from the required amount of stable funding short-term assets with no refinancing risk. More specifically, we believe that NSFR should exclude products that do not have the sort of structural mismatch of assets and liabilities that the NSFR was designed to address.

Consistent with the foregoing proposal, we believe that the Committee should treat all matched funded, non-renewable loans with a maturity of one year or less the same as loans to financial companies with a similar maturity. Specifically, such loans should receive an RSF factor of 0% and be excluded from the calculation of the NSFR. Matched funded, non-renewable loans with maturities of one year or less pose neither a refinancing risk nor a structural funding mismatch risk. Moreover, requiring banks to obtain longer-term financing to fund such loans would generally increase the cost of funding such loans, which, other things being equal, will reduce the margin associated with such loans and banks' incentive to make them.

4. Availability of Central Bank Lending Facilities – Paragraph 84. Paragraph 84 specifies that extended borrowing from central bank lending facilities outside regular open market considerations are not considered in the NSFR in order to avoid reliance on the central banks' source of funding. We agree that banks should not plan to rely on lender-of-last resort facilities from central banks. However, it is implausible to expect no central bank support during a financial crisis lasting as long as one year. We strongly believe that the likelihood of central bank support in an extended period of crisis be taken into account.

5. Funding Parameters – Paragraphs 86-89. We urge the Committee to make public the underlying research and data used in developing the ASF Factors in Table 1 and the RSF Factors in Table 2. Many of these factors seem to us to be inconsistent with historical experience, including during the recent financial crisis, and unduly conservative.

6. Treatment of Intangible Assets – Paragraph 89. Pursuant to Table 2 in Paragraph 89, intangible assets fall under the "all other assets" category and therefore require a 100% RSF factor. We believe that this treatment is inappropriate. The Proposals would assign a 100% RSF Factor to all intangible assets, even those, such as goodwill, that do not impact a bank's liquidity. Instead, we believe they should assign an RSF Factor of 0% to intangible assets, such as goodwill, that do not affect liquidity.

7. Federal Home Loan Bank Borrowings. As discussed in Part II.A.8, FHLB borrowings are a major and reliable liquidity source for U.S. banks. We believe they must be taken into account in the NSFR as well as the LCR. The NSFR would give banks no credit for outstanding FHLB borrowings or the bank's ability to drawdown under its facility with an FHLB. It would apply a 0% ASF Factor to outstanding borrowings and a 100% RSF Factor to mortgages and many other types of assets that could be used to collateralize draw-downs on FHLB facilities. We urge the

Committee to permit the U.S. bank regulatory agencies discretion to establish an appropriate ASF Factor for outstanding FHLB borrowings and RSF Factors for collateral that may be used to support draw-downs on FHLB facilities.

8. Maturing Terms Securitizations and ABCP. The Proposals would apply a 0% ASF Factor to term securitizations and ABCP and a 100% RSF Factor to many of the assets underlying those term securitizations or ABCP programs. We strongly believe that, over a longer-term time horizon, securitizations and ABCP programs have shown themselves to be a durable source of funding. We urge the Committee to permit national regulators discretion to establish appropriate ASF Factors for term securitizations and ABCP, and appropriate RSF Factors for the assets underlying those securities.

9. Asymmetric Treatment of Repos and Reverse Repos. The NSFR treats repos and reverse repos inconsistently and, from the perspective of the banking system as a whole, asymmetrically. Paragraph 86 assigns a 0% ASF Factor to repos (where a bank is the borrower) and Paragraph 89 100% RSF Factor to reverse repos (where the bank is a lender). The repo/reverse repo market is primarily a short-term funding market among banks. We do not believe it is logical or appropriate to exclude repos entirely as a source of stable funding in the numerator of the NCR but in the denominator require that 100% stable funding be provided for reverse repos. Repos and reverse repos should either be excluded from the numerator and denominator or included in both with the same ASF Factor and RSF Factor.

10. Asymmetry Between NSFR and LCR. The NSFR includes in the denominator of the ratio – that is, within the required amount of stable funding – a variety of assets that are defined as liquid assets for purposes of the LCR. These include, for example, marketable securities representing claims on or guaranteed by sovereigns having a maturity of one year or more and, depending upon the configuration of the final rules and the establishment of relevant haircuts, corporate bonds. It is illogical to treat an asset as both a liquid asset for short-term liquidity crisis management and a longer-term asset that requires stable funding. Accordingly, we urge the Committee to provide, as a general rule, that assets treated as liquid assets for purposes of the LCR (after giving effect to relevant haircuts) be assigned a 0% RSF Factor for purposes of the NSFR.

C. Monitoring Tools – Section III

1. Reporting Frequency – Paragraph 132. We believe that the reporting frequency of the new metrics – regarding contractual maturity mismatch (Section III.1), concentration of funding (Section III.2), available unencumbered assets (Section III.3) and market-related monitoring tools (Section III.4) needs to be reconsidered in light of the additional data that banks will be required to gather to report the new metrics. At least in the short term, pending development by banks of systems to routinely capture the necessary data, the reporting frequency contemplated will be excessive. Not only do the metrics require banks to gather detailed and potentially difficult-to-acquire information about significant counterparties (Paragraphs 106 and 107)

and extensive information about contractual cash and security flows along multiple time bands, but they also require banks to calculate these metrics on at least a monthly basis, and possibly even weekly or daily basis under stressed conditions at the discretion of supervisors (Paragraph 132). Marshaling the technological resources and staff necessary to collect and report these data with such frequency will prove extremely time consuming and expensive. We urge the Commission to consider a less frequent reporting interval or to provide supervisors with the discretion to extend reporting intervals for certain of the metrics.

2. Significant Counterparties – Paragraphs 106 and 107. Paragraph 107 defines a “significant counterparty” as a single counterparty or group of connected or affiliated counterparties accounting for more than 1% of the bank’s total liabilities. We believe the 1% threshold is far too low. Paragraph 104 defines the objective of this provision to be to “identify those sources of wholesale funding which are of such significance that withdrawal of this funding could trigger liquidity problems.” That standard should be evaluated in the context of other liquidity tools available to and applied by banks, including the LCR and NSFR. We believe that 5% would be a more appropriate threshold.

D. Operational Challenges

We urge the Committee in developing the implementation schedule for the definitive Proposals to be cognizant of the operational challenges banks will face in implementing the systems and processes necessary to source the necessary data and manage liquidity based on the new liquidity standards. These challenges include, among others, the following:

- Developing and implementing processes to aggregate disparate data relating to the funding factors used in the LCR and NSFR as well as the new metrics concerning contractual maturity mismatch, concentration of funding, available unencumbered assets and market-related monitoring tools. As the QIS exercise demonstrates, in many cases these data are not readily captured or stored in a centralized or integrated manner.
- Banks will need time to educate officers and employees regarding the new informational requirements and to adopt new liquidity management systems and processes.
- In light of the frequency of the reporting requirements of the new metrics (i.e., at least monthly according to Paragraph 132), many banks will need to hire, train and educate additional compliance staff to administrate the systems necessary to comply with such requirements.

- The systems and processes required to manage liquidity risks based on the LCR and NSFR will need to be developed, implemented and monitored.

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The Clearing House appreciates your consideration of the views expressed in this letter. If you have any questions or if the members of The Clearing House can assist you in any way, please contact Joseph R. Alexander, Senior Vice President and Senior Counsel of The Clearing House, at (212) 612-9234 or joe.alexander@theclearinghouse.org.

Very truly yours,



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Letters – Tab 4



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**Joint trade associations' response to the Basel Committee on Banking Supervision
Consultative proposals to strengthen global capital and liquidity regulations, BCBS
164 and 165 issued on 17 December 2009**

Dear Governor Wellink

The Global Financial Markets Association ("GFMA"), the British Bankers' Association ("BBA") and the International Swaps and Derivatives Association ("ISDA") are pleased to respond to the Consultations BCBS 164 *Strengthening the resilience of the banking sector* and BCBS 165 *International framework for liquidity risk measurement, standards and monitoring*.

Introduction

Our members share the Basel Committee's goal of enhancing the regulatory framework, in the context of rebuilding a strong global economy, and commend it on the significant progress that it has made to date. A robust regulatory framework that supports market confidence is as important to industry practitioners as it is to the regulatory community. We believe the Basel Committee has correctly identified a number of key areas for improvement, in line with the regulatory mandate agreed by the G20 Leaders in September 2009. The Pittsburgh Declaration rightly focused on the need for action and set challenging deadlines both for development of revised standards to improve the quality and quantity of bank capital

and to discourage excessive leverage (by the end of 2010) and for their implementation (phased by the end of 2012). These goals were set against a backdrop of ensuring economic recovery and delivering balanced and sustainable global growth. We agree that it is important for the Basel Committee to deliver against these commitments.

In addition, the range and extent of these proposals, combined with the significant changes already implemented, or in train, have potentially far reaching consequences for the real economy. In this context, it is important to reflect on the significant progress made to date, by both regulators and industry, to improve institutional resilience, risk management practice and market discipline. These improvements, while not addressing all the issues arising from the crisis, have already made a fundamental difference to market practice. Before finalisation of these proposals, their consequences must be fully understood. A holistic approach needs to be taken, so this assessment should take account of the broader initiatives to reform the financial system. It should also take into consideration the lessons learned in respect of supervisory approaches, as well as fiscal and monetary policies, which along with issues arising in banks, all contributed to the crisis.

We therefore recommend that, in meeting the G20 commitment, the focus should be on agreeing the structure of the framework by the end of this year and that the detail and calibration should be finalised over a longer time horizon. To this end we urge the Basel Committee to engage in a further round of consultation with the industry, following the QIS and the assessment of broader economic impacts. This review is essential to ensure that unintended consequences are identified and addressed; the goals for economic recovery and growth are met and that banks are allowed to continue to facilitate maturity transformation, support international trade, support risk management services and to provide funding and working capital to meet the continuing needs of consumers and corporates. In this regard, we strongly believe that there is need for refinement and, in some areas, significant amendment of the details of the Basel Committee's proposals if the goals are to be achieved. As part of this iterative process there should be a clear articulation of the detailed objectives that underpin the high level G20 objective of enhancing standards. The consultation recognises the need for phased implementation, which we support. However, given the potential impacts and our views on the need for refinement and amendment, we think that, for some elements, the implementation timetable should extend beyond 2012.

Overarching key issues

Calibration and impact assessment

We are strongly supportive of the Basel Committee's approach to determining the calibration of the proposals through the Quantitative Impact Study (QIS) currently underway, which takes account of these proposals and also other changes in train. Review should also build on experience of the crisis, where the loss attribution exercise will be important in ensuring that the proposals are focused on the areas that need attention, and are implemented in a proportionate manner. However, these studies do not, and cannot, address the effect on the real economy of the changes proposed and the commercial impact they will have on the capacity of the banks to provide financial services and on the price of those services. Therefore the broader analysis that is being undertaken by the Financial Stability Board in conjunction with the Basel Committee, is vital to understand the potential impacts of the range of proposals, both prudential and those addressing wider financial reform, on the services that the banks will be able to provide and the commercial impact this will have on the wider economy. We cannot emphasise too strongly that premature imposition of significantly higher capital and liquidity requirements on banks will result in lower lending volumes at a higher cost to customers, both individual and corporate, with a resultant impact on economic recovery and expectations for growth.

It is still too early for our members to be able to make recommendations on the calibration. However, initial indications have revealed that the consequences of the proposals could be

very significant. For example, the capital required to support the counterparty credit risk proposals for credit valuation adjustments alone may be a significant multiple of the total current trading book capital requirement. As a result we think that it is inappropriate to move from this consultation, and associated impact study, straight to final rules. As members will only submit their QIS data this month, we may wish to provide additional comments in light of the results. These proposals are likely to shape the financial landscape for years to come and, in our view, it is more important to get the proposal right than to finalise all the details by the end of 2010. We therefore recommend that the Basel Committee agree the structure of the proposals by the end of the year, but finalise the detail and calibration over a longer timeframe. We are keen to continue our engagement with the Basel Committee on the finalisation of the calibration and the further consultation that we think should be undertaken.

As this process evolves and the impacts become clearer we think that it is important that the Basel Committee and other key authorities articulate:

- their vision for the regulatory destination;
- the target, in terms of overall capital and liquidity in the system, of the revised framework;
- their view of what financial stability should mean; in that context we also look forward to discussing the framework for balanced and sustainable growth.

It is in the interests of governments, citizens, customers and banks that there is clarity and consistency on the reform agenda and that it is implemented, at the right time and in the right way, in the major economies around the world.

Timing and sequencing

We recognise the political imperative regarding implementation by the end of 2012. However, we think that careful consideration needs to be given to the timing and sequencing of introduction. For some elements, we think that a longer timeframe than 2012 should be agreed to ensure that economic activity is supported. The QIS and broader economic analysis should inform not only the most appropriate timetable, but also sequencing of the changes and any necessary grandfathering measures. In our view the potential consequences clearly support the need to avoid hasty changes.

Additionally, as the Basel Committee acknowledges, some elements of the package, such as systemically important firms and measures to address procyclicality, are at an early stage of design and require considerable thought. Other areas, where the proposals are more detailed, such as the Net Stable Funding Ratio and the leverage ratio, are very new, and require substantial 'road-testing' and discussion before they can be finalised. Further, some aspects of the proposals are inter-dependent with other parts of the package, such as the leverage ratio, and the Basel Committee will therefore need to bear in mind the sequencing of the underlying components. It is also important to recognise that the announcement of final proposals, combined with a short implementation date, will cause many banks to attempt to access the markets at the same time.

In summary, given the need to enhance financial stability, promote economic growth, iterate the design through consultation and impact assessment and to sequence the introduction of these measures appropriately, it is important in our view, to consider a longer time horizon for some elements. Additionally a phased implementation timetable is essential.

Consistent implementation

Many of our members operate globally and therefore strongly support a fully harmonised prudential capital and liquidity regime. This is essential in terms of reducing risk in the financial system globally, whilst also reducing the burden on banks of regulatory compliance; indeed divergence may lead to increased risks in the system. Harmonisation also contributes to streamlining supervisory processes, facilitating a common understanding amongst members of supervisory colleges.

Further, harmonisation of implementation should also create a level playing field across markets, thereby supporting market confidence. Local and regional regulators should be discouraged from gold-plating, or diverging, from internationally agreed measures

We therefore think that the new regulatory regime should be implemented by all members of the Basel Committee, in the same way and at the same time according to a common transition timetable. A lack of convergence on timing will result in competitive and regulatory distortions, which could undermine financial stability and market confidence.

However we acknowledge that the Basel Accord is not legally binding, but would note that the Pittsburgh Declaration also indicated that all major G20 financial centres commit to adopting the Basel II framework by 2011. From this commitment, we expect supervisors to fully implement all three pillars of the Accord, which should include ensuring that they have the necessary tools. This is particularly important for the convergence of Pillar 2 processes and for the effective functioning of supervisory colleges. Our internationally active members are particularly keen to continue to play their part in ensuring that colleges of supervisors deliver a coherent and harmonised approach to supervision, based on a robust Pillar 2 process which is informed by a comprehensive understanding of their activities and based on a common reporting framework applied at the group level.

In some areas of the response we have recommended that a Pillar 2 approach be adopted, either initially, or on an ongoing basis, and we think that the implementation of the commitment to adopt Basel II will facilitate these recommendations. We suggest that the Standards Implementation Group would be an appropriate forum for the review of implementation by Basel Committee members.

Key issues - BCBS 164 and 165

We would also like to bring the Basel Committee's attention to a number of particularly significant issues identified by Members. These issues, and other more detailed comments, are covered our individual responses to BCBS 164 and 165, which are attached as annexes to this letter. The significant issues are ordered in line with their location in the consultation rather than importance.

BCBS 164

Capital and deductions

There are two issues:

Grandfathering: It is essential that there is grandfathering of existing capital instruments and that its scope is articulated quickly. The results of the QIS must be used to determine the calibration and sequencing of the increased capital requirements, particularly in view of the current position in the economic cycle and other measures that are being proposed, along with an appreciation of what can realistically be achieved by banks in the capital markets.

Deductions: The Basel Committee's proposals introduce procyclical effects, for example by deducting deferred tax assets, Expected Loss (EL) provisions and pension scheme deficits from Core Tier 1. We would instead argue that the tier of capital from which deductions are made, as well as the mechanism for doing so, should be reconsidered, based on an understanding of the way in which they could exacerbate the economic cycle, reducing the overall benefits of the reforms.

Counterparty credit risk

Our members believe that the Basel Committee has unduly focused on changes to a counterparty risk capital framework. The proposals in this area are significant and we have a number of concerns we wish to raise regarding the methodologies proposed and the disproportionate impact thereof.

We understand the motivation for the Basel Committee to focus on the credit valuation adjustment (CVA) as an area requiring reform. The credit valuation adjustment (CVA) charge, among the many overlapping counterparty risk measures, raises the most questions, and we note the following key points. The charge:

- a) appears to be highly disproportionate, requiring multiples of extra capital for counterparty risk;
- b) is, via the 'bond equivalent', risk-insensitive and fails to recognise hedging practice;
- c) does not reflect the current variety in the impact on banks' financial statements, under diverse accounting regimes;
- d) could, in principle, reflect the modelling of CVA together with other trading book risks; or be based on Probability of Default (PD)/ Loss Given Default (LGD).

Our response on CVA is built on the premise that (demonstrably prudent) hedging of counterparty risk should lead to a lower capital charge. This should include some recognition of hedging of the systematic component of credit spread risk. The proposal should address any potential inconsistencies between the existing treatment of 'maturity' in the Basel IRB framework and the ultra-conservative treatment of maturity within the bond equivalent treatment. We have suggested two different approaches to the CVA calculation and look forward to working with the Basel Committee on developing them further.

Leverage Ratio

We acknowledge that the level of leverage was a factor in the crisis, as it may have amplified the downward pressure on prices. We therefore agree that it is an appropriate area for regulatory review and support the introduction of some form of leverage ratio as a supplementary measure, provided it is properly calibrated and designed to include fundamental risk management techniques. However, we have some serious concerns over its potential design, particularly around its ability to address differing business models. We would highlight that the role of market makers in risk intermediation (whereby risk is taken on in client servicing transactions and hedged with other counterparties) is not specifically considered by the proposals and is severely penalised because hedging is ignored/disallowed. Interrelated to this issue is our concern that it does not support good management practice more generally by not recognising other forms of credit risk mitigation. As we perceive the leverage ratio to be a going concern measure, we think that total Tier 1 should be the capital input and see no reason to restrict it to Core Tier 1.

Although some of the issues we identify could potentially be addressed by calibration, there remain fundamental concerns with respect to the methodology. While calibration and design must be addressed, we believe the leverage ratio will need to form part of the Pillar 2 framework. We recognise the political dimension of the debate on the leverage ratio, but Pillar 2 not only allows sufficient flexibility to assess a firm's leverage in the context of its business model, structure, governance and risk management, but also provides a forum for robust dialogue between bank and its supervisor to address the methodological and calibration issues that will be specific to banks' business models. In addition, to facilitate this process, we think that the introduction of a leverage ratio range, rather than a single number, should go part way to addressing the issue. Furthermore we would note the improvements that are being made to the regulatory architecture and the existence of the college of supervisors for certain large international banks, which have undoubtedly facilitated the

handling of the financial crisis, and the enhancement of the college process should be further pursued. We think that the Standards Implementation Group could be an appropriate forum for ensuring that convergent practices are adopted.

Procyclicality

The consultation addresses procyclicality with a number of overlapping proposals, the impacts of which need to be understood. Where possible we believe that existing regulatory tools should be used to avoid unnecessary regulatory duplication or double counting. In our view Pillar 2 already gives supervisors extensive tools to address the issues identified, such as preventing dividend distribution and requiring firms to maintain capital buffers to reflect their risks. Indeed, over the past year there have been several occasions where supervisors have constrained the distributions of capital. We therefore believe that the tools to conserve capital already exist within Pillar 2.

We believe that consistent application of Pillar 2 should be a focus of the Basel Committee through its Standards Implementation Group. We support the Basel Committee's proposal to update the guidance on sound provisioning practices rather than introduce proposals for 'dynamic provisioning'.

Where jurisdictions already operate equivalent measures to those proposed, and which are proven techniques, we would urge the Committee to align its proposals with existing supervisory practice, rather than introduce new duplicative or inconsistent requirements which we would not support. This is of particular concern as regards the preliminary capital buffers proposal.

BCBS 165

Calibration of the liquidity proposals and supervisory factors

We are very concerned by the calibration of the Liquidity Coverage Ratio (LCR) and Net Stable Funding ratio (NSFR). This concern derives from two inter-related sources:

- the severity of the assumptions underpinning the factors - e.g. a three-notch downgrade in the institution's public credit rating;
- the use of standardised factors applied to broad asset and liability classes.

This means that firm specific factors (such as business model) and/or changes in a bank's behaviour made over the ratio horizons can not be taken into account.

On an individual firm basis, the proposed ratios will likely result in a complicated set of calculations that overstate the liquidity risk. It is important to bear in mind the aggregate impact on the industry of this conservatism in terms of the objective being set for liquidity risk management and achievability given the availability of funding in the market.

In summary, if the calibration of the LCR and particularly the NSFR are not substantially altered then they will result in a large reduction in the availability of finance to individuals and corporates and will have an early and sustained adverse impact on the wider economy.

Net Stable Funding Ratio

We support the Basel Committee's objective of encouraging more medium and long term funding. However, we have serious concerns that, in its proposed form, the NSFR will distort markets and impede economic growth. We have a number of concerns over its calibration,

complexity and the lack of risk sensitivity which produces perverse risk incentives. As a result we believe further consideration should be given to its design. We appreciate the need for a measure that addresses the structure of funding, and suggest that the Basel Committee's develop an appropriately calibrated and sophisticated risk sensitive measure that could better reflect firm specific factors.

In short, we recommend an approach that recognises that the NSFR is only one measure among many that needs to be used by supervisors in the evaluation of a firm's liquidity profile. Thus the NSFR (and indeed the LCR) should be used by supervisors along side firm's internal measures in the evaluation of liquidity. This will allow some comparability between firms while encouraging the continued development of firms' internal metrics and models and providing supervisors with a more complete picture of firms' liquidity position and processes.

Conclusion

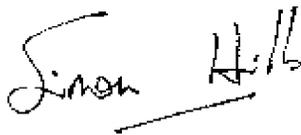
We are supportive of the initiatives that the G20 Member States are taking to reform regulation and strengthen the stability of the financial system. More capital and liquidity are only part of the solution, which should also include a combination of the identification of systemic/macro-prudential risks and strengthened supervision of individual banks. In our view the Basel Committee's primary aim should be to agree the structure of the framework by the end of 2010. Building on the results of the QIS, the details should be finalised over a longer time horizon, based on a holistic assessment of the broader economic impacts, in order to determine the most appropriate timing and sequencing of their harmonised introduction.

If you have any comments or questions regarding this response please contact either, Diane Hilleard (diane.hilleard@afme.eu on behalf of GFMA), Simon Hills, (simon.hills@bba.org.uk), and Richard Metcalfe (rmetcalfe@isda.org) should you require further information.

Yours sincerely,



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Enc: Responses to BCBS 164 & 165

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GFMA joins together the common interests of hundreds of financial institutions across the globe. GFMA's mission is to develop policies and strategies for global policy issues in the financial markets, thereby promoting coordinated advocacy efforts across its partner associations. GFMA is a partnership of the Association for Financial Markets in Europe (AFME), the Asia Securities and Financial Markets Association (ASIFMA), and, in the United States, the Securities Industry and Financial Markets Association (SIFMA).

The BBA is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £40 billion annually to the UK economy.

ISDA represents participants in the privately negotiated derivatives industry, and has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Annex 1: Capital: BCBS 164 Strengthening the resilience of the banking sector.

The Global Financial Markets Association (“GFMA”), the British Bankers’ Association (“BBA”) and the International Swaps and Derivatives Association (“ISDA”) are pleased to respond to the consultation BCBS 164 Strengthening the resilience of the banking sector.

Annex 1 provides a detailed response to the five Committee proposals outlined in the consultation BCBS 164 Strengthening the resilience of the banking sector. Our response should be read in conjunction with the points raised in our covering letter dated 16 April 2010 and Annex 2.

The order of topics in Annex 1 follows the order of proposals as set out in the Basel consultation.

Section 1 Raising the quality, consistency and transparency of the capital base

Section 2 Enhancing risk coverage

Section 3 Supplementing the risk-based capital requirement with a leverage ratio

Section 4 Reducing procyclicality and promoting countercyclical buffers

Section 5 Addressing systemic risk and interconnectedness

1 Raising the quality, consistency and transparency of the capital base

We welcome the proposed approach to the redefinition of bank capital and support the reduction and simplification of its categorisation as well as the removal of the current complex limits structure. We strongly support such harmonisation.

Whilst describing the features of going and gone concern capital – the two future categories of capital – the paper does not explicitly describe the relative purposes of these two types of capital. The Committee's current reformulation of capital provides a good opportunity for it to communicate and debate with a wider audience the different types of risk – for instance unexpected, expected, unrealised and deferred losses faced by the banking community and how capital can be properly held against them.

We believe that *going concern* capital enables a firm to continue trading even during a period of financial stress or where it has suffered severe losses or no longer has the confidence of the market or its creditors. Of course it is difficult to identify the point at which a firm loses the confidence of the market/its creditors. In this respect we believe that the relevant test in times of severe stress should be the lead supervisor's view of the solvency situation of the bank, established and discussed bilaterally based on heightened dialogue with the firm. The outcome of such discussions will be a key determinant of the actions the firm takes to implement its recovery plan and restore its *going concern* capital position to above its regulatory minima, using where necessary the features of Tier 1 and Additional Going Concern Capital.

We view the purpose of *gone concern* capital as being to absorb losses in liquidation, in order to minimise calls on the deposit guarantee scheme, which is funded by the banking industry generally and minimise losses to senior unsecured creditors and depositors not covered by the deposit guarantee scheme.

We observe however that an array of different regulatory initiatives is currently under consideration, many of which are proposed in this Consultation, and all of which have the objective of reducing the probability of an individual bank's failure. The proper application of an appropriate range of these other measures, combined with more robust going concern capital should help to maintain the solvency of the firm. As such there is no need to over-engineer Tier 2 capital over and above what is necessary to protect depositors and other creditors in liquidation by for instance requiring coupon deferral mechanisms or lock-ins. Tier 2 capital should not be seen as providing going concern support in any way, shape or form. Making it more equity-like will reduce the range of investors able to invest in it, unhelpfully reducing banks' diversification of funding sources.

1.1 Key messages

We wish to make the following comments in relation to the capital and deductions section of the consultation paper:

1.1.1 Going concern capital – what is predominant?

We agree that the predominant form of going concern capital should be common shares and retained earnings. However the extent of 'predominant' has yet to be defined – the commonly accepted view is that it should be no more than 50% plus one share although we are aware that regulators may be targeting a much higher number. The ongoing QIS exercise will be used to calibrate 'predominant' and in arriving at a decision we encourage regulators to be cognisant of the current composition of bank capital and investor appetite to supply additional

amounts of going concern capital in the future. For instance we note that innovative capital currently comprises about 25% of all Tier 1 capital and it is proposed that this should be phased out over an indeterminate period. Replacing 25% of the banking industry's capital base will not be possible overnight and we expect regulators to take this into account as they calibrate their proposals and plan the transition to the new regulatory capital regime.

1.1.2 Tax deductibility doesn't matter

In paragraph 76 the Committee is considering the treatment of instruments with tax deductible coupons in Additional Going Concern Capital. In contrast, we are of the opinion that capital recognition should be independent of tax treatment. So long as all of the relevant criteria in relation to loss-absorbency, permanence are met, there is no justification in imposing additional restrictions about tax treatment in relation to capital recognition. Doing so would create an unlevel playing field while providing no additional capital support.

Furthermore, harmonisation of the global taxation rules for capital instruments will be virtually impossible – and any forced regulation through the Committee's proposals will result in an unfair advantage for some issuers over others. There should also be no restrictions imposed on the structure of on-loan instruments as we do not believe these affect capital quality. This view has also been reflected in the recent European CRD 4 proposals which make clear that tax should not be a factor when assessing the quality of hybrid instruments.

1.1.3 Hybrids with innovative features remain useful instruments for regulatory capital purposes

We note the Committee's view that innovative features have eroded the quality of Tier 1 capital and should be phased out. It is not clear which innovative features it has determined to be objectionable – it has particularly identified step-ups meaning that the scope of the possible prohibition is unclear. But we do not consider hybrids pose a threat, particularly when coupled with a regulatory lock-in. Alternatively, they provide our members with the opportunity to structure a range of different instruments to appeal to different components of the investor base promoting funding diversification.

1.1.4 Grandfathering of instruments prior to the consultation paper's release does matter

It is essential that the results of the QIS are used to examine the impact on banks of the limitation on the use existing capital instruments and to work with industry to come up with appropriate grandfathering arrangements and phase-in periods. Not to do so would require banks to raise additional Core Tier 1 capital (or more likely reduce risk weighted assets) at a time when the world's economies have not returned to full health and the investor appetite for bank capital remains muted. This creates the risk of further damage to banks, their customers and the financial system.

Whilst investors now have an appetite to buy new capital instruments and banks want to issue them the Committee's lack of clarity about grandfathering of instruments issued prior to the finalisation of the rules at the end of 2010 means that very little issuance has actually taken place. More clarity on the Committee's proposed approach with respect to grandfathering of instruments before the end of the year would be every welcome including a clear signal as to the effect date from when grandfathering will commence. We are of the opinion that this date should not be earlier than the date on which the proposals are implemented.

1.1.5 Deductions

It is not necessary in our view that all of the regulatory adjustments applied to regulatory capital should be made from Core Tier 1 capital. A number of the deductions considered in the consultation paper do have value on a going concern basis but arguably less so on a gone concern basis. So we believe the Committee should re-consider the tier of capital from which deductions are made.

1.2 Detailed proposal

In addition to these key messages we have the following comments to make on the consultation paper's detailed proposals:

1.2.1 Common equity component

We generally agree with the proposed classification criteria governing the common equity component of Tier 1 capital and itemised under paragraph 87. Our comments on specific criterion are as follows:

5. We note the requirement to pay distributions from distributable items. However the legal definition of distributable reserves varies from jurisdiction to jurisdiction and there may be a need to harmonise these, or alternatively provide discretion in relation to the application of this criterion to ensure it is globally workable.
7. At present, partly as a result of government support for the banking industry some banks have different classes of common equity which have differential dividend rights. These should be accommodated in criterion 7.
10. We suggest the deletion of criterion 10, which links the definition of equity to accounting approaches, which are not yet harmonised. Furthermore future changes to accounting treatments could induce swings in capital ratios which did not reflect a change in a bank's robustness.
14. We suggest that the disclosure requirement be explicitly stated in terms of Pillar 3. This would avoid any suggestion that the disclosure has to happen physically on the face of the bank's balance sheet.

Additional going concern capital

In principal we support the introduction of minimum criteria for Additional going concern capital (AGCC). In reference to the proposed set of criteria identified under paragraph 89 we offer the following comments:

4. Rather than requiring an instrument to be perpetual we believe that there is room for including dated instruments with a lock-in in additional going concern capital. The lock-in would ensure that capital does not disappear just at the time when it is needed but the extra flexibility dated instruments bring would enable finer management of bank capital. We would propose a minimum maturity of 30 years. Furthermore we do

not believe that modest incentives to redeem should be prohibited. Doing so will unhelpfully narrow the investor base for bank capital instruments and regulators can be re-assured that the requirements in criterion 5 will enable them to veto redemption where they deem it necessary. These features could be accommodated by making redemption, as well as the exercise of a call option, subject to prior regulatory approval by amendment of criterion 5.

5. We suggest that points c i) and ii) be moved to the beginning of this criterion – the more natural place we believe for this clause which sets the fundamental premise that a call may not be exercised option but then goes on to establish circumstances under which a call option can be exercised.

We suggest that clause c i) be amended to remove the rather vague reference to ensuring that the conditions upon which it is issued are sustainable given the income capacity of the bank.

We suggest that c ii) be amended to remove again the imprecise 'well above' from the wording replacing it with:

'The bank demonstrates that it will continue to meet its minimum capital requirements.'

So the two clauses of 5 c could be merged to read:

A bank must not exercise a call or redeem an instrument unless they replace it with capital of the same or better quality and it demonstrates that its capital position remains well above the minimum capital requirements.

An exemption (cross-referenced to the deductions proposals, where we are seeking a similar exemption) should be included to allow banks to buy and sell their own additional going concern capital as part of their market making activities.

7. a) We presume that dividend pushers will still be permitted as they are necessary to preserve the relative rankings of AGCC capital instruments with Core Tier 1 and would appreciate the Committee's confirmation of this
 - d) Use of traditional ACSM mechanisms for the settlement of deferred coupon payments through either i) the issuance of new equity or Core Tier 1 instruments to holders or ii) paying holders the cash proceeds raised by the sale of shares into the market, does not reduce the net capital position of the issuer but are needed to maintain the relative positions of hybrid holders vis-à-vis holders of common equity. As such we see no reason why these mechanisms should be restricted and are concerned that this particular sentence could have that effect we recommend it be clarified.
8. A wide interpretation of dividends/coupons should be taken in order to accommodate partnership allocations/profits.
 9. We support the prohibition of features that require a dividend/coupon to be reset upon a change in the issuing bank's credit standing. We note however that some structures include fixed/floating or floating/fixed resets which we would not view as being credit sensitive and would appreciate the Committee's confirmation that this is its view too.

11. This criterion refers to instruments classified as liabilities, whilst remaining silent on whether the accounting or legal definitions of liabilities should be used. In the absence of a harmonised definition approach we suggest that the reference should be to the instruments' classification under national insolvency law as we believe that the Committee's key objective is to ensure that AGCC holders should not be able to petition for the insolvency of the issuer. This interpretation is supported by the CRD 4 consultation paper (see Annex VI criteria 10 and 11). If our interpretation is correct, we believe criterion 10 could be combined with criterion 11 in such a way that would imply that only those AGCC must have principal loss absorption which are: (i) treated as liability for national insolvency law purposes AND (ii) contribute to any tests for the purposes of determination whether institution is insolvent under the national insolvency law.

In addition, for instruments that would be subject to a principal write-down requirement following the above analysis, the national regulator should be allowed additional discretion to permit exceptions to this requirement where such a requirement would otherwise have an adverse impact with respect to the instruments' treatment under national tax and accounting rules. Not having such discretion would put issuers in such jurisdictions at a competitive disadvantage to other issuers in jurisdictions where principal write-downs are either supported by national tax and accounting rules, or not required

- a. criterion a) is silent as to whether the write down should be permanent or temporary. We strongly believe it should be temporary and capable of being written back up upon liquidation. A permanent write down would mean that the AGCC was subordinate to Common equity and that holders could not share in the recovery of the bank or any liquidation proceeds. Without this it is unlikely that there will be any significant investor appetite for such instruments.

12. We agree that if a bank directly funds a customer's purchase of the bank's own capital that capital should not be recognised by the bank. Our concern with this criterion is that the normal provision of financing by the bank to its customer, perhaps through collateralised lending secured over a portfolio of instruments, including some AGCC capital issued by the bank, could be caught by this prohibition which we do not believe is the intention – the bank's intention in providing the finance should be taken into account.

14. We suggest moving the last part of this criterion to follow 'immediately available' such that it would read:

... immediately available *in a form which meets these AGCC criteria*, without limitation.....

Our point here is that the up streaming of the capital need not be in identical form to the instrument issued by the SPV but should, nonetheless, meet the AGCC requirements. So where capital instruments are issued indirectly through an SPV they may be included as part of capital where an on-lending agreement for the transference of the capital to the parent company complies with the conditions for qualification as AGCC.

Additional requirements

- We suggest adding the clarification that the instruments being referred to are AGCC instruments

- The proposed deduction should be on a like-for-like basis

Gone concern - Tier 2 capital

Our only significant concerns with the criteria for inclusion in Tier 2 capital relate to the straight-line amortisation of Tier capital in the final 5 years. This could in itself be viewed as an incentive to redeem as the regulatory capital credit diminishes. We believe the cost of amortisation could be mitigated by the introduction of a lock-in feature which provides issuers with full capital benefit for the term of the instrument but also provides regulatory discretion to prevent the capital instrument from being redeemed under a period of stress. For the capital instrument to be marketable to investors the trigger for 'lock-in' should be transparent and reflective of the 'gone concern' nature of the capital security. The amortisation treatment or 'lock-in' feature for Tier 2 instruments should be used independently i.e. not simultaneously and issuers should have the flexibility to structure Tier 2 securities with either feature when assessing their capital raising opportunities.

Our only other concerns mirror the comments above in relation to AGCC, which are that the ordering of subsections in criterion 5 should be reversed and that a market making exemption should be included in criterion 8.

Transparency

We support greater transparency and expect to deliver this through annual Pillar 3 mechanism and agree that disclosure of the parameters and features of capital proposed in paragraph 80 are appropriate.

We assume that disclosure of the term and conditions of a transaction as usually detailed in a public prospectus would satisfy the Committee's disclosure requirements.

We note that separate disclosure of all regulatory adjustments is required, but request that this be limited to material adjustments only to avoid lengthy and unnecessary disclosure.

We note that paragraph 81 requires 'full' disclosure of all regulatory capital instruments, including, we presume, privately placed structures. This raises concerns about whether public disclosure of private placements on the bank's website could constitute a public offer which would lead to enforcement action.

Grandfathering and transitional provisions

We understand and support the authorities desire to move to the new capital framework in a measured way that permits grandfathering of existing instruments. The QIS process now being undertaken will inform the authorities and banks of the optimum parameters of grandfathering and transitional provisions. Adjusting our capital ratios will take some while and we trust that the authorities will recognise this, taking into account the possible negative impact on the wider economy that early imposition of higher, tighter ratios could cause.

Additional Committee work – contingent capital

We look forward to being able to comment on the Committee's additional work on contingent capital, convertible instruments and instruments with write down features. Our members are keenly assessing the benefits of structures, but have not reached a conclusion. There is certainly a concern that contingent capital instruments, which will effectively require a bank to

hold a buffer over and above the trigger point, could hasten a bank's demise as that buffer is eaten into and holders of such instruments seek to sell their holdings in the market.

Lock-ins for Tier 2 instruments

Lock-ins for Tier 2 instruments are not appropriate. Tier 2 capital is designed to support depositors and other creditors on the event of insolvency. As long as the bank is not insolvent at the point at which the Tier 2 instrument matures, redemption should be permitted. To introduce lock-ins would make Tier 2 capital more loss absorbing on a going concern basis and therefore more equity like, which would reduce its attraction to its current investor base that are invariably not permitted by their investment criteria to invest in such instruments.

1.2.2 Regulatory adjustments applied to regulatory capital

We support the Committee's proposals aimed at harmonising the treatment of certain items from capital but are unsure whether it has thought sufficiently about the potential impact of these deductions and the level at which they should be made. For example the Committee's proposals include deductions made from the Common Equity Tier 1 level regardless of whether these deductions appear on the asset or liability side of the balance sheet or whether cyclical or structural in nature. Each of these elements gives rise to different considerations in terms of how and when they should be financed.

A number of the planned capital deductions (e.g. AFS adjustments, Deferred Tax positions and Pension Fund positions) are, by their nature, volatile with changing economic conditions. In good times they are likely to be broadly capital positive and in bad times capital negative. By proposing their deduction from the Core Tier 1 requirement, procyclicality is being introduced into the Core capital requirement, which is at odds with stated intention of the proposed changes in seeking to eliminate pro-cyclicality from the capital requirements framework.

We believe that the natural volatility of such items during business-as-usual means that they would be more appropriately dealt with by "gone concern" capital, which would be available to absorb the relevant loss when a liquidation actually crystallised, without permanently weighing down the banks performance simply to deal with an effect that will ebb and flow naturally during performance or economic cycles.

1.2.3 Stock Surplus

Stock surpluses, once created, can be used by the bank in an unfettered way, regardless of the Tier of capital giving rise to the premium. The Committee's proposal that a surplus should only be included in Core Tier 1 to the extent that it was generated by Core Tier 1 capital is wrong and reviewed.

1.2.4 Minority Interests

We do not think the proposed approach, removing the eligibility of minorities for inclusion in the common equity component of Tier 1 is appropriate.

Third-party investment in a subsidiary provides loss absorbing capital to that subsidiary and would be recognised as such on a solo basis or by the local regulator: the proposed treatment does not recognise this on consolidation. If such a deduction from capital is made then the risk weighted assets should also be reduced by the proportion of the subsidiary owned by minorities on a consolidated view.

Not to do so would interrupt the gradualist business model that our members use as they plan to increase their exposure to a particular economy, by first working with a local partner

with the necessary local knowledge before possibly buying that partner out if the venture succeeds.

Similarly in some countries national law prevents the ownership of a local bank by an overseas firm, meaning that a joint venture with a local partner is a prerequisite to doing business there. Such business arrangements should not be penalised.

We therefore recommend only deducting excess minority capital above the local regulatory capital required to support local RWAs from the group core Tier 1 but adding it back to total Tier 1.

1.2.5 Unrealised gains/losses on instruments

We support the Committee's objective of eliminating inconsistencies across jurisdictions in the treatment of these items and agree with the Committee's proposal to free up common equity to be fully available to absorb banks' losses as they become realised. In our view, movements in unrealised gains and losses on instruments should be adjusted through Tier 1/Tier 2 capital rather than specifically through common equity and therefore establishing that only at the point the loss is recognised is there a hit to equity.

Furthermore, we recommend that the Committee clarifies its proposal to specifically refer to unrealised gains/losses on AFS reserves.

1.2.6 Goodwill and other intangibles

We agree with the proposed approach in relation to goodwill but believe that there are other types of intangible assets that can be a source of value, for instance software and mortgage servicing rights, and which thus should be excluded from the deduction requirement.

1.2.7 Deferred Tax assets

We agree with the Committee's assertion that firms should not place undue reliance of deferred tax assets (DTAs) for prudential purposes and welcome its recognition that where a DTA relates only to a temporary timing difference on different types of assets such exposures should be risk weighted according to the relevant sovereign weighting. We note that such DTA will typically be balanced by similar timing differences which create an offsetting deferred tax liability (DTL). Concerns about a firm's capital adequacy would not affect the DTA and DTL relating to such timing differences.

However we do not support the proposal that DTAs which arise from Tax Loss Carry Forwards because a bank has incurred a loss of financial reporting/accounting purposes but not for tax purposes should be deducted from Core Tier 1 capital. Deduction from going concern capital cannot be justified when auditors will only agree to their inclusion in the expectation that the bank will remain a going concern so a harmonised approach which permits their inclusion in capital should be permitted as DTAs:

- Are verified by the bank's auditors
- Have value even in insolvency as companies containing DTAs be sold on to third parties for whom such assets would be beneficial
- Barring their inclusion for capital purposes will also be procyclical as firms would be deducting the assets when they were not profitable – at just the time when additional capital is likely to be needed.
- The approach may also discourage banks to make provision for tax timing differences which would not be prudent.

- We therefore suggest that DTAs (adjusted where necessary for minority interest holdings) be permitted up to a threshold percentage of core Tier 1 capital or failing that deducted in their entirety from Tier 2 capital.

1.2.8 Investments in own shares (treasury stock)

Long positions – hedging deferred compensation scheme exposures

Other than for market making purposes banks do not typically hold positions in their own common shares. The main instance in which they do relates to long holdings of common stock acquired to hedge the deferred compensation schemes which regulators are requiring banks to use to a much greater extent than in the past. We therefore believe that long holdings of shares should be netted off against such long term liabilities.

Netting of gross long positions against shorts only if no counterparty risk

We note that the Committee is planning to prevent the netting of long and short positions unless there is no counterparty risk. This runs against existing industry practice and would discourage good risk management practices.

We acknowledge that this proposal may be seeking to avoid wrong-way risk but consider these risks are already dealt with adequately in other areas of the proposed amendments - added conservatism should not be introduced as is proposed in this element of BCBS 164.

Index securities

We do not agree that when a firm has an exposure to an index containing its own shares it should look through to the underlying components of that index in order to deduct them. It is unlikely that the proportion of a bank's own shares in the index will be significant.

The exposure a holding of an index security creates is to the issuer of the indexed securities, not to the underlyings, so is more in the nature of a counterparty risk which is captured by other elements of the Basel framework. When the indexed security is traded on an exchange this risk disappears. The component of an index security that comprises the firm's own common shares should therefore not be deducted from the bank's capital.

Market making exemption

Many of our members make markets in a range of different securities, usually including their own shares, which beneficially promotes market liquidity facilitating the price discovery process that is essential to a thriving market economy. At certain times too they may decide to undertake share buy-backs.

Such market making and buy-back activities should be exempt from the deduction from capital requirement below a certain threshold. We suggest that the CEBS guidelines, which are being implemented in Europe, are used as a model for this exemption. These permit instruments to be held for market making or market smoothing purposes provided that they do not account for more than 10% of the relevant issue or 3% of a firm's total capital. We further suggest that holdings in excess of these levels should be subject to a class by class by deduction rather than entirely from Core Tier 1.

1.2.9 Investments in capital of financial entities outside the scope of regulatory consolidation.

We are unclear of the intentions behind this element of the consultation paper which is likely to affect some firms more than others and are not risk based. Our view of this proposed amendment is that it is designed to achieve a macro-prudential goal – discouraging cross-shareholdings between financial institutions – and that mechanisms are currently being developed to avoid double counting of capital in the banking sector – for instance through the

Financial Conglomerates Directive in the EU. So the use of a micro-prudential tool – deduction of such shareholdings from capital - is not appropriate.

Investments in insurance companies

Insurance companies are already under a regulatory regime that requires them to hold sufficient capital to protect the interests of policy holders. They can also be a source of value in stressed conditions

Deducting the full amount of any investment in an insurance business from the Core Tier 1 capital of a bank is too extreme and implies that the insurance business would have no value in a stressed situation. This is not the case and indeed such investments may have counter-cyclical value to the extent that the risks to which they are exposed are not highly correlated with the risk types to which banks take on.

We therefore reject the proposal that investments in insurance companies should be subject to a deduction and call upon the Committee to recognise the Joint Forum's work on conglomerate regulation and include it in the proposed capital regime.

In addition there should also be a market making and buy-back exemption available as we noted above. Market making in capital instruments should not result in a breach of the limits.

1.2.10 Shortfall of stock of provisions of expected losses

Whilst we agree that the shortfall of provisions to expected losses should be deducted from Core Tier 1 we argue for a symmetrical approach. Where a bank has over-provided, compared to expected losses, any excess should be included in Core Tier 1. Not to do so would penalise prudence.

1.2.11 Cash flow hedge reserve

We agree with the approach suggested by the BCBS.

1.2.12 Cumulative gains and losses due to changes in own credit risk on fair valued liabilities

We agree with the approach suggested by the Committee with regard to the existing deduction (liabilities fair valued under the Fair Value Option). However, we question whether the proposal to make such deductions on all fair-valued financial liabilities is appropriate. This requires further thought which we expect will further evolve through the QIS exercise.

1.2.13 Defined benefit pension fund assets and liabilities

We do not agree that defined pension fund liabilities should be deducted from the common Equity component, but do agree that the two questions of the *quantum* and *level* of any deduction in respect of such liabilities should be addressed.

However in answering these two questions it should be borne in mind that different countries and banks have different approaches to pension provision for their citizens and staff. In some countries the predominant form of pension provision is via a state provided pay-as-you-go unfunded scheme. In other countries employer-provided defined contribution or defined benefit pension plans are more common. The impact of the BCBS proposals will vary from country to country and from bank to bank, depending on the pension model adopted.

A number of jurisdictions explicitly or implicitly require banks to hold capital for this element of pension risk via their Pillar 2 assessment. We would suggest that this be the route by which they continue to approach this matter rather than via this Pillar 1 deduction being proposed.

So we propose that the treatment of deficits arising from defined benefit pension scheme liabilities be subject to a national discretion allowing the local regulator to make adjustments to a bank's capital which reflects the specificities of pension fund arrangements in the country in question. [We should emphasise however that we do not generally support national discretion but think in this case that it can be justified.]

Quantum of Adjustment

There are a number of different methodologies that could be employed to assess the quantum of any deficit, including:

- Accounting approach based on IAS19
- Trustee's valuation
- Pension Fund Regulator's valuation
- Buy-out valuation
- Any deficit recovery agreement (DRA) that has been agreed with the trustees

Whilst we would normally support regulatory capital quantification based on accounting approaches, we believe that an accounting approach is not appropriate for pension valuation from a regulatory capital perspective as it potentially creates unwelcome volatility, based as it is calculated on point in time assessments of market prices. Furthermore changes in the accounting approach in the future – for instance in relation to the risk-free rate used – could impact regulatory capital arbitrarily. It is important to note too that unlike the DRA the accounting approach is not based on contractually agreed amounts.

We believe the DRA, derived from a statutory Recovery Plan that has been contractually agreed by the bank sponsor with the pension fund trustees is the best assessment of quantum that should be used to adjust regulatory capital. Currently the DRA is the sum of five years additional funding under the Recovery Plan, and were the DRA to be extended, to cover say, ten years additional funding, then we would suggest that this be based on the net present value of the additional payments.

Level of Deduction

We do not believe that the deduction of the NPV of the deficit reduction amount should be made from common equity and reserves.

As the pension fund trustees have a claim alongside other creditors in insolvency and this is the point at which any under-funding would crystallise we believe that the default should be deduction from gone concern capital, not going concern capital and recommend that the Committee adopts this approach.

Disclosure

We acknowledge that the treatment by banks of pension funds for reporting purposes can be opaque and would be pleased to consider ways in which the reporting of the details of a banks' pension fund could be improved in Pillar 3, providing the NPV based DRA is adopted and deducted from gone concern capital.

1.2.14 Remaining 50:50 deductions

We agree with the approach suggested by the BCBS but note that this agreement is dependent of the ultimate level at which 'predominant' is set.

2 Enhancing risk coverage

The members agree it is appropriate to review the treatment of counterparty risk, together with its measurement and management, in light of experiences in the period from 2007 on. It seems clear from these experiences that a regime that encourages more accurate and realistic assessments of the level, variability and drivers of counterparty risk is desirable, including such crucial factors as wrong-way risk. At the same time, the regime can usefully recognise where firms hedge counterparty exposures and their variability.

To put the issue of counterparty risk in perspective, we believe it is vital to bear in mind that:

- losses realised because of outright defaults were very effectively contained and mitigated by the operation of netting and collateralisation;
- losses were also realised because of declines in the value of marketable securities, notably because liquidity dropped across the system as a whole, as a result of concerns about creditworthiness more generally – not counterparty risk exclusively.

We note the Committee's desire to see greater and better aggregation of exposure at counterparty level and agree that this is a *sine qua non*.

A closer analysis of the 2007-09 experiences reveals some important aspects of how an improved regime could, in industry's view, best operate. This would not only set the overall level of capital appropriately, but also allocate that capital proportionately to the various components of risk, while avoiding:

1. double-counting (whether with existing measures or as between the current set of new proposals); and
2. arbitrary increases (i.e., ones that are not risk-sensitive and which therefore incentivise behaviour that is at odds with the stated aims of the Consultation).

CVA

We focus particularly on CVA, where we believe that the 'Bond Equivalent' approach violates both these principles in certain ways. As a general principle, we feel that there should be due recognition where firms hedge risk in a demonstrably prudent fashion; and that the proposed approach does not satisfactorily mesh, either with the factors that drive exposure (or, therefore, ways of hedging that exposure) or with credit-risk hedging practice. To formally state the key principle, therefore:

"A firm that reduces its economic risk to the default of a counterparty should post less capital than another firm with the same economic exposure that chooses not to hedge. The reduction in capital should be commensurate with the reduction in risk; and there should never be a capital dis-incentive to reduce economic risk."

We also note in regard to this issue the consultation's observation (in para 120) that "*over time, CCR should...be treated in an integrated manner with market risk*" – something that the Bond Equivalent approach does not achieve.

At the same time, it is clear that 1) different firms (or parts of firms) experience different degrees of balance-sheet impact from CVA changes and that (as we set out in some detail in our response) different approaches to a CVA charge could be adopted accordingly; 2) that the CVA charge will only work effectively to influence behaviour if analysed jointly with other elements of the capital regime, notably charges for jump-to-default and expected loss.

Put another way, important as it is to set the *overall* level of capital that banks hold, it is vital also to get the right *allocation* of that capital between risk classes, relative to their nature and size. This appears particularly relevant in the case of a CVA charge. If the capital rule is

simplistic and risk-insensitive, it will distort relative prices and will create uneconomic incentives that will lead capital-optimizing banks to pursue strategies that are sub-optimal (and could ultimately result in large costs to society). It is better to have risk-sensitive models, whose results are scaled appropriately to reach the desired level of capital, than blunt rules that assess capital on an idiosyncratic basis to each activity and arbitrarily fix the relative amount of capital, irrespective of the actual underlying economic risks.

Firms' analysis clearly shows already that the impact of the CVA charge, as set out in the December 2009 proposal, will be non-trivial. While we recognise that the full, detailed QIS will be important in validating this, we believe it important to make it clear now that, on its own, the CVA charge will demand that significant new capital be raised, with even the most modest impact assessments representing a whole-number multiple of current counterparty-risk charges, *after* hedging.

Business with end-users will attract the largest CVA charge (since portfolios with end-users are those most likely to entail significant open positions). Assisting corporate customers in managing risk is a basic banking function. The impact of the current proposals on the costs and availability of hedging services is likely to be economically significant. Moreover, these increased costs will affect firms whose main business does *not* consist of taking interest rate, foreign exchange or other financial market risks, and the effect will be proportionally larger for smaller end users. These are factors that should be considered when the Committee decides on revisions to its proposals.

We further note i) the double counting with the existing treatment of maturity in Basel II and ii) the ultra-conservative nature of the bond equivalent.

Industry firmly believes that the deficiencies of the bond equivalent approach run much deeper than questions as to how it is calibrated. Merely adjusting the scaling factors, for example, would not address its shortcomings, because it would remain misaligned with both risk and the hedges of that risk. It might, of course, be possible in theory to re-engineer the bond equivalent approach, taking due account of the ways in which it is deficient and addressing each of them in turn. In practice, though, this would constitute no more than a modest step in the direction of the risk-sensitivity that we advocate in this response.

In summary, among the many overlapping counterparty risk measures, the CVA charge raises the most questions. We note that the charge:

- a) appears to have a disproportionate, multiplier impact on charges for counterparty risk;
- b) is, via the 'bond equivalent', risk-insensitive and so does not mesh well with hedging practice;
- c) does not reflect the current variety in impact on bank's financial statements, under diverse accounting regimes;
- d) could, in principle, reflect the modelling of CVA together with other trading book risks.

Our response on CVA is built on the premise that (demonstrably prudent) hedging of counterparty risk should lead to a lower capital charge. This would include some recognition of hedging of the systematic component of credit spread risk.

Stressed EEPE

On Stressed EEPE, while we recognise the overall objective, we believe greater clarity is needed as to the role that could be played by a) back-testing and b) the Pillar II stress charge.

Asset Value Correlation

As regards Asset Value Correlation, we believe that the incentives for looking at this, as well as the calibration merit further careful consideration. The measure allows for no distinction between quality of financial counterparty; and appears to ignore the changes in practice as regards collateral and central clearing, which mitigate and reduce the 'interconnectedness' the charge is presumably targeting. It is hard to comment more fully, without access to the data on which the Committee has based its proposal. We do, however question the inclusion of a strong *disincentive* for financial firms to face each other, particularly when the liquidity regime already strengthens firms' resources, let alone the further measures that are contemplated in relation to systemically important banks (paragraph 47).

On all of these items, more detail follows. We also take this opportunity to mention briefly some points on some other issues.

Overall

Overall, we would note that the Consultation contains a very large number of measures, each of which may have some merit in its own right but whose integrated, cumulative effect is not yet clear. If, taken piecemeal, the effect is to put a strain on the economy (because of a need for increased capital raising, *whatever* the stage of the economic cycle) and to damage the effectiveness of risk-transfer markets, we do not believe either outcome to be desirable.

Clearly, there is scope within the QIS exercise to take stock of relative allocations, as well as overall levels of capital (taking into account the changes to the Trading Book treatment, published in July 2009). We assume that will take into account the incentive issues we mention in this response.

CCPs

For CCPs, we believe that there has been a clear and demonstrably strong move towards central clearing, which was accelerated by but not fundamentally driven by the crisis. We fully accept that there should be a relative incentive to face a CCP (provided, of course, that the CCP adheres to reasonable international standards set by CPSS-IOSCO and, in particular, does not undertake the clearing of contracts that would be inherently unsafe to clear centrally). We would, however, caution against penalising contracts that are not centrally cleared, since by definition this would include the very tailored contracts that are most valued by end-customers.

With regard to CCPs, we would note that paragraph 121 switches terminology from 'zero EAD' to 'zero percent risk weight' part way through, and would suggest that 'zero EAD' captures the desired intent.

Margin period of risk

Increasing the margin period of risk makes sense for portfolios that include illiquid transactions (or collateral). We suggest, however, that the introduction of materiality thresholds and note that a large portfolio is not necessarily synonymous with difficulty in valuing contracts or replacing them (particularly on a net basis, using risk-factor assessments). Moreover, industry has made significant progress in implementing both portfolio reconciliation (obviating disputes about trade *population*) and dispute resolution (addressing disputes about trade *value*)¹

¹ viz: www.isda.org/c_and_a/pdf/ISDA-Collateral-Committee-Dispute-Resolution-Proposal-Briefing.pdf.

Securitisation in repos

We further note that penalties for using securitisations in repos will slow the access of firms to alternative sources of funding, which in some cases may prolong the burden on the taxpayer. This is particularly important since repo of securitisation tranches can work well, as has been the case in 2010; in other words, while it is important to reflect experiences from stressed situations, it is right to recognise these as extreme rather than the norm.

2.1 CVA

Capitalizing for Unexpected Loss Arising from Variation in CVA

*BCBS 164, page 5, paragraph 21, "Banks will be subject to a capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty. While the current Basel II standard covers the risk of counterparty default, it does not address such CVA risk, which has been a **greater source of losses than those arising from outright defaults.**"*

BCBS 164, page 28, paragraph 114, "Mark-to-market losses due to credit valuation adjustments were not directly capitalised. Roughly two-thirds of CCR losses were due to CVA losses and only about one-third were due to actual defaults."

BCBS 164 correctly references the large losses faced by (numerically) a small proportion of the overall industry. It attempts to characterise these risks with a single approach, that will (per paragraph 20, page 5) "provide incentives to strengthen the risk management of counterparty credit exposures." The industry concurs with this goal, with particular emphasis on recognising demonstrably effective hedges of such exposures. However, it is already clear the impact of the charge as currently drafted will be disproportionate. Moreover, capital requirements should assess the propensity for the unhedged portion of a trading or banking book risk to generate unexpected losses. The capital requirements themselves should not introduce new risks, and firms should certainly not be penalised for hedging. Without recognising the differentiating factors within the industry that drive management of, and practices around CVA, the consultative paper both introduces new risks (through an unhedgeable, procyclical, spread-sensitive capital charge); and fails to incentivise prudential risk management and hedging where appropriate. Depending on the exact impact, it may also reduce the availability of hedging services to the real economy. Industry analysis already suggests that, as currently proposed, the CVA charge *on its own* will be likely to require firms to raise new capital.

The intended goals of the industry, as reflected in this response, are:

- Recognise that a firm which hedges against changes in credit should face a lower charge than one that does not.
- Ensure a charge that is proportionate to the risk.
- Recognise the progress made by the industry during, and since the crisis to address the proper characterisation and measurement of the risks faced.
- Recognise the need for demarcation of trading book and banking book treatments for CCR.
- Recognise that where firms assign positions differentially to trading and banking book, different capital treatments may be necessary.
- Progress towards a capital framework across trading and banking book that does not penalise hedging.
- Progress towards a capital framework where the sum total of capital components is reflective of the overall balance-sheet risk faced by firms over a one-year horizon.

Preliminary estimates from the industry suggest that the proposals could result in a very large increase in counterparty credit risk capital, even where largely hedged. This is

disproportionate to the risk. The bond equivalent CVA defined by the Consultation is also disjointed from the real balance-sheet risks faced by firms, and represents a blunt tool with which to increase capital requirements. The industry clearly recognises, and fully accepts the requirement to appropriately capitalise for *unexpected* variation in P/L arising from movements in the CVA. We also note, however, that since the crisis, tens of millions of dollars have been spent increasing the risk management capabilities at all firms.

Central to the industry's argument is the recognition that, where *marked-to-market*, counterparty credit risk is a *trading book* risk; where the risk is accounted for using non-market based approaches, it is a *banking book* risk. Firms should not be penalised for hedging in the capital constructs and, when comparing the same portfolio with the same counterparty across two firms, the firm that has existing hedges should hold less capital than the firm that does not. However, care must also be taken when comparing different firms on different treatments (trading book or banking book).

On the Validity of "Same Counterparty, Same Portfolio = Same Risk = Same Capital"

It is clear that the loss distribution arising from default at some future date T is theoretically dependent only on the counterparty credit and the portfolio of derivatives. However, the moment we introduce a risk horizon $t < T$ and ask ourselves, "What is the capital required to buffer the firm against unexpected variation in P&L until t?", then the balance-sheet risk (and hence capital requirement) faced by the firm depends directly on its choice of market-value adjustment. The more volatile the measure, the greater the need to hedge the measure, in order to avoid bankruptcy between today and time t. Of two firms opting for different treatments (trading/banking book), if one firm cannot survive to time t, it is irrelevant that ultimately the loss distribution is the same for both upon default of the counterparty.

This undermines the quoted principle above: It is therefore precisely the difference in chosen approach that led to the mark-to-market losses referenced by the Consultation; it is also why a single approach may not truly be able to 'look through the accounting' and describe the potential for unexpected variation in P&L over the next year.

Globally, firms opt for one (or more) of four approaches to the problem of provisioning for expected counterparty default loss.

1. No adjustment.
2. A through-the-cycle adjustment, based on expected exposure and a historic loss-norm, calibrated from firms' histories of PD and LGD experience.
3. A market-implied adjustment to the mark-to-market of the derivative contracts in question.
4. A model-based, forward-looking EL adjustment, calibrated to estimates of PD that use both CDS spreads and historic values as input to the model.

Within each firm, different treatments are applied. These treatments are reflective of the relevant accounting standards that apply; these broadly follow IFRS outside the US, or FAS within. Rarely is a single approach ubiquitously applied across a group; the Committee, in applying the proposal across the board, fails to recognise that potential balance-sheet losses, arising from unhedged variability in CVA, are limited to the scope of application of each method. Firms simply will not register the impact that the proposal, as a broad measure, intimates. Moreover, in creating a third (yet another) valuation of expected loss² through the bond-equivalent CVA, the proposal creates fictitious risks that are not present in the way risk is valued or hedged in firms today.

One area of particular focus must be the maturity adjustment in the existing Basel II framework. As detailed in the BIS publication, *An Explanatory Note on the Basel II IRB Risk*

² Besides the actual accounting definition and the regulatory expected loss.

Weight Functions, the maturity adjustment was calibrated to incorporate the 'mark-to-market valuation of credits'. In particular, it relates to 'potential down-grades and loss of market value of loans'. To some extent, therefore, this already captures some of the sensitivity of the CVA. The consultative paper goes further in trying to isolate the spread sensitivity, and to some extent, the cross-sensitivity of CVA to both market and credit movements, but fails to address the maturity adjustment.

The remainder of this CVA-focused comment is as follows: We look first at the Consultation's proposal against these goals through the bond-equivalent CVA. We then discuss, in turn, the banking book and trading book. We look at how the sum of capital components must make sense, and then consider the nature of fallback approaches. All approaches are dependent on the recognition of the reduction in jump-to-default risk from single-name credit hedges (and equivalents). Therefore, we follow the main proposals with a discussion of single-name default swaps. Whatever the chosen approach, we recognise the need for a framework where the underlying assumptions of diversification behind the EPE measure are well-founded, and specific wrong-way risks are addressed more fully.

The Bond-Equivalent CVA

A new standalone, credit sensitive capital charge creates multiple undesirable consequences and, contrary to the stated intention of the Consultation, *reduces* the incentive for firms to prudentially manage and/or hedge their risk. We consider a few of the implications here.

For firms with no CVA, the proposal to capitalise CVA in this way bears few similarities with the real risk. Indeed, the proposal actually creates new risks for these firms, and will spur the need to hedge regulatory capital in markets that simply may not support the necessary credit instruments (which will drive 'skew' in credit indices). These firms treat CCR as a banking book risk, and the EAD framework and maturity adjustment provide adequate accounting in the capital calculations.

For firms applying a through-the-cycle adjustment, it is clear that they do not have this spread risk either; rather, it is the risk of rating transition or downgrade in the loss-norm that largely drives an adjustment through net income. The stability of their PD and LGD estimates drives the potential for loss associated with deterioration in creditworthiness of their counterparty. Again, the fictitious risks created here will skew credit markets.

Moreover, it is important to recall that the through-the-cycle approach to CCR is conceptually identical to the standard approach of the wholesale loan portfolio. It is also the underlying assumption of the current IMM rules for CCR. Of course, the one material difference between a loan portfolio and a CCR portfolio is the dynamic and stochastic nature of CCR exposure. That is already captured and modelled in the IMM via ($\alpha \times \text{EEPE}$) and the effective maturity M .

If the proposal was adopted verbatim, a firm with no CVA, or one opting for a through-the-cycle methodology, would quickly find itself running a large, potentially unhedgeable, *procyclical* CS01 risk in its capital charge. The very reason the firm opted for the approach in question is likely the lack of a deep market for single-name hedge instruments for the counterparty risk in question; one might extrapolate that the firm would be forced to hedge the new charge with index positions if available — however, the index hedge (being excluded from the bond-equivalent CVA calculation) would, itself, become an unbalanced market risk in the firm's trading book charge (either VaR or SMM), requiring additional capital!

For firms applying a market-implied CVA, the Consultation ignores the fact that spread sensitivities are, by definition, already available from the calculation of CVA. The proposal in the Consultation also creates a bond position which materially differs from the economic risk faced (see Appendix 1). In particular, the Consultation approximates the credit sensitivity as a function of exposure only (EAD and effective maturity), when in reality, the spread sensitivity is a function of exposure *and* prevailing spread. As outlined in Appendix 1, it is

also clear that the sensitivity of the CVA to changes in market rates is equally important as the spread sensitivity. A firm with a market-implied CVA would therefore see every hedged position become unhedged for capital purposes, due to the difference between the real CS01, and the fictitious risk of the bond equivalent.

Critically, all market vectors and many credit sensitivities would also become unbalanced in the market risk VaR, suggesting a potential for trading loss that is not reflective of the real risk. In stable, low-spread environments, the principal sensitivity of the market-implied CVA is to market vectors and the vega-risk represented by the exposure profile; in volatile, high-spread environments, the sensitivity is geared more to the joint movement of credit and market vectors (with the market sensitivities converging to that of the underlying derivative in the limit). Carving out the single-name hedges from VaR leaves behind a significantly misrepresented, unbalanced risk in the trading book VaR.

In general, the rationale for a standalone VaR is flawed; there are a multitude of instruments that provide economic offset to CVA movements, in particular when the idiosyncratic risk of jump-to-default is carved out, as it is with the banking book treatment of EAD. Furthermore, the bond-equivalent prescription misstates, and potentially understates, the market-sensitivity of the CVA.

All standalone VaR approaches create opportunities for arbitrage, and in marked contrast to the Consultation, the focal point should not be so much the perception that VaR of CVA conceals risk, but rather the assessment of the jump-to-default measure against:

- The implicit diversification assumptions and the potential for concentrated risks.
- The potential for wrong-way risk.
- The correct calibration of the maturity adjustment to capture market sensitivity of the CVA.

Furthermore, the annualisation (5x) and scaling (3x) embedded in the proposal are not consistent with the trading book regime, with which the Consultation seeks to attain alignment. The rationale for the scaling in the trading book VaR equates to a 99.9%, one-year principle, with which the industry agrees. However, the two scaling factors put this approach well beyond that tail estimate. For a normal distribution, the 99.9%, 250-day VaR is circa 6.6 times the 99%, 10-day VaR; *not* (5x3 =) 15 times. Taking into account the addition of Stressed VaR, and the reality of fat tail effects, this is an extreme measure.

In summary, therefore, the bond equivalent CVA:

- assumes that spread risk hedges are most important, whereas industry analysis (see *Appendix 1, Example B, Table 1*) suggests that rates and volatility hedges together are generally larger in magnitude than spread hedges;
- entails double counting with the maturity adjustment in the existing Basel II framework;
- does not recognise the difference between trading and banking book approaches to the management of risk;
- further penalises hedging by isolating the single name hedges; and,
- with no corresponding adjustment of jump-to-default risk for the benefit of hedges in the banking book construct, is strictly additive to the capital.

Industry therefore firmly believes that the deficiencies of the bond equivalent approach run much deeper than questions as to how it is calibrated. Merely adjusting the scaling factors, for example, would not address its shortcomings, because it would remain misaligned with both risk and the hedges of that risk.

It might, of course, be possible in theory to re-engineer the bond equivalent approach, taking due account of the ways in which it is deficient and addressing each of them in turn (as illustrated below). Once one goes down this route, however, it logically and rapidly leads one towards the market-implied approach we outline in this response, or its banking-book equivalent.

1. The additional capital charge could be calculated based on the actual CS01 of the firm wherever possible:
 - a. For firms that calculate a market-implied CVA, use the actual CS01.
 - b. For firms that calculate a through-the-cycle CVA, the CS01 should be scaled accordingly.
 - c. For firms that do not calculate a CVA, but do have an IMM permission, this can be inferred from their EPE profile.
2. For firms with a VaR approval for general and specific market risk, subject to national supervisory permission, the charge should be based on a suitably conservative integration with the existing VaR, or on a standalone basis otherwise.
3. The charge could be based on 10-day VaR and Stressed VaR, but not IRC.
4. The 10-day VaR and Stressed VaR could be scaled by 3, to be consistent with the market risk standard, and to avoid arbitrage of the rules.
5. For those firms with an IMM permission under the IRB framework, and for whom the integrated VaR is permitted, the effective maturity should be set to 1 in the calculation of the jump-to-default, EPE-based capital component, since the market sensitivity of the CVA is captured in the VaR.
6. For those firms with an IMM permission under the IRB framework, and for whom the integrated VaR is not permitted, the effective maturity could be recalibrated to isolate only the market sensitivity of the CVA.
7. Any such approach could work at the level of netting set, rather than counterparty. This mirrors the calculation of counterparty credit risk capital and ensures greater sensitivity to amounts that would actually be realised through netting. Moreover, the maturity of the 'bond' could be the capped effective maturity, as 5 years is a reasonably long forecasting horizon and the CDS market is not necessarily so liquid for transactions with a maturity significantly longer than 5 years.

For Firms Opting for a Banking Book treatment for CCR

Firms that apply banking book treatment to CCR are not necessarily subject to the same balance-sheet risks over a one-year horizon as those applying an unhedged trading book treatment.

Ubiquitously, firms should defend the assumption of diversification underpinning the EPE framework if they choose to apply it, or look to alternative measures to capture concentrations of, or specific wrong-way risk; the CEM approach naturally errs towards a higher measure of EAD, whilst the EPE framework has the alpha multiplier. The fragmented and piecemeal approach, taken by the Consultation to addressing these fundamental issues, clouds the overall assessment of whether the risks are adequately capitalised.

Firms with no reserve methodology are not subject to the same volatility arising from a variation in reserve, but are exposed to the full jump-to-default distribution. Under paragraph 43 of International Convergence of Capital Measurement and Capital Standards, the addition of regulatory expected loss to Tier 1 and Tier 2 capital requirements provides the basis for an adequate capital measure, when combined with the EAD-based measure of jump-to-default risk, and the full maturity adjustment M. However, the industry does accept that the overall

incentives of this approach are not yet aligned with the stated aim of strengthening risk management practice.

Firms with a through-the-cycle approach are subject to variation arising from changes in exposure, PD and LGD. The industry has developed the CVA Variability Charge (CVC) proposal to address this. The stated aims of this proposal are, in addition to those above:

- Model to capture the unexpected loss of potential variability in CVA due to changes in quality of counterparty.
- In keeping with the bond-equivalent CVA, the expected exposure profile remains constant.
- Soundness standard of 99.9 percentile 1-year, in line with the banking book treatment under Basel II.
- Aim for a stable capital charge, in line with the through-the-cycle approach.
- Incorporate credit correlations explicitly in the model. Stress testing can then help identify the impact of wrong-way risks.
- The single name hedges can be directly modelled in the exposure calculation leaving only the residual exposure for the CVA calculation.

The CVC approach involves defining a discrete set of credit states that counterparties can migrate between. The 'defaulted' state is excluded, since this is accommodated by the EPE charge. The CVC approach focuses solely on the credit worthiness and how a change impacts the CVA. It is therefore predicated on the existing maturity adjustment being appropriately calibrated to capture the market sensitivity of the CVA. In the case where CVA charges are calculated using a historical probability based transition matrix, the credit states are already well defined and correspond to either internal or external ratings.

For all counterparties, the change in CVA caused by counterparty migration across credit states (i.e. moving from one rating category to another) must be calculated. The CVA will increase as the credit state worsens, and vice versa when credit states improve, with no change in CVA as long as the counterparty remains in the same credit state. For each counterparty, one would generate a set of numbers representing the change in CVA corresponding to the pre-defined credit states.

Where there is a single counterparty in the portfolio, the change in CVA relating to the worst credit state represents the CVC because of the extreme choice of confidence interval. However, in a larger portfolio, the diversification among the counterparties will be a key driver in assessing the CVC as the change in CVA in a given scenario could be different for each counterparty within the portfolio.

To account for this correlation, a Monte-Carlo approach might be adopted where, in each trial, we draw the credit states for all counterparties in a correlated fashion. The banking book IRB approach uses a single factor with correlation calibration in the range of 12%-24% depending on rating. More granular correlations could be defined, involving grouping counterparties by, for example, sector, rating, region, country and then determining the correlations between groupings. Internal models for credit correlation should be subject to the same standards of validation and integrity as for other IRB models.

At the end of each trial the sum of change in CVA due to the migration of credit states for all counterparties is calculated. The process is then repeated until we have performed enough trials to obtain a stable distribution from which we can extract losses for a required confidence interval as the CVC measure.

For Firms Opting for a Trading Book Treatment to CCR

Over the last fifteen years, large banks have spent substantial resources to enhance their capabilities to measure, price and manage counterparty credit risks. During the same period, an expanding credit derivative market (especially for vanilla index and single-name CDS) has created opportunities for the risk management of counterparty credit risk as a trading book operation with active hedging.

Most large derivatives dealers have built sophisticated risk management systems and have established trading desks that are dedicated to the pricing and management of their counterparty risks. Those desks have executed large amounts of hedges against the CVAs, to the tune of tens of billion of dollars in CDS notional amounts.

The banks that marked to market their CVAs experienced severe CVA volatility during the 2007-8 financial crisis, especially during the fourth quarter of 2008. The variability of their CVAs reflected the turbulence in the markets and, to the extent that their CVAs were un-hedged, the banks' P&Ls were affected, in some cases quite negatively and severely.

We recommend that the regulatory capital treatment of portfolios of counterparty risks that are marked to market and managed within a trading book regime be consistent with other similar trading risks.

Our proposal has the following stated aims, above and beyond those stated above:

- To be consistent with the actual risk measurement and management practices of the banks.
- To align the risk measurement and stress testing capabilities to what drives capital charge.
- To set proper economic incentives for active hedging and mitigation of counterparty credit risks.
- To provide a platform for identification, and stress testing of specific wrong-way risks.

Specifically, we recommend that the regulatory capital on counterparty risks should be assessed by including the CVA (and all its single-name, credit index and other hedges) in the trading VaR, stressed VaR, and IRC frameworks. The adoption of the trading book regime comprising these three elements is now considered robust. In this way, the CVA risks and hedges would be treated as integral parts of the full trading book and would be measured within the full trading book context. Currently, the hedges of the CVA reside in the trading book but the CVA does not. This creates a very material split-hedge problem that will in practice penalise banks that do hedge the CVA.

The IRC framework is analogous to the IRB Asymptotic Single Risk Factor (ASRF) model that is used to calculate the Risk Weights in the banking book but it has the advantage that it captures the concentrations (granularity) of the portfolio of exposures. We recognise the importance of setting the liquidity horizons of the various CVA risks correctly and the dependencies between market prices and counterparty credit need to be modelled appropriately to capture the right and wrong-way risk effects.

The IRC framework has the following stated aims:

- Capture the jump-to-default risk, based on the appropriate liquidity horizon.
- Be consistent with the wider trading book regime; assume no further hedging over the liquidity horizon.
- Integrate the effect of both market and credit vectors on the jump-to-default calculation.
- Integrate the effect of both market and credit vectors into the VaR component.
- Address concentration risks.

- Address specific wrong-way risks.

The industry feels that this is a practical goal: The modelling of CVA within the trading book frameworks is not more complex than the modelling of other hybrid credit risks that exist in the trading book. In that sense, VaR and IRC of CVA are not more complex than the current applications of those models to other derivative products in the trading book. Indeed, some banks already include CVA and its hedges in their VaR models (both internally, and in some cases, for regulatory purposes, to prevent mis-statement of their market risk). Furthermore, the full integration of the market sensitivities into VaR and IRC correctly removes the need for the maturity adjustment and the requirement to approximate the cross-gamma of risk to joint credit and market movements.

In addition, when a firm marks-to-market CVA and captures both the credit and market-risk deltas in VaR, there is a strong argument to also include DVA market-risk sensitivities in VaR. These provide an effective partial hedge to the market sensitivities of the CVA. Large banks measure and manage CVA risks as integral parts of their overall trading risks. At times, long credit positions in the CVA book are used to offset short credit positions in other portions of the trading book, as part of the overall risk management strategy.

A further advantage of an integrated approach is that stress tests bind the capital impact more closely to with the potential economic risk to the firm, strengthening the alignment of senior management's risk appetite to the day-to-day management of counterparty risk within the firm's risk culture.

On the Double-Counting Issues, and the Sum Total of Capital Components

With regard to the role of CVA as a dynamic provision, the consultative paper clarifies and removes the perceived incentive to provision at low levels, by deducting any shortfall of provisions against expected loss under the IRB approach 100% from the common equity component of Tier 1 capital. Where the provision is in excess of the regulatory expected loss, however, the current framework allows for a deduction of the excess only from Tier 2 requirements, and subject to a cap. Given the new explicit charge for the variability in CVA proposed even where CVA is not measured today, it seems prudent to re-evaluate the role of CVA vis-à-vis a Tier 1 or Tier 2 deduction, and in particular the caps.

Tier 2, as an expression of gone-concern capital, is not the correct place to account for a forward-looking dynamic provision. If a default occurs, the CVA is available to offset in whole, or part, the loss when a claim needs to be provisioned. In that respect, for the part of the loss where a bank holds an amount of CVA, it is unnecessary to have a capital charge, as the CVA is already reserved for that loss. As CVAs are fully dedicated for well-identified counterparties, the industry proposes that the excess of CVA over regulatory expected loss be incorporated as a direct deduction from CCR capital charge rather than being made eligible to Tier 2 capital; this provides stronger incentives to provision and adhere to the governance and validation standards that underpin the forward-looking modelling of exposure. The knock-on effect is stronger risk management practices across the industry.

It is clear to the industry that additionally capitalising against unexpected variation in CVA introduces a further concern, namely that losses cannot arise from both a change in CVA and a default at the same time:

- The fully integrated trading book approach deals with this through the IRC component in fully assessing the jump-to-default risk net of hedges.
- For other approaches, there would be a double counting between, on the one hand, the base amount of CVA plus the new capital charge to reflect the potential increase of CVA; and, on the other hand, the regulatory expected loss and unexpected loss for counterparty risk. In no real scenario would a bank make a loss due to the CVA in addition to a jump-to-default loss. Industry urges regulators to take this double-counting effect into account.

Recognition of Vanilla CDS Hedges to CCR

An important step towards more effective management of counterparty credit risk, irrespective of trading or banking book treatment, would be to recognise designated CDS hedges as also offsetting the EAD of counterparty credit risk calculated under Annex 4 of the existing Basel II text (BCBS128). While paragraph 7 of Annex 4 allows CDS hedges in principle, the recognition requirements do not generally permit any regulatory effectiveness of hedges, even though there are valid economic arguments that CDS are an effective cover of CCR and thus should be prudentially recognised.

The CDS market has simplified and further standardised default swaps, in response to the needs of the financial markets to provide effective transfer of risk. This is illustrated inter alia by the presence of central counterparties in this marketplace. The following points illustrate the economic validity of CDS as hedges of CCR:

1. Case where there is a public credit event (Bankruptcy or Failure to Pay):
 - Straightforward. The Master cross-accelerates and will be closed out. The termination value is a claim that is pari passu with other unsubordinated claims of the defaulted counterparty.
 - The CDS then makes use of the Determinations Committee and the established protocol to ascribe a value to unsubordinated assets. This is the same situation as for bank loans.
2. Case where there is a public credit event (Restructuring):
 - For a bond or syndicated loan, the meaning of Restructuring has a clear inference. Restructuring relies on observable tests in the public domain, such as principal deferral or reduction in interest rates for example.
 - This logic is unclear for a Master. To highlight this ambiguity, consider a few situations:
 - i. A reduction in interest rates may be a feature of a derivative contract.
 - ii. Contractual terms involving interest rates could be changed, but the net present value of the payment streams may be unaffected.
 - iii. A derivative contract does not have a notional principal value and so the idea of an actual principal deferral has no meaning.
 - Requiring a CDS to cover Restructuring for a bilateral obligation implies that the holder of the bilateral obligation is able to trigger the Restructuring event. However, leaving this assertion to the holder of the bilateral contract would subject the CDS seller to an abusive triggering that may not objectively be related to a credit event.
 - More importantly, assuming that a counterparty to a derivative contract is 'credit challenged', then a change in the timing of derivative payments, for example, is a choice and not an obligation of the stronger party. In effect the stronger party has, of its own accord, given up its right to early terminate and require immediate payment (which, if not made, which would constitute a failure to pay).
3. Case where there is no public credit event but we face a close-out under a Master:
 - Where a genuine credit event has arisen, if the claim is unpaid, the unpaid party has the ability to go to court and petition for bankruptcy of the counterparty. That event cannot stay private and it will become a public credit event.

- In recognising that there can be a timing delay between petitioning the courts and when the credit event information becomes public, we would propose that in the case of bilateral exposures that the maturity of a standard CDS used for hedging purposes be considered 6 months shorter than its scheduled maturity.
4. Case where there is a credit event but the claim cannot be delivered into a CDS contract:
- Not relevant. Standardisation of CDS, notably through the Big Bang protocol and use of the Determinations Committee and the growth of the CDS market mean that cash settlement has largely supplanted physical settlement as the method for valuing defaulted obligations.

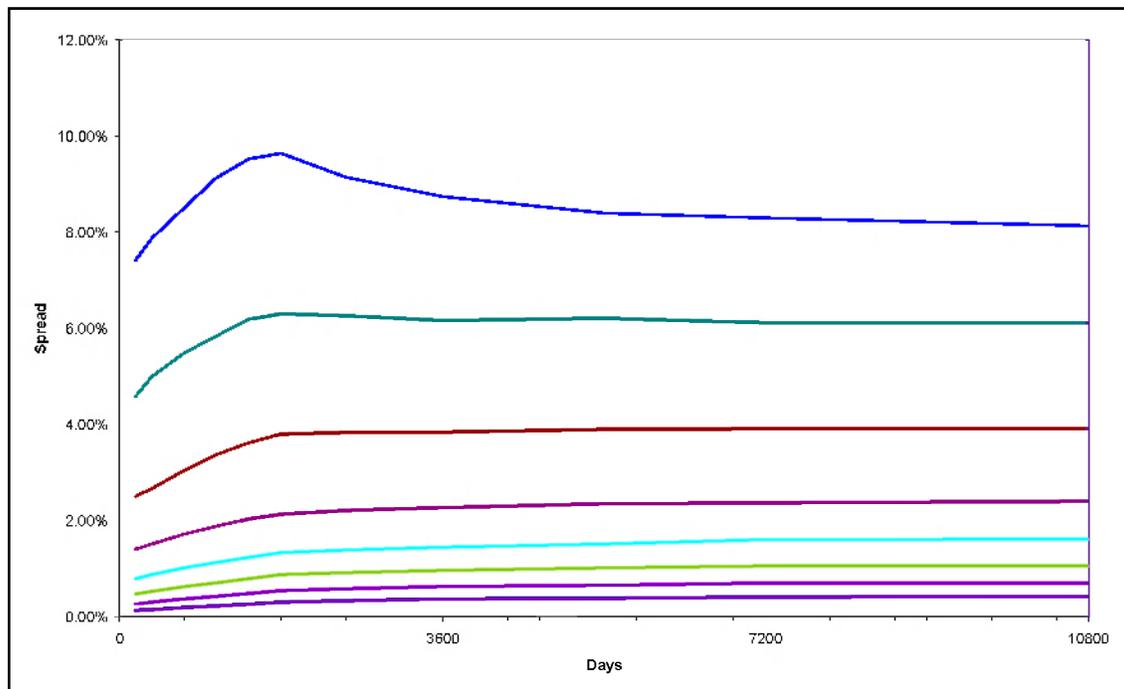
2.1.1 CVA / Appendix 1: Observations on the Bond Equivalent CVA

A Zero-Coupon Bond Is a Poor Approximation of CVA Risk

The purpose of the following examples A, B, C and D is to show how various aspects of the bond-equivalent CVA lead to a crude and erroneous picture of the market implied CVA. We believe that the QIS comprehensive results will confirm this point quite strongly.

Example A

Here we take a \$100MM, 10yr pay fixed swap at-the-money, settling annually, with rates modelled lognormally with a volatility of 20% and drifting to forward rates. We look at the spread sensitivity of the CVA to a 1bp parallel shift of the par CDS spread, a 1bp parallel shift of interest rates, and a 1% absolute increase in volatility. We define eight levels of starting spreads (from Level 1 being the lowest to Level 8 being the highest), stratifying the market place:



The CS01 for the CVA with each of these spreads is then compared to that of the bond-equivalent. EAD, CVA and sensitivities are expressed in \$.

In the table below we compare the sensitivities of the CVA with the Bond-Equivalent. EAD is \$2.082MM.

Level	CVA	CS01	DV01	VEGA	BE CS01
L1	155,749	3,957	920	1,504	1,512
L2	261,120	3,800	1,607	2,601	1,396
L3	390,813	3,606	2,496	3,998	1,262
L4	563,871	3,343	3,724	5,917	1,080
L5	834,948	2,926	5,750	9,036	866
L6	1,272,264	2,249	9,249	14,358	560
L7	1,718,218	1,497	13,736	20,882	299
L8	2,037,644	896	18,081	26,851	168

From the table, it is clear that the Bond-Equivalent fails to capture the nature of the risks faced.

Example B

In this example, we assume that the bank is receiving fixed in a plain vanilla USD interest rate swap. We choose a trade in which the bank is receiving fixed since exposure to the counterparty will rise at the same time the counterparty's credit quality is worsening (assuming that official rates will be lowered in such an environment). We assume paths of interest rates, volatility, and spreads over a hypothetical 2 year period consistent with the recent financial crisis. We assume that the 10-year swap rate is 4.6% at the inception of the trade and that implied volatility is 20%. The counterparty's initial credit spread is 100 basis points. Although CVA is in reality hedged very frequently, such as daily, we calculate the CVA and the sensitivities to the risk factors, i.e., interest rates, volatility, and credit spreads on a monthly basis for simplicity. We then calculate hedges to those risk factors and compare to mark-to-market changes in the CVA. The Table below reports the results.

Notional of Swap (\$MM)	100
Tenor of Swap (yrs)	10
Forward Swap Rate	4.60%
Fixed Swap Rate	4.60%
Current Swap Rate	4.60%
Swap Rate Volatility	20%
Spread (bps)	100.00%

Year	Market Data			Sensitivities			Hedges					CVA Change
	Swap Rate	Swap Vol	Spread	Rate dv01	Spread sv01	Vol dv01	CVA	Rates	Spread	Vol	Total	
0	4.60%	20%	100	-1608	1917	101	205,279	0	0	0	0	0
0.08	4.43%	23%	125	-2184	2343	120	318,157	27,336	47,925	30,300	105,561	112,878
0.17	4.27%	26%	150	-2776	2748	135	454,055	34,944	58,575	36,000	129,519	135,898
0.25	4.10%	29%	175	-3375	3129	148	611,236	47,192	68,700	40,500	156,392	157,181
0.33	3.93%	32%	200	-3976	3486	157	788,296	57,375	78,225	44,400	180,000	177,060
0.42	3.77%	35%	225	-4577	3816	165	983,202	63,616	87,150	47,100	197,866	194,906
0.50	3.60%	38%	250	-5173	4121	169	1,194,222	77,809	95,400	49,500	222,709	211,020
0.58	3.43%	40%	275	-5767	4403	172	1,420,363	87,941	103,025	33,800	224,766	226,141
0.67	3.27%	43%	300	-6355	4662	173	1,659,560	92,272	110,075	51,600	253,947	239,197
0.75	3.10%	46%	325	-6938	4899	173	1,910,327	108,035	116,550	51,900	276,485	250,767
0.83	2.89%	49%	350	-7518	5117	170	2,172,223	143,617	122,475	51,900	317,992	261,896
0.92	2.77%	52%	375	-8092	5315	167	2,443,174	92,471	127,925	51,000	271,396	270,951
1.00	2.60%	55%	400	-8662	5496	162	2,721,962	137,564	132,875	50,100	320,539	278,788
1.08	2.68%	52%	375	-8050	5307	155	2,427,120	-69,296	-137,400	-48,600	-255,296	-294,842
1.17	2.77%	49%	350	-7448	5109	147	2,148,239	-72,450	-132,675	-46,500	-251,625	-278,881
1.25	2.85%	46%	325	-6858	4902	139	1,885,582	-59,584	-127,725	-44,100	-231,409	-262,657
1.33	2.93%	43%	300	-6280	4687	130	1,640,244	-54,864	-122,550	-41,700	-219,114	-245,338
1.42	3.02%	40%	275	-5712	4463	120	1,411,411	-56,520	-117,175	-39,000	-212,695	-228,833
1.50	3.10%	38%	250	-5155	4231	110	1,199,264	-45,696	-111,575	-24,000	-181,271	-212,147
1.58	3.18%	35%	225	-4609	3992	100	1,004,540	-41,240	-105,775	-33,000	-180,015	-194,724
1.67	3.27%	32%	200	-4072	3746	89	826,572	-41,481	-99,800	-30,000	-171,281	-177,968
1.75	3.35%	29%	175	-3545	3493	77	665,420	-32,576	-93,650	-26,700	-152,926	-161,152
1.83	3.43%	26%	150	-3027	3235	66	521,442	-28,360	-87,325	-23,100	-138,785	-143,978
1.92	3.52%	23%	125	-2517	2972	54	394,088	-27,243	-80,875	-19,800	-127,918	-127,354
2.00	3.60%	20%	100	-2014	2704	42	283,260	-20,136	-74,300	-16,200	-110,636	-110,828

As can be seen in the above table, we assume that interest rates, volatilities, and spreads follow a pattern similar to their dynamics over 2008 and 2009. At the beginning of each month, we calculate the rates, spread, and volatility sensitivity of the CVA. These sensitivities are defined to be the dollar change in the value of the CVA given a 1 basis point increase in the underlying risk factor. We also calculate the CVA at the beginning each month. We then assume that we put on trades for each risk factor equal to the CVA sensitivities to be hedged. We then calculate the change in value of these hedges as well as the change in value of the CVA.

Although the bond-equivalent approach makes the assumption that spread risk hedges are most important, a glance at the results in Table 1 suggests that rates and volatility hedges together are generally larger in magnitude than spread hedges.

Example C

To get a sense of the magnitude of the potential double counting between the CVA charge and the existing IRB treatment of maturity, we consider a simple portfolio comprised of 1000 BBB-rated counterparties, all of whom have a single trade in their portfolio – a 10-year USD \$100 million interest rate swap. We assume that interest rate volatility is 20% in order to compute EEPE and that there are no CVA hedges. We use 18 basis points for the probability of default, the 1983-2008 1-year Moody's average for a BBB-rated counterparty. We also assume that LGD is 65%. The table below shows the regulatory capital calculations using the five year maturity cap.

Capital with M = 1	86,759,696
Adjustment to M = 5	110,866,872
Total Capital	197,626,568

Total credit regulatory capital for this portfolio would be \$198 million. Using a one year maturity, total capital would have been \$87 million, implying a mark-to-market add-on of \$111 million for maturity implicit in the current Basel II capital formula.

To compare this add on to the proposed bond-equivalent VaR add on, we use a simple linear VaR model in which we specify a bond-equivalent notional equal to EEPE of the trade with a

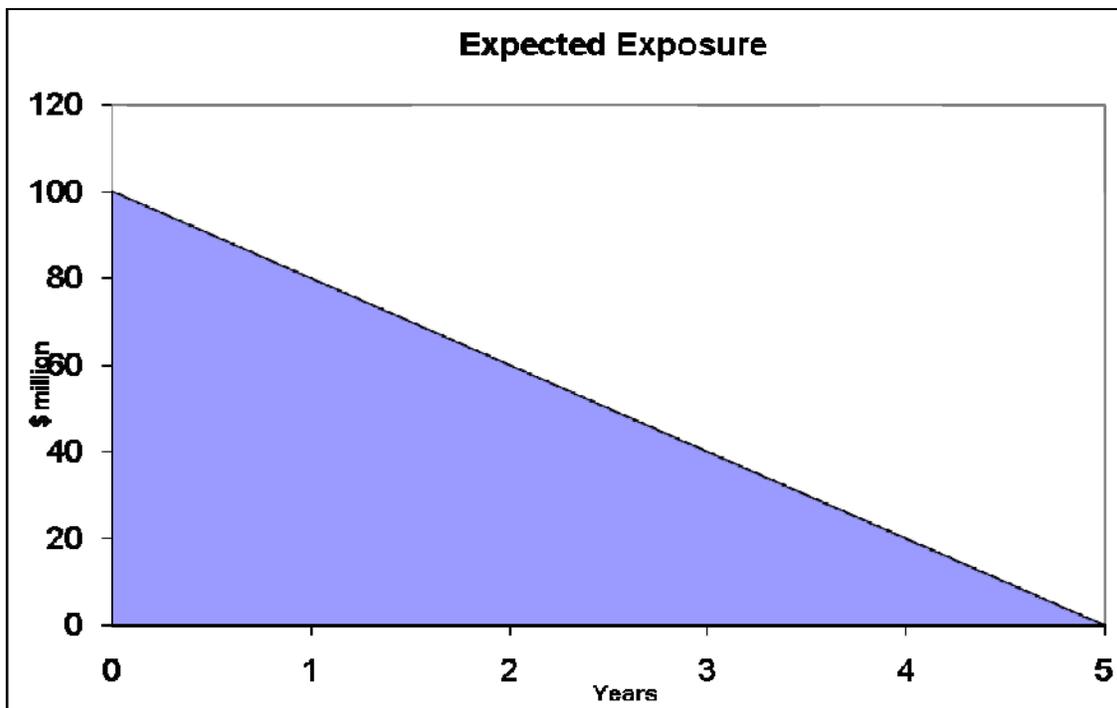
5-year maturity. We assume spread correlation is 40% and calculate VaR for a range of typical BBB credit spreads between 50 and 100 basis points. The table below reports the results.

Spread (bps)	50	60	70	80	90	100
Spread Correlation	40%	40%	40%	40%	40%	40%
Spread Volatility	32%	32%	32%	32%	32%	32%
99.9% 1-year VaR	68,361,905	82,034,286	95,706,667	109,379,048	123,051,429	136,723,810

The results in the above table suggest that under ordinary circumstances the mark-to-market adjustment already built into the Basel II IRB formula covers the proposed bond-equivalent risk fairly well. These results are not surprising given the calibration done by the regulatory community to ensure that the maturity adjustment is quantitatively reasonable. But, the results do serve as a reminder that CVA mark-to-market risk can be accounted for in the current framework. Of course, during a stressed environment in which the level of spreads or volatilities is larger, particularly for firms that are using risk-neutral exposure models, the bond-equivalent add on could be larger than the mark-to-market maturity adjustment add on in the Basel II formula.

Example D

Consider the expected exposure profile of the bank’s exposure to counterparty XYZ. The shape of the exposure profile below is typical of counterparties with large portfolios of trades. As time evolves, the expected exposure declines because the in-the-money cash flows roll off. The exposure forms one part of a group of netting-sets with differing effective maturities.



For this profile:

- CE = \$100 M
- EAD = \$140 M
- M = 5 years (set exogenously by the longest netting set of the counterparty)

Assuming:

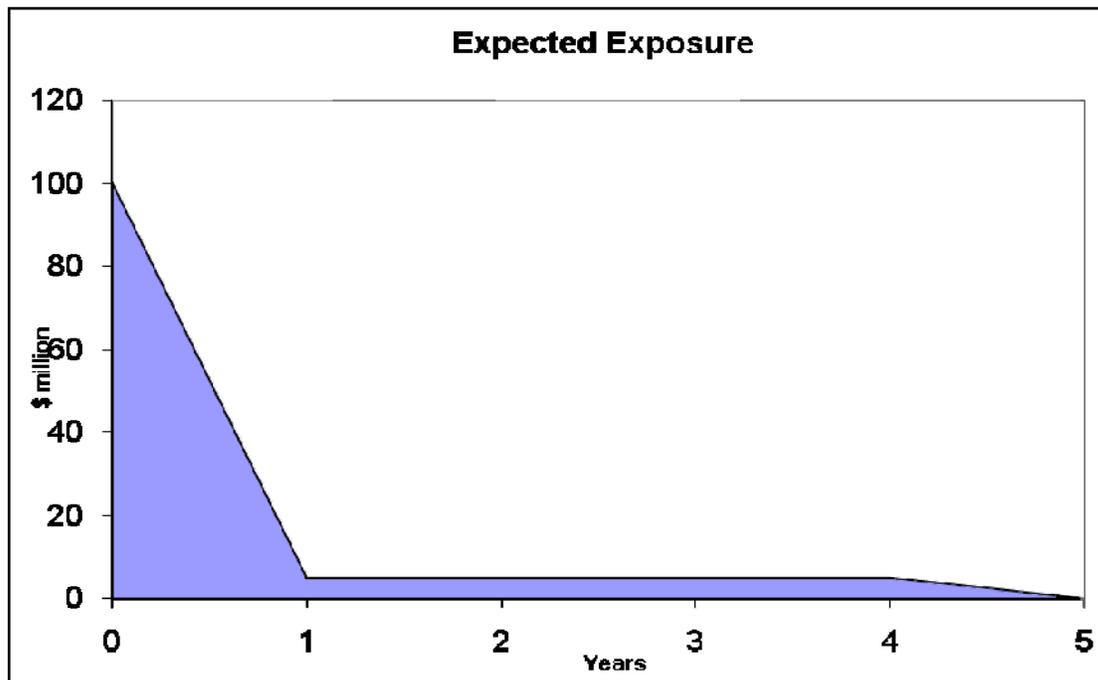
- Interest rate = 4% flat
- Credit spread of the counterparty = 2% flat

We calculate:

- CVA = \$4.49 M
- The CS01 of the CVA is \$0.0215 M per bp.
- The CS01 of the zero coupon bond equivalent is \$0.0511 M per bp.

Thus, the bond equivalent CS01 is 2.4 times the correct CVA CS01.

Consider the following expected exposure profile of the bank's exposure for another netting-set with XYZ. This profile is typical of counterparties with whom we have many short-term trades and a small number of long-term ones.



For this profile:

- CE = \$100 M
- EAD = \$140 M
- M = 5 years (set exogenously by the longest netting set of the counterparty)

Assuming:

- Interest rate = 4% flat
- Credit spread of the counterparty = 2% flat

We calculate:

- CVA = \$1.30 M
- The CS01 of the CVA is \$0.0063 M per bp.
- The CS01 of the zero coupon bond equivalent is \$0.0511 M per bp.

Thus, the bond equivalent CS01 is 8.1 times the correct CVA CS01.

In summary, the use of the longest maturity for any netting-set significantly overstates the CVA spread risk.

2.2 Effective EPE with stressed parameters to address general wrong-way risk

The Consultation sets out suggested changes, to address problems seen in respect of general wrong-way risk (WWR – paragraphs 118 – 122). The concern in respect of this risk is shared by the industry, even though it has been notably difficult to quantify WWR historically. The opportunity to work with the regulators in ways to assess and capitalise this type of residual risk is welcomed.

The proposal to take the higher of current market factors and stressed market factors is clearly appealing, as it is simple in concept and prevents a benign market environment from unjustifiably and increasingly impacting results, as historic spikes fall out of the time series used.

It is, however, noteworthy that the Pillar 2 stress test charge should already take potential wrong-way risks into account through the stress scenarios envisaged and there is, therefore, a risk that a stressed EPE charge – which would be computationally highly intensive – is duplicative.

For a number of reasons, we believe that EPE based on stressed inputs may not produce the intended benefits and may even increase overall risk.

- Where the stressed charge dominates, the use test may be weakened, as it is unlikely to be adopted for credit sanctioning purposes. Credit risk management already considers tail values on a client by client basis.
- It will become harder for firms to manage exposures; undertaking additional trades to offset risk based on current market factors could potentially increase the exposure of a stressed EPE basis due to differences in correlations. Furthermore, clients are unlikely to be willing to post initial margin against stress volatility instead of current or market implied volatilities.

Industry would add that the main (and most credible) tool to demonstrate EPE validity is back-testing, on which a regulatory approach is of course still in development. We consider that materiality of the use of a stressed EPE should be reviewed, once a) results of the QIS are known and b) a back-testing framework is published.

2.3 AVC for Financial Institutions

Our members have shown considerable interest in the proposal to increase AVCs for categories of financial institutions. The Consultation suggests that empirical work has been performed, yet more is required. The Consultation suggests that the definitions of 'large' and 'systemically important' require further thought and consultation, itself suggesting that the interpretation of the empirical work has been inconclusive in this regard.

The Consultation also suggests uncertainty remains in areas such as the inverse relationship between low PD and high correlation. In the absence of a published, detailed study, it is hard for the industry members to arrive at any conclusion with regard the assertion of the Consultation. Noting the lead time to integrating the new capital constructs, the members feel that the details of a full and comprehensive study should be agreed with the industry prior to the analysis being performed, and then published for comment by the Committee.

It is not clear to the industry members how a snapshot of the impact within the QIS can better inform the outstanding decisions.

At the same time we note the rapidly increasing use of central counterparties, reducing the apparent 'interconnectedness' of financial institutions that is presumably one target for the AVC charge in the first place. We also observe the possibility of increased incentives *not* to face financial firms, which could reduce the 'network efficiency' of the market while increasing relative exposures elsewhere.

We include some specific observations related to the Consultation.

BCBS 164, pg 6, para 21, "Moreover, to address the systemic risk within the financial sector, the Committee also is proposing to raise the risk weights on exposures to financial institutions relative to the non-financial corporate sector, as financial exposures are more highly correlated than non-financial ones. It is conducting further analysis of the appropriate calibration as part of the impact assessment."

BCBS 164, pg 10, para 48, "In addition, refinements to the Basel II risk weighting functions can be made to directly address the risks created by systemically important banks (see for example the proposal in Section II.2 to increase the asset value correlation for exposures to large financial institutions relative to those for non-financial corporate exposures...)"

The industry is keen to learn further how the Committee performed an analysis of AVCs, given the opacity of many accounting approaches across the markets, and the greater or lesser degrees to which exposures are hedged and managed by financial institutions. The industry is also keen to understand how financial and non-financial institutions have been brought together comparatively.

BCBS 164, pg 28, para 114, "Large financial institutions were more interconnected than currently reflected in the capital framework. As a result, when markets entered the downturn, banks' counterparty exposure to other financial firms also increased. The evidence suggests that the asset values of financial firms are, on a relative basis, more correlated than those of non-financial firms. As such, this higher degree of correlation with the market needs to be reflected in the asset value correlations. The Committee, based on its empirical work, found evidence that asset value correlations were at least 25% higher for financial firms than for non-financial firms."

A large proportion of exposures between financial institutions are collateralised. The increase of these exposures is a function of market volatility, and the relationship between market volatility and exposure is attributed to general wrong way risk by the Consultation (pg 28, para 114), not asset-value correlation or interconnectedness. The alpha multiplier in the existing IMM framework, intended to capture general wrong way risk, is untouched by the Consultation. The industry members can only speculate on the approach used by the Committee to arrive at the Consultation's conclusion. However, recalling the RMMG Survey

Information from July 2009, it is hard to conceive how market driven exposure measures lead to an AVC conclusion that spans both trading and banking book positions. Considering further the many methods that can be used to derive AVCs from equity prices, the data is inherently flawed by other market influences at the height of the crisis, namely speculation, market rumour and fear. The dislocation in traded availability of credit derivatives and equity prices through the crisis can also mislead in determining the level of underlying interconnectedness across financial institutions.

BCBS 164, pg 30, para 116, "Apply a multiplier of 1.25 to the asset value correlation of exposures to regulated financial firms (with assets of at least \$25 billion) and to all exposures to unregulated financial firms (regardless of size). The Committee continues to conduct analysis to assess the appropriate calibration of the proposed multiplier and asset size threshold."

BCBS 164, pg 36, para 135, "During the crisis, financial institutions' credit quality deteriorated in a highly correlated manner and they proved to be relatively more sensitive to systemic risk than non-financial firms. As a result, financial institutions were more correlated than reflected in the current Basel II IRB framework. The work conducted by the Committee indicates that asset value correlations for financial firms were, in relative terms, 25% or more higher than for non-financial firms, and the Committee is of the view that this higher degree of correlation with the market needs to be reflected in the IRB capital framework. For this reason, the Committee is proposing that a multiplier of 1.25 be applied to the AVC of financial firms. Under this proposal, the AVCs between financial firms would range from 15% to 30%, as opposed to the 12-to-24% range currently set forth in the Basel II framework. The Committee is conducting further analysis on the appropriate calibration of this proposed multiplier."

BCBS 164, pg 37, para 136, "The definition of financial firms would be broadly defined to include banks, broker-dealers, insurance companies, and highly leveraged entities, such as hedge funds and financial guarantors, since all of these firms exhibited heightened sensitivity during the crisis. Exposures to smaller banks, broker-dealers and insurance companies did not exhibit this sensitivity to the same extent. As a result, the Committee is proposing to limit the application of the multiplier to exposures to banks, broker-dealers and insurance companies with assets of \$25 billion or more. It is conducting additional analysis to verify the appropriate calibration of the proposed threshold. Under this proposal, exposures to unregulated financial intermediaries, including highly leveraged entities that derive the majority of their revenues from financial activities, such as hedge funds and financial guarantors, would always be subject to higher AVCs, regardless of asset size. The Committee is seeking comments from the industry and other stakeholders on the appropriate definitions for regulated and unregulated financial institutions, and will seek to capture consistent data using possible definitions during the 2010 impact assessment."

The industry members are willing to work with the Committee to help categorise the definitions of regulated and unregulated financial institutions, noting the differences in accounting treatment across the many markets around the world.

BCBS 164, pg 37, para 137, "While the higher AVC was evident in counterparty exposures, the effect was not limited to such exposures, but extended to other exposures between financial institutions such as interbank lending, which also experienced system wide stress. Furthermore, default on any of these financial exposures leads to default on all other such exposures. For this reason, the Committee proposes that the multiplier on the AVC parameter be applied to all financial exposures under the IRB approach, subject to the above \$25 billion limit."

The Consultation again alludes to the conclusion of a higher AVC driven by counterparty exposure. The relationship between counterparty exposure and market volatility is not evidenced by other forms of near-term risk such as interbank lending, settlement and

clearing lines. The conclusion that an AVC multiplier should be broadly applied across credit and counterparty exposures is not wholly supported by the language used in the Consultation.

BCBS 164, pg 37, para 138, "The Committee is aware that the proposed 25% increase in AVC could result in a percentage increase in capital requirements that is actually higher due to the nonlinear relation between capital and AVC. The effect is more pronounced for the low PD and high AVC counterparties for whom capital could increase by approximately 35%"

BCBS 164, pg 38, para 140, "The Committee welcomes comments on the definition of unregulated financial institutions. The Committee believes that further work on the absolute level of AVCs and on the assumption of an inverse relation between PDs and AVCs is required."

The industry members are keen to engage with the Committee on both aspects.

2.4 Collateral

In recent years, firms have heavily invested in their collateral management units, processes and systems, and have worked with industry and regulators to strengthen collateral management throughout the industry. Examples are the dispute resolution protocol, standardized electronic messaging for margin calls and reconciliation requirements imposed by regulators (Fed reconciliation).

With this in mind, industry welcomes the proposed rules to strengthen collateral management units, as the majority of the proposed changes have already been implemented by industry.

However, industry does not agree with all circumstances where the margin period of risk is to be increased.

Large netting sets

Counterparties with big portfolios are usually counterparties with large credit lines, i.e. counterparties with good credit quality. Firms would not have as many trades with them if they were not comfortable with having such large portfolios with these counterparties. Also, since the credit crisis, regulators have imposed reconciliation requirements on the "Fed 14" counterparties: daily reconciliation for all Fed 14 counterparties with more than 500 transactions and monthly reconciliation for all counterparties with more than 1000 trades. This is complemented by extensive regular reporting. These reconciliation requirements improve data quality, significantly reduce the risk of disputes, make sure that the portfolios are tightly managed and would support a quick closing out of such positions. Note here that every transaction within a netting set does not have to be closed out separately; rather, the position is closed out on a net-market-risk basis. For large netting sets this typically requires orders of magnitude fewer transactions.

An arbitrary threshold defining a large netting set will only lead to an incentive for firms to split these netting sets into smaller ones, actually reducing the netting effect and increasing risk. Industry therefore suggests not to introduce increased margin periods of risk for large netting sets.

Disputes

Industry has already been active and is – led by ISDA – currently implementing the Dispute Resolution Protocol. Using this protocol should considerably reduce the time for resolution of a dispute, i.e. there should be fewer instances where a doubled margin period of risk needs to be triggered.

We would however suggest introducing a materiality threshold, so that the margin period of risk is not doubled because of a few minor disputes in the past. Industry will be proposing a

consistent framework for dispute reporting to regulators by May 31st, which will include such thresholds. We suggest using these thresholds when determining whether the margin period of risk should be doubled or not.

Illiquid contracts or collateral

Industry accepts that there is a possibility that these positions cannot be closed out quickly and accepts that the margin period of risk will double in these cases. However, similar to netting sets with disputes industry suggests introducing a materiality threshold

3 Supplementing the risk based capital requirement with a leverage ratio

We acknowledge that the level of leverage that increased risk within firms was certainly a factor in the crisis and amplified the downward pressure on prices and we agree that leverage should be an area for regulatory review. However, leverage was not the primary cause of the crisis, nor did it affect all firms equally.

We therefore consider that the leverage ratio should be carefully designed to address the role it played in the crisis, appropriately calibrated and sensibly interpreted for it to be a useful tool for supervisors. Provided that this is the case, we support the introduction of a leverage ratio, as a supplementary measure to complement the main focus for supervisors, which is the risk based measure for capital adequacy. It is vitally important that all regulatory measures, including the leverage ratio, continue to include incentives for improved risk management. We would caution against regarding the leverage ratio as a panacea to all ills; strong corporate governance and risk management practices have a very important part to play.

Our comments therefore focus on the issues we perceive around the current proposals, absent information on the calibration, and our recommendations for a way forward.

3.1 Key messages

3.1.1 Supplementary measure

We support the Committee's view, in paragraphs 204 and 205, that a leverage ratio should be regarded as a supplementary 'backstop' measure. It is important to consider both the risk that a firm is facing as well as its degree of leverage to get an accurate picture. Used on its own, as contemplated in the current proposal and without full understanding of the firm's risk profile and management practices the leverage ratio will be a very blunt tool that could cause users to come to inappropriate conclusions about a firm and how it compares to its peers. A firm that uses its capital to invest in high grade corporate securities is quite different to one that invests in low grade assets, yet they both could have the same leverage ratio. Further, it is necessary to take account of the different business models and structures adopted by firms. For example firms that have extensive trading activities are likely to be more significantly affected, particularly if there is no netting, because of the volatility in gross exposures. Therefore the leverage ratio risks introducing procyclicality into the regulatory framework.

Inverting the notion of a regulatory supplementary 'backstop' measure, we essentially see the leverage ratio as akin to an internal risk management limit arising from a very severe, but still plausible, stress test. The severe stresses in this regard relate to a broader range of market and operating assumptions breaking down. However, for the stress test to remain plausible it is inappropriate to assume all operating assumptions breakdown simultaneously and a number of our comments below address this issue.

3.1.2 Integration into the supervisory framework

The Committee has articulated that it has designed the leverage ratio with a view to it migrating to a Pillar 1 treatment. We would encourage the Committee to reconsider the appropriateness of this decision because of its shortcomings as a simplistic tool, as a result of our very significant concerns about some aspects of the design (see below). A Pillar 2 approach, however, would facilitate a better dialogue with supervisors, which can take account of the firm's individual risk appetite, business model, structure, governance and risk management practices. A hard limit in Pillar 1, if inappropriately calibrated, has the potential to create perverse incentives by encouraging firms to invest in more risky assets to gain returns or to exacerbate problems by encouraging forced sales.

We think that a Pillar 1 ratio potentially has significant implications for trading activities and firms carrying out market-making and market intermediation activities. In this regard we are also concerned by the volatility of exposures values that result from some of the proposals – notably the lack of recognition of netting and an appropriate treatment for hedging. With a Pillar 1 measure these firms would need to manage to a much lower level of leverage (i.e. operate with a significant buffer) to ensure that they do not breach.

We recognise that there are concerns amongst some authorities that Pillar 2 potentially creates an unlevel playing field because it may not operate the same way in all jurisdictions and because it might result in 'similar' firms getting different leverage ratios. We are therefore recommending that the leverage ratio be expressed as a range rather than a single number, to introduce a bound on supervisory discretion. We would also note the commitment in the Pittsburgh Declaration that all major financial centres would adopt the Basel II framework by the end of 2011. We take this to mean that supervisors will implement all three Pillars of the Accord fully. Although we recognise that the Basel Accord is not binding, we would suggest that the Supervisory Implementation Group would be an appropriate forum for delivering greater supervisory convergence. At a more granular level much is already being done to deliver supervisory convergence through the college process and peer reviews of supervisory implementation. As a result we believe that this concern will be addressed. Supervisory disclosure, at an aggregate level across jurisdictions, could also be used to help drive convergence.

3.1.3 Interrelationship of initiatives

It is important to take into consideration the other changes being proposed or introduced, or proposed, to the prudential regulatory framework that also address the causes of the leverage that increased risk in firms. In particular, we note some of the possible causes of leverage to be: the availability of cheap money over a sustained period of time, risk mispricing in certain sectors and an over-reliance on short term funding. It has also been suggested that firms expanded their balance sheets by increasing their exposures to assets where the risk was underestimated to take advantage of lower capital charges³. A concerted effort has been made by the regulatory community to address the failings of the Basel Accord. In particular capital requirements are being increased significantly in the trading book and a number of measures have been introduced in respect of securitisation (removal

³ Bank of England Financial Stability Review, December 2009, page 48

of the reduced credit conversion factors for liquidity facilities, increases to the risk weights for certain securitisation positions).

The cumulative impact of the proposed measures, in this consultation package, also need to be taken into account, not only the specific improvements to the quality of capital and increase in the quantity of capital, but the introduction of quantitative standards for liquidity. We therefore welcome the Committee's decision to undertake a comprehensive impact assessment of the combined effects of these measures on banks in advance of the proposed implementation date of the end 2012. Although these measures do not provide an absolute cap on leverage they go towards reducing incentives to increase leverage.

The accounting framework is also undergoing significant changes, including classification and measurement of financial instruments, impairment, de-recognition and consolidation. As regards de-recognition, the IASB is moving away from the current risk and rewards based model and converging towards the FASB's control based model. As such the accounting balance sheet will not necessarily be a good indicator of a firm's risk. As a result it is necessary to take these changes into consideration if financial accounts are to be the starting point for calculation

3.1.4 Timing of introduction

Although we acknowledge the political imperative behind the timetable, we believe that the leverage ratio should be one of the last of the regulatory changes in this package to be implemented, and consideration should be given to a longer timeframe than end 2012. We have some serious concerns over the design of the leverage ratio, which we strongly believe require further consideration and consultation. It is also important for industry and regulators to achieve a common understanding of the factors (such as the components of capital) feeding into the ratio. In our view, it is more important to take sufficient time to ensure that the design and calibration of the leverage is appropriate than to implement a measure that has undesirable and unforeseen consequences.

Design and impact of the proposal

In the absence of a suggested calibration it is very difficult for us to comment on the impact of the proposal outlined. Appropriate calibration is essential if the desirable characteristics of a leverage ratio are to be achieved and we consider that further consultation will be needed with the industry post the QIS analysis. A ratio that has not been carefully calibrated has the potential to create perverse incentives when it starts to bite by encouraging firms to invest in more risky assets to gain returns or to exacerbate problems by encouraging forced sales, and will send an inappropriate and potentially inaccurate signals about firms and their risk management frameworks.

However, we would highlight a few areas where we believe that material issues will arise:

Netting: The failure to recognise netting for derivatives and repo and securities financing transactions will grossly inflate balance sheets out of all proportion to the risks that institutions are running and give a false impression of the levels of leverage. It will also introduce significant volatility into the exposure values and therefore potentially introduce

procyclicality. Gross figures also have the potential to disproportionately impact some business models and create perverse incentives. This could result in these activities migrating to less regulated markets to the extent that the leverage ratio is binding. In addition netting is assumed in contracts with central counterparties. Although we note that the position of such exposures is unclear in the proposal, if netting is not recognised this would seem to be at odds with the initiatives to encourage more extensive use of central counterparties. Legally enforceable netting has been proven to work during the crisis and we strongly urge the Committee to recognise its benefits in the design of the leverage ratio. We propose that regulatory operational criteria should be used.

Market making/market intermediation: By not recognising any hedging benefits, a misleading picture of leverage will be created which would not be reflective of the firm's position. Furthermore, the proposal results in double counting because both the exposure as well as its hedge/mitigant will feed into the leverage calculation. As a result good risk management practice is not recognised, and risk intermediation roles, such as those performed by market-makers would be disproportionately affected.

Other forms of credit risk mitigation: The failure to recognise financial collateral will also create a misleading view of leverage in individual firms and the system and provide a disincentive to good risk management. We therefore believe that financial collateral should be recognised, as it can be realised reasonably quickly in stressed conditions, albeit at a reduced price. We note that the consultation is not seeking to change the operational criteria for recognising financial collateral (although we note that the consultation seeks to improve collateral practices for IMM). As regards haircuts we note there is only a change proposed in respect of securitisation exposures. We therefore assume that regulators are generally content with the robustness of the existing requirements and recommend that financial collateral be recognised if the operational criteria are met. There are a number of methods for recognising collateral in the capital framework; we suggest that the comprehensive method be made available for the purposes of calculating leverage in situations with financial collateral. We accept that physical collateral is a more complex proposition, in light of the breadth of assets covered and the time that might be needed to realise some asset classes. However, we do regard it as a useful risk mitigant and it should be encouraged. We also think this is another reason to support a Pillar 2 approach.

Securitisation: The proposal indicates that accounting will be followed, but that the Committee is also considering recording all securitised exposures on balance sheet. While the industry acknowledges that there have been issues in certain sectors of the securitisation market, securitisation is a very important funding tool and there have been significant strides made by the both the market and regulators in addressing shortcomings. Not recognising the transfer of risk through securitisation will create a misleading picture. We recommend using the regulatory operational criteria in the securitisation framework. Further detail on securitisation is included below.

Other off balance sheet exposures: It is important that the leverage ratio does not unduly curtail the intermediary function provided by banks in funding/liquidity provision to real economy market participants. Assumptions about the extent to which these exposures can be fully drawn and full losses taken require further consideration. The use of a 100% conversion factor for all contingent exposures is not in line with firms' experiences of draws

or losses, which are in nearly all cases substantially less. Unconditionally cancellable commitments are an invaluable tool for corporates to manage contingent liquidity requirements. This traditional and very important, banking service proves a vital function for the real economy. Trade finance, is also a key concern; as it is an essential part of global trade and economic recovery. We would note that it is a G20 priority. In order to facilitate business commitments and trade finance, we strongly recommend that lower conversion factors are permitted. If regulators are concerned about arbitrage possibilities, we suggest that the higher of the standard conversion factors, or firms' IRB estimates be used.

Credit derivatives: The consultation proposes an asymmetric of approach for bought and sold protection through credit derivatives. The approach is punitive on the sold protection side because it does not even recognise that notional may overstate the maximum possible loss, even without recognising any hedges. In addition by not recognising any hedging benefits, a misleading picture of leverage will be created, which is not reflective of the firm's position. Furthermore the proposal results in double counting because a credit derivative hedge purchased will also feed into the exposure calculation. The treatment should recognise the economic substance of firms' activities. Therefore in the trading book we think that the standard rules for market risk provide a template to recognise the risk position; these require the notional of the credit protection sold to be reflected but also recognise the offset of exactly matching protection bought.

It is also important to avoid conflicts arising between the various parts of the prudential framework; therefore we agree that it is important to consider excluding highly liquidity assets as defined in the proposed liquidity standards. In our view, inclusion of such assets within the exposure calculation, while theoretically pure, risks creating perverse incentives to take on riskier exposures if the leverage ratio becomes a binding constraint, so we support scoping them out.

Recommendation

In summary our position is as follows:

Desirable characteristics of the leverage ratio

In our view the desirable characteristics of a leverage ratio would be as follows:

- Capable of addressing a variety of business models.
- Comparable across jurisdictions with different accounting regimes.
- Binding only in periods of credit exuberance, not a main driver of firms' activities.
- Complementary to other risk, and non risk-based measures.
- Encourage good risk management practices and not create perverse incentives.
- Differentiate between firms on based on the risks that they are running.

Framework for the leverage ratio

Design: The leverage ratio should be expressed as a range, rather than a single number. Such an approach would allow the leverage ratio to take account of differing business models and firm specific factors. While the leverage ratio is a supplementary measure, it is still important that it take account of the nature and scope of a firm's business model otherwise it is too blunt an instrument to be really useful. This approach allows intelligent use of the leverage ratio through robust dialogue between the firm and its supervisor about the appropriate level of leverage for its particular business. It is also important to build in incentives to continually improve risk management.

Integration into the supervisory framework: We firmly believe that the leverage ratio, as a supplementary measure, should be incorporated into Pillar 2.

Timing of introduction: As a result of its interdependence with other aspects of the framework and as a result of the need to address certain design and calibration issues, it should be one of the last parts of the package to be implemented.

Capital inputs: As a preventative measure it is appropriate that a going concern measure of capital is used and therefore Tier 1 after deductions should be used.

Exposure inputs: In line with our view that a leverage ratio is essentially a limit imposed as a result of a very severe but plausible stress test, it should continue to provide positive incentives for good risk management. It should work with, not in conflict with, other elements of the prudential framework a number of exposure value. As a result:

- Legally enforceable netting that meets the operational requirements in the regulatory regime should be taken into account.
- Financial collateral should be recognised where the regulatory operational requirements have been met. For this purpose comprehensive approach should be available. We do not propose that physical collateral should be recognised.
- For other off-balance-sheet exposures, we propose the higher of the standard conversion factors and firms' IRB estimates should be used.
- For credit derivatives in the trading book, we propose the standard rules for market risk whereby the notional of the credit protection sold would be reflected, and exactly matching protection bought would be offset.
- The risk transfer benefits of securitisation should also be reflected and as such we would recommend the use of the regulatory risk transfer requirements.
- Highly liquid instruments, that are required to be held as part of the liquidity requirements should be scoped out to avoid creating conflicts between different parts of the framework and to avoid perverse incentives to take on risk.

3.2 Additional comments on the proposal

The numbering in this section relates to the sections of the consultation document

3.2.1 Level of application

In keeping with the rest of the Basel Accord, the consultation indicates that the leverage ratio should be applied at the group rather than solo, or any intermediate consolidation level. We agree that this is appropriate.

Given the changes that are currently being considered in the accounting framework, which will change the scope of consolidation for financial statements (including some special purpose entities and funds) and the exclusion of others it would seem appropriate to use the regulatory consolidation.

(A) Capital measure

As a preventative measure, we agree that a going concern definition of capital, i.e. Tier 1, should be used. We do not see any reason for tightening the definition still further, by focussing on core Tier 1. Deductions from capital should be taken where these items reduce the loss absorbency of capital, subject to our comments in Section 1 (Raising the quality, consistency and transparency of the capital base) of this Annex.

(B) Exposure measure

1 General measurement principles

a. Relationship with accounting

We agree that it is inappropriate to take account of risk based capital requirements, as this would not meet the objectives of a limit resulting from a very severe but plausible stress test. However, we can see arguments for starting from the accounting or regulatory balance sheet, as both would require adjustment to form a base for the calculation. The accounting balance sheet provides an independently verifiable starting point for calculation that is not risk adjusted. However, it does not necessarily capture exposures on the basis of risk and reward. The regulatory balance sheet addresses some of these issues, but presents its own challenges in terms of the various options available to firms and the need to address the treatment of modelled approaches.

If using the accounting balance sheet we agree that the leverage ratio should operate in a neutral manner between accounting regimes and over time. The issues identified by the Basel Committee for adjusting the accounting balance sheet are the correct ones, although our views differ in some areas as to the nature of any adjustments made.

We agree that exposure value should be reduced by provisions and value adjustments.

b. Netting

See above.

2 On balance sheet items

a. High quality liquid instruments

See above.

b. Repurchase agreements and securities finance

While we accept that reliance on repos and securities funding as a form of financing may have caused regulatory concern. Falling asset prices resulted in margin calls and consequent further sales and further depressed asset prices. However, an over-reliance on short term sources of funding is more appropriately addressed through liquidity requirements than the leverage ratio.

c. Securitisation

Securitisation has been an important source of financing for the real economy and the scope of its inclusion in the leverage ratio should be carefully considered. The securitisation market is currently very fragile, for example public issuance in the EU has fallen from €450bn in 2007 (90% of which funded real economy assets) to a few billion in 2008 and 2009. The majority of issuance in 2008 and 2009 has been retained by firms to use as eligible collateral to use with the ECB and other central banks. Regulatory uncertainty is one of the factors contributing to the lack of return of the market. The FSB report on enhancing market and institutional resilience recognised that when accompanied by adequate risk management and incentives, securitisation can offer a number of benefits to loan originators, investors and borrowers. 'Originators can benefit from greater capital efficiency, enhanced funding availability and lower earnings volatility. Investors can benefit from a greater choice of investments, allowing them to diversify and to match their investment profile more closely their risk preferences. Borrowers can benefit from expanded credit availability and product choice, as well as lower borrowing costs.' Given, the acceptance by the authorities of the usefulness of securitisation, and the likely withdrawal of central bank liquidity over the coming year, it is important not to provide unnecessary disincentives to this form of financing.

The industry acknowledges that there have been issues in certain sectors of the securitisation market and that there have been cases where banks took assets back for relationship rather than legal reasons. However, significant strides have been made by the industry and regulators to address shortcomings. The industry has undertaken a significant amount of work to address disclosure levels to ensure that investors understand the risks inherent in the position under consideration. In Europe the 5% retention requirement is intended to ensure that originators and sponsors have a vested interest in the risks of the underlying pools after issuance, similar measures are proposed in the US. Further, the understatement of risks in liquidity facilities has been directly addressed through the removal of preferential conversion factors. The recognition of higher risks contained in re-securitisation positions will also provide a disincentive to more complex structures such as CDO², CDO of ABS and other similarly highly leveraged structures. As a result, securitisation going forward is likely to be simpler, more transparent, with a clearer trail of responsibilities. As a result it would seem appropriate, particularly given the recognition of

the need to restart securitisation markets to provide funding to the real economy, to de-recognise securitisation transactions.

However, we admit that de-recognising securitisation transactions is not without its difficulties. We would note that accounting standard setters are currently revisiting the rules for both consolidation and de-recognition, which will change the basis of the accounting balance sheet for securitisation. The Basel framework provides a set of tests for de-recognition of securitised exposures, which are based on the transfer of significant risk. However, these criteria are not applied uniformly across all jurisdictions – in Europe additional criteria have been developed.

In our view, the changes made to the framework will deliver a more robust and appropriately managed securitisation market, where responsibilities and risks are clearer. On balance therefore, and in line with the approach taken to credit risk mitigation more generally, we think that the regulatory operational requirements should be the basis for de-recognition of securitisation transactions.

3. Derivatives

In terms of the basis for recording derivatives, we think that mark to market, without add-on for potential future exposure (PFE) is appropriate because there is no time horizon implicit within the leverage ratio. The PFE assumes market moves over a one year time horizon.

We also seek clarity on how centrally cleared derivatives will be treated.

a. Credit derivatives

See above.

3.2.2 Off balance sheet items (excluding derivatives)

See above.

3.2.3 Disclosure

The industry is very supportive of disclosure as a mechanism for delivering market discipline and recognises that it has a role to play even with leverage. However, although no potential disclosures have been consulted upon in this proposal, we would like to register some initial thinking around Pillar 3 in this area. We are concerned by the potential for misinterpretation of leverage numbers presented. The leverage ratio proposed is a very simplistic measure and without a full understanding of the risk profile and risk management practices of the firm, erroneous comparisons may be drawn between institutions, particularly if some of the issues that we have identified have not been addressed. On the current proposals allow levels of leverage would not correspond to low levels of risk nor would high levels of exposure correspond to high levels of risk. Careful thought will need to be given to the disclosures required in this area so that they balance the need to provide information with the risk of overburdening with data to explain very simplistic requirements. If a Pillar 2 approach is pursued, then confidentiality considerations will also need to be reviewed. Thought should

also be given to whether aggregate leverage statistics, disclosed by supervisors, may serve to better inform market participants rather than individual firm disclosure.

3.2.4 Calibration

See above.

4 Reducing procyclicality and promoting countercyclical buffers

4.1 Key messages

We note the Committee's concern that the interaction of the capital and accounting regimes proved to be excessively procyclical and the prominence the G20 has given the consideration of changes to the existing frameworks to reduce this effect going forward.

As is made clear in the consultation document, however, procyclicality has a number of sources and there are many interrelated proposals for how it could be addressed. Care must be taken to understand the full impact of each proposal and time taken to develop a package which works as a whole. This consideration should include a review of existing regulatory tools, some of which already achieve the desired aims, to avoid duplication and double counting. Analysis must include the trade-offs which the adoption of each would imply in terms of the impact on the real economy, financial institutions and financial stability. It is also important to recognise that some measures considered in the Consultation, such as the elimination from capital of deferred tax, pension fund deficits, counterparty risk changes etc. if adopted, could potentially increase procyclicality.

The industry believes there should be two core parts to the regime to address procyclicality and that it is necessary to keep a clear distinction between the accounting and regulatory capital frameworks. It should not be forgotten that accounting and regulatory loan loss provisions are calculated and used for different purposes. The first part to the regime to address procyclicality should concern the earlier recognition of *expected* losses and should be achieved by moving the accounting framework from an incurred to an expected loss basis, amending supervisory guidance on provisioning and unwinding disincentives to provision in the Basel II framework. The second should provide for a buffer to mitigate *unexpected* losses which arise through the economic cycle. This should, as the Committee indicates, be a regulatory counter-cyclical capital buffer outside the financial reporting framework, sitting in the Pillar 2 framework.

In our view Pillar 2 already gives supervisors extensive tools to address issues identified, such as prohibiting distributions and requiring firms to maintain capital buffers to reflect their risks. We believe that consistent application of Pillar 2 should be a focus of the Committee through its Standards Implementation Group.

Where markets already have equivalent measures we strongly oppose a further buffer process being introduced which will merely serve to duplicate existing proven techniques and measures. We also suggest that where firms already maintain a substantial buffer and have sound risk management and corporate governance practices, this should be taken into account rather than requiring a further buffer.

We do not support proposals for 'dynamic provisioning' which inter-alia conflate the recognition of losses for accounting purposes with the need to provide a buffer against losses which may arise in future over the economic cycle from business which has yet to be written. We believe such measures amongst other issues reduce transparency and have the potential to seriously damage market confidence in financial institutions.

4.2 Detailed comments on the proposal

4.2.1 Cyclicalities of the minimum requirement

The industry agrees that the Basel II framework has increased the risk sensitivity of the regulatory capital requirement. We recognise that there is a trade off between increasing risk capture and sensitivity at a given point in time and the degree to which the minimum capital requirement is cyclical over time. As the Consultation notes, credit losses in the banking book are only now moving to their peak level. We therefore support the Committee moving, once further evidence has been gathered, to assess what additional measures to dampen cyclicalities could be developed, over and above the flexibility already afforded to banks and their supervisors in the framework, to dampen cyclicalities via the more general application of downturn or through the cycle PDs.

In developing proposals, it is important that the fundamental link between Basel II processes being used for management and regulatory purposes is not broken by the use of overly conservative regulatory PDs. The introduction of overly conservative PDs would also increase the capital with the perverse effect of incentivising institutions to increase their exposure to 'riskier' business lines.

We strongly support the decision to conduct an impact study on the proposals in this area, and look forward to evaluating the outcome through a further consultation process.

4.2.2 Forward looking provisioning

We welcome the progress which is being made towards the G20's recommendation that standard setters should strengthen provisioning practices. As the Committee notes, this work has been disaggregated into three distinct streams:

- the revision of the IAS 39 impairment methodology to move it from an incurred to an expected loss basis;
- a consequential amendment to the supervisory guidance on provisioning; and
- moves to address disincentives to provisioning under the capital framework.

The banking industry supports the IASB's objective to move to an expected loss regime and the idea of ensuring that provisions raised incorporate a broader range of credit information than may currently be the case, and believes that it is important that this be achieved within the context of the objectives of financial reporting, which are different in certain ways to the objectives of prudential regulation. We agree that it should be possible to achieve more forward looking provisioning in financial statements by using a broader range of credit information, but are concerned that the introduction of excessive subjectivity into provisioning methodology, or approaches that seek to accumulate a prudential 'buffer' during benign periods in order to stabilise reported earnings during times of stress, will reduce the objectivity of financial reports and damage market confidence.

That being said, we do not agree with the expected cash flow approach based on an EIR (Expected Interest Rate) methodology as currently proposed by the IASB. This is an overly complex model both in terms of its design and ongoing application. We estimate the cost of implementation for the UK banking industry alone to be in the region of 50 to 75 per cent of first time adoption of IFRS or between £150 to £225 million in aggregate. That being so we strongly recommend the Committee does not pursue an EIR methodology.

In our view, the IASB can meet the G20's objectives via the adoption of a simpler model which aligns with risk management practices makes greater use of existing systems

developed for Basel II purposes. We agree with the Committee that the methodology adopted should reflect expected credit losses in loan portfolios over the life of the portfolio as at the balance sheet date.

As regards the treatment of the difference between provisions and regulatory expected loss, where accounting and regulation does not align we are not convinced that the approach proposed (i.e. to deduct the shortfall from core Tier 1, as opposed to 50:50 from Tiers 1 and 2) will deliver the desired objective of removing disincentives to sound provisioning. If accounting and regulation align, which the industry supports, then such provisions will be unnecessary. However if they do not align then other tools should be considered. We would note that the deduction of the shortfall represents another tightening of the requirements for which the impact requires assessment. While we understand the rationale for the current approach, to address the focus of the capital framework on unexpected rather than expected loss, the industry would emphasise that firms displaying sound provisioning practices should have recognition for their prudence, which could, for example, be reflected in the assessment of the need for capital buffers; the removal of any 'cap' on expected provisions over expected losses.

We note that the Committee is still considering its approach to any excess and look forward to continued dialogue in this area.

We look forward to the publication of proposals to update the supervisory guidance on sound provisioning practices and welcome the recognition of the importance of the new guidance utilising approaches that draw from relevant information in banks' internal risk management and capital adequacy systems wherever possible. The Committee should continue to work with the standard setters to achieve a satisfactory, globally applicable solution and continue to consult with the industry as these further develop.

4.2.3 Building buffers through capital conservation

As is acknowledged above, we believe that there may well be a case for capital buffers to be built over and above the minimum capital requirement but strongly oppose measures such as 'dynamic provisioning' which distort the financial reporting framework. We therefore are supportive that the proposal set out in the consultation document is focused on regulatory capital. We observe that a number of the institutions which weathered the financial turmoil well had discretionary buffers in place over their minimum capital requirements, supported by effective utilisation of the Pillar 2 process and sound risk management and corporate governance practices. In fact, a number of countries, including the UK and Canada, already operate a capital planning buffer measure as part of the existing regulatory Pillar 2 framework, which is closely monitored as part of the ICAAP protocols and stress testing framework. It should also not be forgotten that under the existing Pillar 1 parameters there already exists a number of stressed parameters (e.g. downturn LGD and the soon to be introduced stressed VAR), which already therefore form part of the capital plan and provide buffer for counter cyclical situations. The Pillar 1 credit risk framework also includes a stress test, which can potentially result in a buffer to cater for an economic downturn. On top of this in Pillar 2 many countries operate on a more severe stress scenario which further informs the buffer level to be held.

It should also be noted that the starting point for any capital buffer framework should be an explicit recognition that the buffer should be designed to be drawn down at the appropriate point in the economic cycle and in adverse external circumstances. It would be inappropriate if constraints were placed on the use of the buffer which resulted in it being viewed by either supervisors or the market as establishing a new minimum capital requirement or in breach of a regulatory requirement when drawn down.

We emphasise that it would be inappropriate to create a situation where buffers sit upon buffers trapping capital from its efficient use in the real economy. Firms which maintain a strong capital base which already has a buffer to offset cyclical capital depletions and stress situations should not be required to hold additional capital buffers as a result of these measures. The impact assessment currently underway needs to assess the extent to which there is double counting before determining any calibration to optimise efficiency.

In terms of the design of a capital buffer framework, it is always important to ensure the following principles apply to the buffer review process:

- be risk-based, recognising the individual firm's existing capital strength and robustness of its corporate governance and risk management practices. This should include taking account of the robustness of the firm's recovery and resolution plans, and management prudence. These qualitative measurements should all act as a mitigant to the resultant quantitative buffer sum.
- be established at the group consolidated level. There should be no room for national discretion, which could lead to an international firm having capital buffers in multiple locations; thereby tying up capital in an inefficient manner and not necessarily optimising its usage throughout the group both on a 'business as usual' basis or indeed in an economic downturn. Rather the consolidated supervisor should, working closely with the firm and its college of supervisors, lead the review of what the appropriate buffer at a consolidated level should be.
- remain a private matter between the firm and its consolidated supervisor/ college of supervisors to avoid the serious and potentially significant impact of any market or public knowledge, which could have serious and significant impacts. It should therefore remain part of the Pillar 2 supervisory process. As such the buffer should not be a 'hard' target but rather is 'soft' recommended target, which will form part of the ongoing dialogue between firms and their supervisors in relation to the firm's specific business activity.
- the use of the buffer should not trigger either corporate governance obligations and / or result in action that would alert the investor and/or public domain. Such an outcome could have far reaching consequences. Careful thought needs to be given to disclosure obligations that capital conversion standards could potentially trigger, with the ensuing serious risk of reputational damage to the institution.
- managed at the discretion of the individual firm.

As regards capital conservation, we would also note that the Principle 4 of the Pillar 2 framework also suggests a range of actions that supervisors might take to prevent capital falling below minimum levels, including the right to prevent firms from distributing dividends. We think that these tools can be used rather than creating additional capital conservation buffers which result in double counting. We therefore recommend that the Committee through its Standards Implementation Group focus on ensuring the uniformity of application of the Pillar 2 both as regards distributions and counter-cyclical buffers as well as strengthening stress testing parameters globally. This could be augmented through specific rules for college of supervisors to follow in the implementation of such measures on a firm specific basis.

We further note that capital constraints should only be imposed if capital levels fell within the buffer range and that the constraints would be proportionate to the level of incursion into the range but at all times not affecting the operation of the bank. However, we are unclear as to

how the Committee envisages the approach working, nor do we understand the methodology and we would appreciate further clarity in this area. Discretion should rest with the management of the firm over the way in which the buffer should be rebuilt. The balance between the various options should be for management to decide, in discussion with the consolidated supervisor.

We do not comment on the numbers provided in the table as we note these are for illustrative purposes only. However, this is not a simple subject and it has overlap with existing tools and therefore the industry welcomes further consultation with the Committee as it evolves its thinking and approach.

In summary, we do not believe that the Committee should pursue the establishment of a new regime of capital buffers or capital conservation, but should focus its efforts on the consistent application of existing tools and processes globally and recommend that the Standards Implementation Group is the appropriate forum through which to achieve that. That said, if the Committee pursues the model proposed, it will be vital that the calibration of the appropriate range for the capital buffer be considered alongside the exercise to recalibrate the capital framework and in light of the recommendations reached on forward looking provisioning. This exercise should include the review of existing national buffer processes to align processes, minimise double counting, and take account of the wider consequences for lending capacity and the real economy, as well as the impact that restrictions on the payment of dividends might have on the attractiveness to the market of an institutions' common equity. Full consideration would also need to be given to appropriate implementation and transition provisions, including further industry consultation

We also suggest that where firms that already have a substantial buffer and are seen to be well run with adequate systems and controls, this should be taken into account rather than requiring a further buffer. For such firms it would be sufficient to require the firm to notify its lead supervisor if its Pillar 2 stress testing indicates that its own buffer would be fully utilised in the recent of an economic downturn or other severe stress scenario to maintain minimum capital requirements.

4.2.4 Excessive credit growth

We agree that one of the lessons of the financial turmoil is the need for macro-prudential regulation to link the macroeconomic stewardship of the economy with the supervision of individual firms. We believe that a macro-prudential regime could go some way towards increasing the resilience of individual firms and better protecting the economy against the consequences of financial instability so as to maintain the essential services banks provide to the real economy. However, the outline proposal suggested is just one possible tool and it can not be considered in isolation. We are therefore not proposing to comment on the suggestion that the capital buffer could be used for this purpose, but have included more general comment on macro-prudential supervision.

We believe a macro-prudential supervisory framework must sit outside the micro-prudential regulator. The macro-prudential framework would use relevant indicators to detect 'bubbles' at a national level with input as relevant from regional bodies such as the European Systemic Risk Board and international bodies such as the Financial Stability Board. The macro-prudential body would be accountable for detecting areas of over-heating where problems may arise and laying these out for the micro-prudential supervisor. The micro-prudential supervisor would then assess the firms operating within the market over which it has supervisory authority to identify, as to which individual institutions it considers to be most exposed to the risk(s). Determination of any specific actions necessary to manage risk(s) should be assessed and determined through Pillar 2 supervisory review and discussion with the individual firm whether any specific action is necessary by that institution to manage the

risk(s). Macro-prudential supervision supervisors would therefore link to the micro supervisor in providing information, or recommendations that action should be taken, but should not have direct control of the remedial actions at institutional firm level. Determination of the precise actions required should be made by the micro-prudential supervisor on a case by case basis, with specific discussion with the individual firm.

It is also worth stressing that we do not believe macro-prudential regulation is sufficient by itself to address excessive credit growth. In particular, it should not be allowed to disguise from the need for reform in other areas, such as monetary policy, where the financial crisis has exposed weaknesses. Without a holistic approach (i.e. one that also recognises issues which address monetary policy, the need for a sustainable fiscal policy, and structural issues, such as in the housing market), macro-prudential regulation - however well designed - is unlikely to prevent another crisis. Prudential regulation (macro or micro) should not be looked upon as the panacea for a wide range of issues. The focus on prudential initiatives to address the supply side can divert attention from more uncomfortable questions about the role of monetary policy authorities in managing the demand side. Given the build-up of public sector deficits and sovereign rating concerns, the next crisis (and systemic risk) could conceivably be on the fiscal/demand side rather than originating in the banking sector.

The tools to implement a macro-prudential regime will be dependant upon its objectives. The decision on which to adopt should be based upon thorough analysis and an understanding of the trade-offs involved in terms of the impact on the real economy, financial institutions and the international competitiveness. A number of papers have been prepared on this, for example in response to the Bank of England's recent paper - "The role of macro-prudential paper policy" - and at the international level by affiliated associations, outlining the key principles the international banking arena believes will be necessary for such a macro-prudential regime to operate effectively.

5 Addressing systemic risk and interconnectedness

We acknowledge the role and consequences systemically important financial institutions can have on the real economy. We recognise that the Committee has not outlined policy proposals in this area as yet, but look forward to reviewing the details of these approaches in due course. However, we would like to make some high level comments at this stage on systemically important financial institutions because of the comments in paragraph 47 regarding the possibility of introducing capital and liquidity surcharges.

We recognise that for some firms, or categories of firms, maintaining the confidence in the financial system is a more important supervisory objective than for others. However, we urge the Committee to consider a holistic assessment of the approach to systemic risk and interconnectedness, taking account of the broader range of regulatory initiatives that serve to mitigate some of the risks. In particular we would note the importance of the development of resolution tools and an effective framework for cross border resolution. The proposed enhancements, already in progress or in development, will also serve to enhance these firms' ability to absorb losses and the cumulative impact of these proposals must be taken in to account. As the consultation document notes, the proposal to increase the asset correlation among financial institutions will directly address this issue, but other changes will also be important for example the proposals to dampen cyclicality, i.e. the link between macro and micro prudential regulation. Measures introduced to improve risk management practices will help to reinforce the importance of risk identification, measurement, monitoring and action. The international efforts to increase the use of central counterparties will serve to reduce interconnectedness between financial firms. Standards for central counterparties being developed will also serve to protect payment systems and improve resilience. Early intervention measures, supervisory and crisis colleges and recovery and resolution plans are other measures that should serve to mitigate the risk of failure as well as the potential impact if failure should occur. Existing competition tools in national jurisdictions and regions can continue to ensure that market dominance is addressed.

In designing any framework for systemically important firms, as well as taking account of the other initiatives, it is also important to establish a balance between enhancing the regulatory framework and economic recovery, sustainable and balanced growth, to meet common objectives in line with the G20's commitment in the Pittsburgh Summit Declaration. It is vital to recognise that large and complex firms bring social, economic and market benefits, as well as risks, through their capacity to intermediate between borrowers and investors across a range of markets. These firms perform a risk taking function that is necessary for economic vitality. Large firms can deliver economies of scale, scope diversification, improve market efficiency and support global trade. Any measures introduced should be carefully considered so as to avoid eroding these benefits and ensure that measures do not overcompensate for any perceived competitive advantages created by systemically important financial institutions.

As practical approaches are developed to assist supervisors measure the systemic importance of banks to the financial system, we urge the Committee to recognise that a number of factors are relevant to determine systemic importance and these should be taken into consideration. There is no one 'silver bullet' for the measurement and management of systemically important financial institutions and an element of judgement will be required. In particular we think that the following factors should be taken into account:

Financial stability: An assessment of the systemic importance and the implications for supervision of a firm, group, or collection of firms, will depend, at least in part, on how financial stability objectives are defined. Agreement of financial stability objectives is therefore a necessary preliminary step.

Objectives: It is important to be clear as to the objectives of a regime for systemically significant firms. We are pleased to note the Committee is not recommending a system that aims to limit size or complexity.

Definition: It is challenging to define systemic importance and it is important not to come to the conclusion that it can easily be equated with size. Systemic significance could be measured in terms of a combination of factors, such as size, connectedness, group/solo sectoral significance or market dominance. However, we think it would be difficult and potentially counter-productive to base this determination on a single objective test or in relation to a single factor. The boundaries of the categories may be very difficult to maintain as markets and the participants in them develop and continue to evolve. In a crisis, contagion risk may well make those boundaries meaningless. Furthermore, the assessment of what is or is not systemically significant may differ at national, regional, and global levels. A scorecard approach that can weight differing factors and involve supervisory judgement is a more appropriate way forward. Determination should therefore be made of where a firm sits on the scale of systemic risk, rather than having a single hard boundary. A hard boundary could distort competition and firms' ability to plan ahead.

Risk migration: It needs to be recognised that further requirements placed on systemically important firms creates the possibility of risk migration. Any framework needs to ensure that systemic risk does not migrates to unregulated or less well-regulated sectors or jurisdictions, where risks will be less visible and may accumulate to systemic levels.

Global dimension: Given the global nature of financial markets it is essential that any initiatives in this area are fully supported internationally, in terms of consistency of definition, treatment and implementation (substance and timing).

Better regulation and impact assessment: The assessment of any additional requirements for systemically important firms needs to be made with full knowledge of the cumulative effect on such firms of other requirements introduced in response to the market turmoil (see above). In addition, it is vital that the other process disciplines of good policy formulation are followed. While we appreciate the desire to maintain momentum, we urge the Committee to ensure that sufficient time is given to properly consider the full range of policy options to deliver the desired outcome.

Forward looking: It is important not to design a system specifically to cater for past failures, but take account of possible future stresses as well.

Tools of regulation: It is important to consider all available tools of regulation when determining an appropriate regime. In particular, Pillar 2 and the intensity of the supervisory relationship should be considered. The Pillar 2 process allows supervisors to take a holistic view of the impact of a firm's failure (taking account of risk mitigants) as well as its probability of default.

Risk management incentives: It is important to retain, and not undermine, the incentives to improve risk management currently provided by the Basel framework.

Disclosure: We do not think that it is appropriate for systemically important financial institution status to be disclosed because of the potential market distortions that could result. In addition, the introduction of other measures that will allow institutions to fail, such as resolution tools will mean that an absence of disclosure is not inappropriate. This would be consistent with our view that recovery and resolution plans remain confidential.

In summary, as the Committee develops its thinking in this area, we would stress that supervisory tools, changes to the capital framework, the introduction of a liquidity framework,

as well as broader regulatory developments, such as central counterparties, will contribute significantly to reducing the risks systemically important firms pose to the financial system and the economy. We do not believe that capital or liquidity surcharges should be considered until the QIS has been completed and reviewed, conclusions have been reached on the calibration design, timing and sequencing of the proposals in this consultation and the full range of options (particularly existing regulatory tools) have been assessed). The industry looks forward to working further with the Committee in developing its thoughts in this area and responding the forthcoming consultation.

Annex 2: Response to the Committee's Banking Supervision Proposals to strengthen Global Capital and Liquidity regulations (BCBS 165)

1 Introduction

The Basel Committee for Banking Supervision (BCBS) proposal for an *International framework for liquidity risk measurement, standards and monitoring* (BCBS 165) is welcome by our members including those of the Association of Foreign Banks. The recent crisis underlines the need for a common approach to liquidity risk standards which, compared to the framework for capital, are relatively underdeveloped. As such we view the Committee's proposal as the first stage in an on-going discussion to develop liquidity standards.

In principle we support the introduction of a short term measure that focuses on the adequacy of a financial institution's liquidity buffer in times of stress and a long term measure that focuses on the structure of its funding. The adoption of such standards will help to promote a more balanced approach to funding in the industry and ensure a globally consistent framework.

Nevertheless, we caution the Committee against the introduction of an overly prescriptive one-size-fits-all framework that assumes that all firms are equally affected by the liquidity crisis specified and, in the case of the NSFR, do not make adjustments to their balance sheets or strategy over the year that the stress is assumed to occur. The requirements do not appear to reflect minimum standards but rather a maximum stress based on an aggregation of recently experienced stress events. In Section 2, we highlight some of the potential consequences of such a framework and offer possible alternative solutions for the Committee's consideration.

We also welcome the Committee's proposals for common monitoring tools and the Committee's implicit recognition that firms deploy a variety of monitoring metrics in their day-to-day management of liquidity risk. To support the proposed international liquidity rules and their consistent application, we provide further recommendations on further harmonising reporting standards and urge the Committee to encourage a cross-border liquidity framework.

We are very concerned by the calibration of the LCR and NSFR. On an individual firm basis, the proposed ratios will likely result in a complicated set of calculations that overstate the liquidity risks being managed. So we support the QIS and suggest that a further calibration exercises will be required.

BCBS 165 generated a discussion among our Members from which emerged suggestions to improve the framework in addition to a number of detailed comments. We hope all our comments will be of interest to the Committee. Key messages and recommendations on BCBS 165 are presented in Section 2 while our detailed comments on aspects of the proposals are presented in Section 3.

2 Key Messages and Recommendations

2.1 Timing of Implementation

We recognise and welcome the Committee's 17 December 2009 statement⁴ that a fully developed set of standards should be in place by the end of 2010 with the aim of phasing them in, subject to economic and financial market conditions, for implementation by end-2012. Nevertheless, the calibration of the proposed liquidity measures depends on the outcome of the QIS. Currently, the full impact of the liquidity proposals is still unknown so it is difficult to fully evaluate the appropriateness of the current timetable for implementation. Thus, we urge the Committee to be generous in its implementation targets and suggest that the Committee's liquidity proposals be considered more carefully over a longer timeframe, with implementation starting, rather than finishing at the end of 2012. This would allow for an improved understanding of the likely impact on the global economy, give markets sufficient time to stabilise and let some form of 'new normality' establish itself before the new liquidity standards are fully implemented, at some point after 2012.

Furthermore, the Committee must not underestimate the workload that the proposals require. Complying with the new requirements – liquidity coverage ratio (LCR), net stable funding ratio (NSFR) and the suite of monitoring tools – is not dissimilar to a Basel II implementation project for which a minimum of 12 months was accepted by most regulators as a reasonable lead time once rules had been agreed at the national level.

Moreover, the exclusion of central bank funding from the NSFR, in paragraph 84 means that this funding will need to be replaced with funding by the market. However, given current market conditions, in the near term, we suggest that it would be unrealistic to have firms replace this funding with funding from the market without disrupting the economic recovery, so grandfathering arrangements also need to be explored.

Recommendation i: Agree international transitional and grandfathering arrangements for implementation of the BCBS liquidity framework after 2012.

2.2 International Alignment

We support the Committee's strong lead in the introduction of an international agreement on quantitative liquidity risk standards and monitoring tools. However, international consensus building requires time, so we urge the Committee not to rush implementation at the expense of a coordinated implementation process. Only a globally consistent framework will guarantee a level playing field and discourage regulatory arbitrage.

Recommendation ii: We urge further international discussion policy discussion on all aspects of the liquidity proposals and agree an internationally coordinated implementation timetable.

2.3 Calibration of the proposals and supervisory factors

We are very concerned by the calibration of the LCR and NSFR. This concern derives from two inter-related sources:

⁴ <http://www.bis.org/press/p091217.htm>

- The severity of the assumptions underpinning the factors - e.g. a three-notch downgrade in the institution's public credit rating.
- The use of standardised factors applied to limited broad asset and liability classes.

This means that firms specific factors (such as business model, product types, funding types and varying counterparty behaviour) and or changes in firm strategy made over the ratio horizons can not be taken into account.

On an individual firm basis, the proposed ratios will likely result in a complicated set of calculations that overstate the liquidity risks being managed. It is important to bear in mind the aggregate impact of this conservatism in terms of the objective being set for liquidity risk management and achievability given the availability of funding in the market. From a macro economic perspective, this would have the impact of significantly dampening the provision of credit to the system and / or have the consequence of transferring activities to less regulated sectors of the financial system.

A related concern is the lack of discussion of how the Committee arrived at these standardised factors. We suggest that some of the factors appear to be arbitrary and we ask the Committee to explain how the percentages for the outflows and inflows were derived – they do seem somewhat ad-hoc. In many cases they appear even more severe than experienced during the recent crisis.

Recommendation iii: Reconsider the severity of stress test assumptions which in their current form can not reflect firm specific factors/behaviours and would therefore, on aggregate, be considered severe but implausible.

Recommendation iv: Disclose the methodologies used to derive the LCR and NSFR factors.

2.4 Unintended consequences of the proposals

A. Incentives for good risk management overlooked

On a point related to the severity and standardisation of the stress assumptions being applied to the LCR and NSFR, there is a concern that these assumptions could come to dominate firms' efforts to assess the impact of less severe but more plausible scenarios. Over time this could effectively discourage firms from developing and analysing their own liquidity stress test models taking account of firm specific liquidity risks, stress scenarios and mitigating actions.

Especially, in the case of the LCR, the conservative run-off assumptions driving the LCR computations threaten to overshadow firms' own assessment of run-off rates with the effect of undermining the further development of firms' liquidity risk management frameworks.

We also note the difficulty in defining concepts such as stable and non stable sources of funds. We urge the Committee to remember that there is a multi-dimensional liquidity spectrum that spans across different types of depositors and types of products. Drawing hard lines within the spectrum, to create arbitrary buckets, and applying behavioural overlays to each of these buckets will result in risk insensitive measures which will then get reflected in the pricing of liquidity across the liquidity spectrum.

In terms of the NSFR, the prescription being introduced appears to be unaligned to the risks that the NSFR is attempting to capture. For instance, it is not intuitive that an unsecured

three month loan to a hedge fund requires less support than a blue chip security. This puts the proposed framework at odd with firms' own risk management efforts.

We recognise that the Committee's proposal for a liquidity risk framework is at an earlier stage of development than the Committee's standards for credit, market and operational risk, but we are concerned that the proposed liquidity framework stands in stark contrast to the Basel II requirements as well as the CEBS's December 2009 *Guidelines on Liquidity Buffers*⁵ and the UK FSA's liquidity framework⁶. Basel II and alike, actively encourage firms to use internal models to improve risk measurement and management and to better understand firm specific risks. We continue to support the use of internal models and measures, but caution the Committee against being overly prescriptive in setting behavioural overlays that should apply to contractual outflows and inflows or sources and uses of funding.

Recommendation v: Refine the proposed framework to allow firms, with the capability to estimate behavioural factors (funding factors), to apply their own behavioural (or funding estimates) to contractual inflows and outflows (sources and uses of funding) associated with the LCR (NSFR)

B. Macro - economic impacts: lending to consumers and business

It is important to remember that the strength of a liquidity buffer derives not just from the quality of the assets held alone, but also the nature of the liabilities funding the buffer - the longer the maturity profile of these liabilities, the longer the survival period. Recent reports from UK clearers indicate that the five major British high street banks together could hold approximately £ 550 billion in liquid assets to meet the 100% funding of the LCR, all of which would have to be funded for a significant period reducing the ability of banks to lend to the wider economy. This locked-up liquidity equates to 25% of the estimated total of deposits from UK residents of £ 2.3 trillion.⁷

Moreover, the construction of the NSFR needs to consider the delicate balance of providing greater financial stability and draining long term liquidity as the pool of investors providing long term liquidity is expected to shrink considerably (e.g. in respect of money market funds). The current formulation of the NSFR will translate into an increased demand for long term funding (i.e. most non government assets require 100% funding) and will no doubt increase funding costs, which again will be passed on to customers as margins are compressed.

Additionally, the creation of long term funding by banks will be heavily curtailed by the exclusion of bank CD's and FRN issues by financial institutions from the LCR. Liquidatum Ltd has calculated that the top 100 banks in the world will have to raise €3.3 trillion in long term funding to reach the 100% coverage mark based on 2008 figures (see Figure 1).⁸ There are concerns that this will result in significant deleveraging as firms are likely to adapt their business model rather than raise more expensive long term funding. The economic impact will potentially be reduced access to finance for consumers.

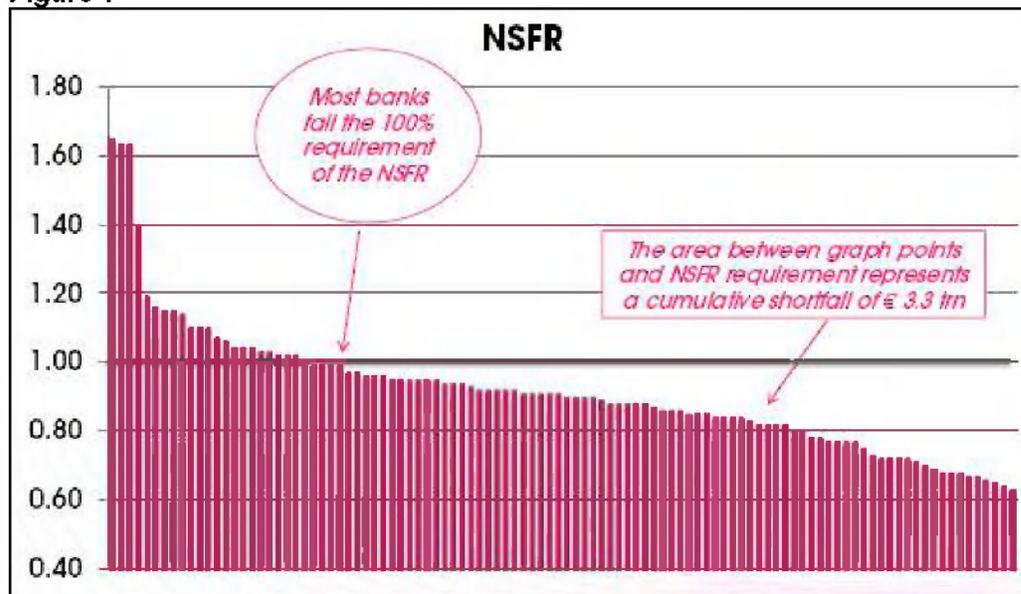
⁵ <http://www.c-eps.org/documents/Publications/Standards---Guidelines/2009/Liquidity-Buffers/Guidelines-on-Liquidity-Buffers.aspx>

⁶ http://www.fsa.gov.uk/pubs/policy/ps09_16.pdf

⁷ These numbers are source from - <http://blogs.telegraph.co.uk/finance/jeremywarner/100001873/banks-forced-to-hold-punishingly-large-liquidity-buffers/> and <http://www.bankofengland.co.uk/statistics/ms/2010/feb/tabcl.1.xls>

⁸ Liquidatum Ltd: The corresponding chart provides an analysis of the effect of implementing the NSFR using the coefficients in Appendix 2 of the BIS Consultation Paper published in December 2009. This data comprises approximately 100 banks from Australia, China, SE Asia, Continental Europe, Scandinavia, UK and North America. The data set represents their year - end 2008 data. We have excluded data on Japan as the granularity of their report we believe is insufficient to carry out meaningful analysis.

Figure 1



Our concerns about the macro-economic impact of the Committee's proposals are heightened when we consider the potential impact of the Committee's liquidity proposals in conjunction with the new capital requirements agreed by the Committee in 2009 and the capital proposals contained in the BCBS Consultation Document 164 *Strengthening the resilience of the banking sector* (BCBS 164).⁹

Recommendation vi: We invite the BCBS to evaluate and discuss the proposals along with QIS results in terms of macro-economic consequences and more specifically the impacts on consumers and businesses.

C. Impact on markets: Inter-bank market and government

We also note that the proposals appear to favour retail over wholesale deposits (i.e. the LCR run-off factors for wholesale funding assume that elements of wholesale funding are less sticky than retail deposits, and under the NSFR value of retail deposits < 1year is 85% versus 50% for wholesale funding < 1year) giving little recognition to the fact that retail deposits are finite, and, taking Northern Rock as an example, not necessarily more sticky. Furthermore, for the purposes of the liquidity buffer, no recognition is given to assets issued by financial firms, effectively penalising transactions with banks in comparisons to transactions with unregulated entities. This is a paradox and, moreover, likely to increase systemic risk.

Financial institutions which specialise in providing the market with assets which are now intended to be excluded from eligible liquid assets will see their business model disappear. The issuance of securities provided by financial institutions has developed into a significant market in Europe more so than in other locations and would therefore be more seriously affected than in other jurisdictions. Ultimately, more banks will have to issue 1 year liabilities, while their counterparties would be penalised. Implementing the proposed requirements will imply a huge burden for smaller banks that are often reliant on deposit business and investment products from larger firms.

⁹ <http://www.bis.org/publ/bcbs164.pdf?noframes=1>

We recognise the concern that holding assets issued by financial services firms can create artificially inflated liquidity in the system and wrong-way-risk where two or more banks issue assets to one another. However, we believe that there is an argument for smaller banks, at least, to be given value for holding the paper of larger banks. It is true that during the recent crisis such paper became difficult to sell, but for idiosyncratic stress scenarios smaller bank holdings of larger bank paper have proved beneficial over a longer time horizon. Furthermore, the effort to strengthen bigger bank liquidity and capital positions make it less likely that their paper will not be marketable in a crisis. In Europe these measures are being complimented by large exposure rules that will mitigate concentration risk in inter-bank funding.

Finally, an additional point to consider is the distinction between inter-bank deposits (which are illiquid) and inter-bank bonds, as a case can be made for bonds still being tradable even during an idiosyncratic stress.

Recommendation vii: Give value to smaller firms holding larger firm bank paper for idiosyncratic stress in a 2 nd tier buffer.
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D. Impact on markets: Government bonds

The narrow range of assets eligible for inclusion in the liquidity buffer will introduce distortions in markets for those assets. The focus on government bonds potentially props up markets for some government bonds that may not otherwise be demanded by investors. Furthermore, it is likely that there will be increased concentration risk in 'cheapest to deliver' assets of certain government bonds.

E. Impact on European and US mortgage markets

One of the criteria set for liquid assets requires that marketable securities guaranteed by non-central government entities be zero risk weighted. This excludes mortgage securities such as Freddie and Fannie Mac and sets their treatment apart from covered bonds, which are in the liquidity buffer. The potential impact of this exclusion on mortgage market needs to be considered.

Recommendation viii: We invite the Committee to discuss the potential economic consequence of the proposals in terms of the market volatility they may introduce and the economic impact it may have on the markets for some instruments.
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2.5 LCR and NSFR – objective and use

A. Using long and short term buffers

The Committee has not discussed the buffer and usage in terms of whether the firm is a going or gone concern. This lack of discussion obscures the objectives being set for the buffer. Paragraph 20 states that the LCR “should enable the bank to survive until day 30 of the proposed stress scenario, by which time it is assumed that appropriate actions can be taken by management and/or supervisors, and/or the bank can be resolved in an orderly way.” Furthermore, no reference is made that the liquidity buffer is expected to be used in times of stress to alleviate funding pressures leaving the reader with the impression that the LCR is there to ensure funding for the gone concern, implying a requirement for a “buffer on top of a buffer”.

We maintain that liquidity buffers are there to be used in stressed times to ensure that a firm remains a going concern, even if this means they may need to temporarily be run below the levels set by supervisors. We concede that there needs to be an appropriate governance structure and day-to-day oversight for the use of the buffer (and for its level to be considered

in the light of other liquidity measures and metrics). If there is a crisis - which may be measured by the firm triggering certain liquidity or other metric hurdles - then the institution's Contingency Funding Plan (CFP) would be activated, and if necessary, its supervisors advised. Such plans would, of course, include the plan for the subsequent rebuilding of the buffer after the regulatory level has been breached, once the institution's crisis has passed.

We agree that supervisors should be able to challenge the level of the buffer at any time and that they should be able to satisfy themselves that the appropriate governance processes to control the buffer are in place.

Recommendation ix: Allow for use of buffers in stressed times and, utilise Principle 11 of the BCBS's *Principles for Sound Liquidity Risk Management and supervision* which sets out that banks should have CFPs that address shortfalls in emergency situations and require clear lines of responsibility.¹⁰

B. LCR

While we support the concept of holding a liquidity buffer, we are perturbed by the narrow definition of eligible liquid assets and the stress assumptions applying over 30 days. In part, our concern relates to outcomes such as the distortion of the government bond market, reduction of inter-bank funding, and increased concentration risk in 'cheapest to deliver' assets of certain government bonds. Other concerns relate to the lack of alignment between the horizon suggested by the Committee and that suggested by CEBS's in its *Guidelines on Liquidity buffers and survival periods*.

So we urge the Committee to widen the list of qualifying liquid assets by adopting a tiered approach to the buffer that is aligned to two phases of stress occurring within the 30 day time horizon. Underpinning this approach is an understanding that following two weeks of stress marketable assets can be realised with less forced sale risk. Also, given the availability of special resolution regimes and possible recovery and resolution planning requirements an initial 15 day severe stress period is quite sufficient.

Recommendation x: Split the 30-day horizon into two phases and allow a wider range of assets in the buffer over the second phase. The narrow definition of the buffer would apply over the first 15 day period when the institution is experiencing a combined idiosyncratic and market related stress, and the wider definition of the buffer (including the second tier of assets) would apply over the next 15 days when the firm is subject to a moderate market wide stress.

If the Committee does not support the idea of broadening the definition of the liquidity buffer, we then ask it to consider recognising less severe net-outflows while also counting some of the excluded assets in the stock of liquid assets (i.e. what we refer to as the second tier) under the LCR's denominator.

Recommendation xi: If the Committee rejects recommendation x, as an alternative, include in the denominator some of the assets excluded from numerator (i.e. stock of liquid assets) in the LCR's denominator and review the conservativeness of the factors being applied to outflows and inflows.

C. NSFR

We support the Committee's objective of encouraging more medium and long term funding. However, we have serious concerns that, in its proposed form, the NSFR will distort markets and impede economic growth. We have a number of concerns over its calibration,

¹⁰ <http://www.bis.org/publ/bcbs144.pdf?noframes=1>

complexity and lack of risk sensitivity which produces perverse risk incentives. As a result we believe further consideration should be given to its design. We appreciate the need for a measure that addresses the structure of funding, and suggest that the Committee develop an appropriately calibrated and sophisticated risk sensitive measure that could better reflect firm specific factors.

In short, we recommend an approach that recognises that the NSFR is only one measure among many that needs to be used by supervisors in the evaluation of a firm's liquidity profile. Thus the NSFR (and indeed the LCR) should be used by supervisors along side firm's internal measures in the evaluation of liquidity. This will allow some comparability between firms while encouraging the continued development of firms' internal metrics and models and providing supervisors with a more complete picture of firms' liquidity position and processes.

Recommendation xiii: Develop an appropriately calibrated and sophisticated measure of the structure of funding that could better reflect firm specific factors.
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D. Asymmetries

There appear to be a number of asymmetries, for example, intra-group flows and commitments and derivatives. These should be addressed.

Recommendation xiii: Resolve all asymmetric treatments.
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2.6 Need for cross-border liquidity framework and convergence

The Consultation leaves the quantitative standards and monitoring tools open to "...apply at group and/or entity level and to foreign bank branches (para. 130)." Without coordination between national supervisors then there is a real danger of multiple liquidity buffers and reporting requirements being implemented which would create inefficient duplication of liquidity reserves, i.e. trapped pools of liquidity, and reporting efforts (para 133 does nothing to guard against this).

The ability to manage liquidity centrally for some banking groups promotes the efficient use of funds in order to reduce the overall funding liquidity risk, minimise cost and earnings risk, decrease consolidated capital, credit and balance sheet usage, and optimise liquidity and exposure to third party funding across the group. The recent financial turmoil has shown that global markets can fragment, becoming a collection of separated domestic markets in times of stress. This is due to internationally uncoordinated responses by national authorities within their own jurisdictions to the pressures facing the banking system.

With no coordination between national supervisors there is a real risk that the prescribed strengthening of liquidity buffers in some host entities of a group will result in the weakening of the group, which will by default affect its various entities. We thus urge the Committee to develop and encourage an international framework for the management of cross-border liquidity risk and supervision. We see colleges of supervisors and a framework for the delegation of supervisory task i.e. Global Liquidity Concessions (GLCs) as a viable option for cross-border liquidity management. In turn we see colleges of supervisors as instrumental in identifying early warning signs and effectively coordinating supervisory action. We recognise that the sharing of group wide liquidity information is a paramount first step for cross-border supervision.

Recommendation xiv: Encourage a cross border framework for liquidity management via colleges of supervisors and delegation of supervisory tasks.

2.7 Need for harmonised reporting

We believe that the first step towards advancing a cross-border supervision framework for liquidity risk is the development of an internationally harmonised liquidity reporting framework. Such a framework should ideally take account of banks' individual liquidity risk profiles to ensure that the appropriate metrics are monitored.

A common reporting standard will also do much to facilitate the monitoring requirement of frequent and granular data requests. Agreeing on one globally acceptable format will eliminate duplication of reporting and keep down costs for firms, while also enabling supervisors to better understand liquidity data for cross-border groups.

In turn we see colleges of supervisors as offering a platform for developing these reporting standards and sharing key liquidity information for individual banks efficiently between supervisors. We thus urge the Committee to address these issues in its final paper and call on national and regional supervisory bodies to develop a common reporting language and format. We note that the current QIS work stream or the existing CEBS Liquidity Identity Card¹¹ would be good starting points in developing a comprehensive list of monitoring tools, i.e. building on metrics already identified in the QIS template and Liquidity ID.

Recommendation xv: Develop a harmonised and comprehensive list of monitoring tools and common reporting language and templates.

2.8 The public disclosure requirements and exposure to reputational risk

While, we generally support the principle of transparency, the Committee's proposal imposes far-reaching public disclosure requirements on the standards and monitoring metrics. Obviously, disclosing detailed quantitative information on changes in the firm's liquidity positions could have negative consequences for the firm, and potentially the financial services sector. If, for example, firms are required to disclose a fall in the buffer, this drop could be misunderstood by the market, trigger a run on the firm and undermine its efforts to rebuild its buffer. The European Central Bank in its discussion paper *EU Banks' Liquidity Stress Testing and Contingency Funding Plans (2008)* has rightfully pointed out:

...public disclosure could have negative repercussions on the liquidity situation of some banks under certain circumstances. While more disclosure, in particular on banks' liquidity risk management, is generally to be encouraged, the BSC considers that, in the case of liquidity stress test results, the detrimental effects of mandatory public disclosure are likely to outweigh the benefits.¹²

Furthermore, disclosures made on a routine basis under normal conditions tend to limit the possible actions firms can take in the face of stressed market conditions.

Therefore, we do not recommend disclosure of liquidity metrics to the public. If it is viewed as essential to the Committee, we suggest that these metrics be disclosed in arrears and be based on rolling averages computed over an extended time period rather than point in time

¹¹ <http://www.c-eps.org/getdoc/747246f8-2236-4f25-816f-3985b7f24cee/Liquidity-Identity-Card.aspx>

¹² <http://www.ecb.int/pub/pdf/other/eubanksliquiditystresstesting200811en.pdf>

metrics. This would remove contextual information from market makers who are likely to act on and escalate certain disclosure events which, allows firms the flexibility to act without raising undue market concern.

Recommendation xvi: Public disclosure requirements should be avoided or at least be delayed and based on rolling averages computed over an extended time period.

2.9 Treatment of repos and derivatives

While the Committee's liquidity proposal appears to include treatments for repos, reverse repos and derivatives, it is not entirely clear this is achieved and lacks any explicit discussion of the logic underpinning the proposal. Clarity of treatment and the rationale is important for both supervisors and firms, particularly as these instruments have been the focus of much debate as a result of the crisis.

It is our understanding that in the case of the LCR, repos and reverses are treated on a transaction basis and derivatives on a contract basis. However, in the case of the NSFR it appears that the legs of such transactions are considered separately but we have questions in relation to:

- the scope and treatment of 'repo-like' transactions excluded by paragraph 88;
- the rationale for the apparent lack of value given to secured borrowing (0% ASF and 100% RSF);
- the rationale for the 100% support and 0% value attributed to derivatives;
- the rationale for the lack of differentiation between types of derivative transactions (e.g. FX products versus interest rate products); and,
- whether netting is permitted, we assume that this would be the case from brief instructions provided under the BCBS QIS FAQs document.

We urge the Committee to engage with firms to clarify its intended treatment of these instruments.

Recommendation xvii: Clarify the treatment of repos, reverse repos and derivatives in both the LCR and NSFR ensuring they are conceptually aligned and symmetric.

Recommendation xviii: Provide examples of how the LCR and NSFR tables apply.

3 Detailed Comments

3.1 Comments on Liquidity Coverage Ratio (LCR)

Purpose of LCR

The Committee has not discussed the buffer and usage in terms of whether the firm is a going or gone concern. This lack of discussion obscures the objectives being set for the buffer. Paragraph 20 states that the LCR “should enable the bank to survive until day 30 of the proposed stress scenario, by which time it is assumed that appropriate actions can be taken by management and/or supervisors, and/or the bank can be resolved in an orderly way.” Furthermore, no reference is made that the liquidity buffer can be used in times of stress to alleviate funding pressures leaving the reader with the impression that the LCR is there to ensure funding for the gone concern, and implying a need for a “buffer on top of a buffer”.

Also, we caution against applying adjustment factors that reflect severe stress results in the computation of the LCR. This approach creates the impression that a quantum of liquidity must be held against all possible stress events and ignores the fact that liquid assets will be used up over the course of the stress event. We are also concerned that by setting a minimum stress based LCR, regulators create a self defeating ratio, whatever the definition of the liquidity buffer. If a firm is not permitted to fall below the minimum ratio, it cannot use the assets in the buffer in just the circumstances that it needs to. So by inference, the assets are no longer liquid.

Liquidity buffers

We maintain that liquidity buffers (i.e. the LCR's numerator) as above are there to be used in stressed times to ensure a firm remains a going concern, even if this means the buffer will need to temporarily be run below the levels set by supervisors. We understand that there needs to be an appropriate governance structure and day-to-day oversight for the use of the buffer (and for its level to be considered in the light of other liquidity measures and metrics). If there is a crisis - which may be measured by the firm triggering certain liquidity or other metric hurdles - then the Contingency Funding Plan (CFP) will be activated internally and, if necessary, supervisors will be advised. Such plans will, of course, include the subsequent rebuilding of the buffer, once the firm's crisis has passed.

We agree that supervisors should be able to challenge the level of the buffer at any one time and that they should be able to satisfy themselves that the appropriate governance processes to control the buffer are in place.

Term of Funding

Some of our membership would also like to highlight that the funding requirements of the liquidity buffer should have a tenure that is conservatively longer than the survival period so as to provide sufficient coverage. We agree with the Committee that the LCR buffer and supporting funding should be separated from other activities. However, to ensure liquidity, the buffer needs stable funding and under the Committee proposals elements of the liquidity buffer (i.e. qualifying marketable securities from sovereigns, central banks, public sector entities, and multi-lateral development banks) only require 5% stable funding (Table 2 of BCBS 165). By implication, 95% of these could be funded at 1 month and 1 day thereby

exposing the LCR to a potential cliff effect with funding of the buffer running out in 1 month. Conservative funding of the LCR, therefore could be regarded as out to 90 days.

Qualitative Variables in LCR

It would appear that paragraph 19 imposes “more stringent standards or parameters” on the supervisory assessment of a firm’s compliance with Committee Sound Liquidity Principles, however the proposed framework is silent on benefits or incentives for good liquidity risk management practices. We would encourage the Committee to consider how the qualitative and quantitative elements of its proposed framework, in connection with its *Sound Liquidity Principles*, could be used to encourage firms to improve their modelling techniques.

Prescription of LCR Assumptions

We are of the view that the Committee is overly prescriptive in setting behavioural overlays applying to outflows and inflows particularly given the difficulty in defining stable vs. non stable sources of funds. We urge the Committee to remember that there is a multi-dimensional liquidity spectrum across different types of depositors and types of products. So to draw hard lines within that spectrum and apply behavioural overlays to each segment may create dysfunctional behaviour in the evaluation of the liquidity risk and hence, ultimately, pricing.

It would be helpful for the Committee to explain how the percentages for the outflows and inflows were derived – they do seem a bit ad-hoc. In many cases they appear even more severe than experienced during the recent crisis. In particular we believe some of the percentages relating to undrawn facilities are completely unrealistic while also being asymmetric, depending on whether the facility is being given or received, and fail to take account of the nature of the facilities. By publishing prescribed outflows the Committee takes away from an institution the ability to set its own liquidity risk appetite and dictates the way in which the industry will value different types of funding. We are concerned that regulatory arbitrage will occur and dysfunctional pricing will follow.

We propose that firms use their own behavioural assumptions. Where a supervisor disagrees with a firm’s assumptions or risk management practices, or the institution lacks the requisite modelling ability the Committee’s outflow and inflow factors would then apply.

Definition of the metric (para 21-25)

In principle we agree with the formula set for the LCR but we are concerned by the narrow range of assets eligible for the liquidity buffer, and the stress scenarios being applied both in terms of their severity and formulation.

We would therefore recommend at least one of the following alternatives:

- a) Widen the list of qualifying liquid assets in numerator.
- b) Split the 30 day time horizon into two phases and adopt a tiered approach to the buffer aligned to these phases with a wider list of qualifying liquid assets available in the second tier.
- c) Create two tiers of qualifying liquid assets with a wider list of qualifying liquid assets available in the second tier.
- d) Recognise a wider range of assets in the denominator
- e) Reduce the severity of the net outflow assumptions

We recognise the Committee's concerns about a) so we wish to signal our preference to b) and c). An alternative compromise is d) and e). With regard to option b) we believe that a 30 day time horizon under an acute liquidity stress scenario is overly excessive and recommend a split of this period into a 15 day period combined stress scenario followed by another 15 day period with a moderate market wide stress. In this split the first 15 day period would require a narrow range of liquid assets as currently proposed while the second 15 day period could include a wider range of assets for the numerator as discussed below under definition of liquid assets.

With regard to option a), b) and c) we suggest that the following assets should be included as qualifying liquid assets in the liquidity buffer:

- Precious Metals
- Commodities
- Bank Paper
- Corporate Bonds
- Covered Bonds
- Equities
- Government sponsored paper

Recognising that the Committee may not have the appetite to widen the range of assets for inclusion in the liquidity buffer, we also offer option d) and suggest that the above list of assets be recognised in the denominator to count towards the net inflows.

In this approach a narrow definition of the liquidity buffer remains for the numerator. However, a firm would be allowed to bring forward the haircut value of unencumbered less liquid securities in the mismatch ladder in accordance with the time taken to sell/repo them at a value consistent with the stressed environment.

In terms of option e), we make this recommendation independently of the view that firms should be using their own estimates and suggest that the Committee's severity assumptions (paragraph 22 of BCBS 165) are overly draconian. For example regarding paragraph 22.a) we agree that 100% of the additional collateral should be included although we would argue that this should be considered against a 2 notch downgrade for the purposes of the published measure. We do, however, recognise that banks must be able to identify downgrade levels where any significant additional liquidity is required and that this should be shared with the bank's regulator (and, of course, through its own risk management governance). For this purpose firms should identify factors such as the proximity of its current credit rating to the non-investment grade level. We expand further below under **Net Cash Outflows** on option e).

Characteristics of high quality liquid assets (para 28-33)

We agree with the Committee on the characteristics of a liquid asset, but we would point out that a large firm must be seen by the market to be trading the asset for it to be liquid. This will reduce the risk that the sudden sale or repo of a new asset class by the firm will result in reputation risk which will only exacerbate the liquidity problem.

For smaller firms we stress the need for a proportional approach as trading in the markets is costly and resource intensive. Smaller banks are concerned about not having repo capabilities for government bonds to test their CFP. Thus we urge that some allowances be made for smaller firms to test their CFPs without executing costly transactions. In practice these concerns could be alleviated by allowing smaller banks access to central bank reserve

accounts and permitting the use of money market funds for liquidity purposes if they invest in government bonds.

Central bank eligibility criteria: We note that the Committee is of the view that high quality assets should also ideally be eligible at central banks, and although some allowance is made for a wider definition of acceptable liquid assets in jurisdictions where central bank eligibility is limited to an extremely narrow list of assets, we urge the Committee to include those assets that central banks accept during normal times as counting towards the stock of liquid assets. Being accepted by central banks during normal times is an appropriate indicator of liquidity and one that will reinforce their acceptability in the open marketplace.

We understand the Committee's proposed criteria, that liquid assets be central bank eligible, is intrinsically linked to a broader debate, i.e. the role of central banks in resolving financial crises. We fully agree that central banks should not be considered as lenders of *first* resort and that the liquidity buffers should, therefore, be populated by suitable assets that can be liquefied directly into the markets. We also understand that central banks would wish banks to restrain from relying on emergency facilities to obtain liquidity, although banks are none-the-less encouraged to test the central banks' effectiveness in providing liquidity against eligible assets on a regular basis. One of the main issues to be addressed within the framework of such a discussion is if prudential measures in the area of risk liquidity management would indeed be an appropriate instrument to achieve central banks' objectives.

We are strongly convinced that the liquidity of an asset does not only depend on its quality but also on the market infrastructure. This view is supported by experience drawn from the recent crisis: markets in certain assets, which probably did not meet the requirements which are being proposed in the Consultation, nevertheless remained liquid because the infrastructures through which they were traded ensured anonymity and had established links with central banks. On this ground, we believe that the Committee should adopt a more balanced view: instead of relying on the proposed distinction between highly liquid and less liquid instruments, more emphasis should be put on funding channels and exchanges which remained available to counterparties during the crisis and through which firms were able to obtain a high liquidity value for their collateral.

We strongly agree with the observation made by the Committee of European Banking Supervisors (CEBS) that "(B)anks should periodically test whether central banks will effectively provide funding against (assets eligible as collateral) and should apply appropriate haircuts to reflect the amount of funding that central banks might actually provide in stressed scenarios (for the assets in question and for the banks themselves). Furthermore, banks will have to demonstrate adequate diversification in the total composition of the buffer so as to guarantee to supervisors that they are not relying too heavily on access to central bank facilities as their main source of liquidity." This would also indicate that a narrow definition of assets considered liquid should not be too narrow.

Definition of liquid assets (para 34-37)

Our comments on the definition of the buffer can be divided into three sets. The first set focuses on cash and government guaranteed paper already recognised in BCBS 165. The second set concerns the case for widening the buffer and the third looks at recognising the marketability of other assets.

Cash: A number of regulators have argued that cash balances are held for the reason that they are necessary to enable payments over the counter and through ATMs etc. In this respect, these holdings have been compared with intraday collateral required for settlement

purposes. We would agree, with the Committee, however, these cash levels move up and down according to a firm's assessment of its liquidity needs and, in times of stress, these are likely to be increased.

Government guaranteed paper: We welcome the recognition that government guaranteed paper and non central government public sector entities can be included (subject to conditions) and also that the Committee recognises the value of paper issued by lower credit rated governments to support liquidity risk in the local currency of that government. We note, however, that in terms of claims guaranteed by sovereigns there has been no attempt to differentiate between the credit worthiness of different sovereigns or the concentration risk associated with the tendency of nationally based financial institutions to hold the government paper of the jurisdiction they operate in. A recent example is Greek sovereign debt which has recently been downgraded. For most firms who may look to raise liquidity through repo, the risk-weighting is not particularly relevant. Therefore linking liquidity value to risk-weighting does not appear to make sense in practice.

We also welcome the recognition in paragraphs 34d and 134 that firms must meet their liquidity needs in each significant currency. That is, liquid assets match foreign currency liabilities. This could imply that the framework allows local liquidity buffers in countries whose government issued paper's credit rating is not high enough to qualify in the liquidity buffer. For example, a net outflow in Indian rupees matched by Indian government securities with a market value greater than the stress net outflow, should count as part of the liquidity buffer. However, India's sovereign credit rating does not meet the criteria as set out in 34c (i) of a 0% risk weight for credit risk under the standardised approach, so the Committee's proposed intent is unclear.

We encourage the Committee to allow the highest corresponding government bonds to qualify in the liquidity buffers so they can match respective foreign currency exposures which are appropriate to where a bank operates. This is especially important for firms active in emerging markets.

Furthermore, we note that it is not uncommon for local liquidity regulation to require banks to hold a stock of local liquid assets and/or deposits with central banks to meet local liquidity requirements.

Widening the buffer

Taken together with the treatment of debt securities, the liquidity buffer is too narrow. This has a number of consequences:

- Firms will not be able to diversify their liquidity risk against a market wide stress event thereby creating concentration risk. There is a scenario where all banks are trying to sell or repo the same type of assets at the same time. (We appreciate that, at least at present, there is no shortage of government securities but that could change.)
- Where securities of a particular government become ineligible e.g. due to a downgrade, there will be significant market disruption as banks seek to rebalance their portfolios.
- Assets not in the buffer become less marketable making it harder to fund certain markets (e.g. the mortgage market)

Our comments on the narrowness of the buffer and the inclusion of a wider set of assets are, in part, referenced to the experience that during a crisis there may be a wide range of assets which continue to trade but with wider spreads. So the issue should not be their blanket exclusion, but their liquidity potential demonstrated by the haircuts, where the haircut

represents the level of the market's acceptance of the liquidity of the asset, and perceived credit risk of the counterparty. Other factors to consider for the calculation of the haircut should include:

- The period over which the asset might be sold. On one hand the longer the period to offer for sale the less forced-sale risk, on the other, however, the greater the risk that the underlying market price moves against the seller.
- The periodicity that the firm marks the asset to market. It cannot be assumed all firms will necessarily mark to market each and every asset daily.

As pointed out above we also believe that more consideration needs to be given to diversification. For example, under the current formulation of the buffer, concentration risk will likely arise from institutions looking for the same 'cheapest to deliver' assets. A broader range of assets will help to ensure that the buffer operates across different liquidity scenarios and avoids concentrations in particular government instruments and also does not risk creating incentives for the behavioural patterns that might intensify a liquidity squeeze.

Also we argue that over a longer survival period (i.e. beyond 15 days of stress) the pool of marketable assets that are saleable is wider. We suggest that assets that should be considered for inclusion in the buffer beyond 15 days are:

Corporate and Covered Bonds: In response to Committee's consideration of corporate and covered bonds (para 35), we are of the view that a broader definition of the buffer should include these instruments.

We argue that any haircuts applied should reflect observed price volatility, particularly during the crisis. With regard to the proposed haircuts in (para 36 and 37) we ask how these have been calculated. Moreover the requirement that these instruments have 10 years of history to prove their reliability excludes a large proportion. For some corporate and covered bonds, a 3-5 year data history would be sufficient, although a haircut of 25% would likely apply.

We suggest that a better way to look at the eligibility of covered and corporate bonds would be to require firms to assess them by instrument type subject to the firm being able to demonstrate that it regularly trades the asset by sale and/or repo. Firms not able to undertake these assessments but regularly trading the asset would then be subject to standardised haircuts.

Government sponsored paper: We urge the Committee to expand the buffer so that government agency paper, such as FNMA (i.e. Fannie Mae) and FNLMC (i.e. Freddie Mac) corporate debt and mortgage-back securities, are included. These securities represent a very large, liquid and important international market, with well-developed repo and financing frameworks (consider that they are eligible central bank collateral in the US) and generally proved to be extremely liquid in times of stress.

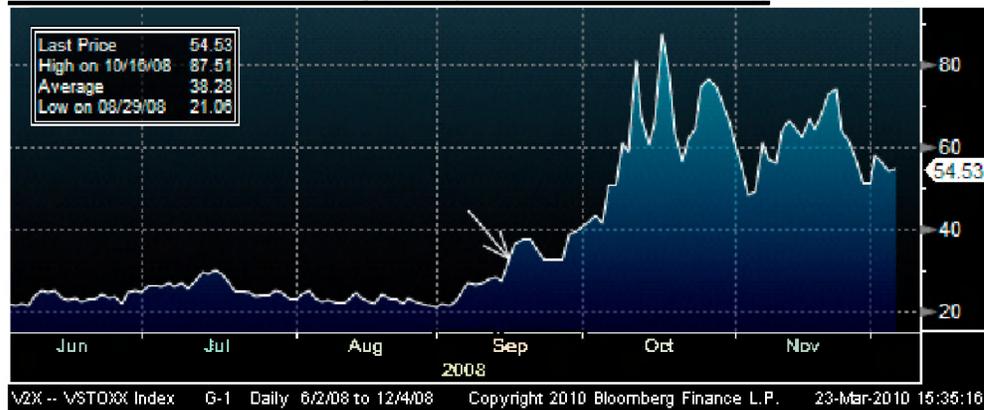
Recognising the marketability of other assets

Equities: We encourage further supervisory dialogue on the inclusion of equities, above a suitable quality threshold and with a suitable haircut. Our members are concerned that Committee's proposal will greatly hamper equity markets liquidity and efficiency, with consequent impacts to the global economy. Additionally, our members believe that the Committee's exclusion of equities seems particularly harsh and more consideration should be given to the liquidity of these markets and their resiliency. Consider, for instance, that during the recent crisis:

- a) Trading volumes for major indexes remained considerable, showing the equities could be disposed of and monetised.
- b) Secured financing/ E4E (equity for equity) trades in primary index equities continued on these assets (and although some haircuts were eventually applied the market did not lock up)

Moreover, in the aftermath of Lehman's demise equity markets primary equity markets continued to function and facilitated a significant de-leveraging that occurred across the hedge fund and banking sectors; this resiliency is somewhat explained by the significant level of shorts that were outstanding and also closed out during this period, aiding price discovery and providing market liquidity.

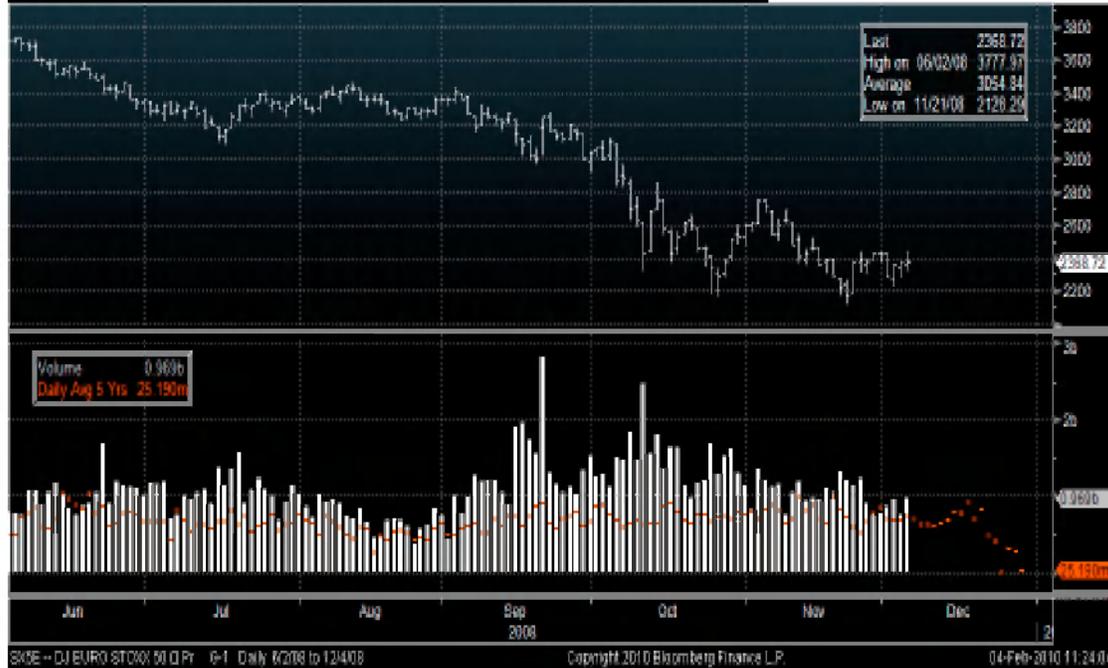
Exhibit 1: V2X - Stoxx Volatility Index (2 June 2008 – 4 Dec 2008)



As shown above, market volatility clearly spiked in the aftermath, although it did take several weeks to peak.

The extent of the market de-leveraging that occurred is best illustrated by the SBL market data sourced from Dataexplorers which valued the total equity securities lending market in August 2008 at \$3.34trillion. By October 2008 this figure was \$2.3trillion and by Jan 2009 \$1.8trillion, which has remained roughly the total to date. Widespread de-leveraging, especially by hedge funds, explains the reduction seen, although the market remains substantial.

Exhibit 2: Euro Stoxx 50 Price Index (2 June 2008- 4 Dec 2008)¹³



The size and depth of the equity securities lending market supports asset funding (collateral deployment). Whilst we clearly acknowledge that lower quality assets and certain secured funding transactions (such as triparty repo and upgrade trades) are unlikely to be resilient during a stress or crisis, we do believe that high quality (primary index) equities deployed to stock loan counterparties (equity-for-equity or “E4E”) are resilient, even though the market standard contractual maturity is “open”.

Daily mark-to-market collateral implicit in these stock loan transactions assures counterparties that haircut protection is maintained. Risk management practices within the stock loan community held up well during the market crisis and have continued to evolve with lenders more inclined to accept positively correlated collateral, increasing the opportunity for resilient equities funding.

Precious Metals and Commodities: Gold is included in the NSFR ratio with a risk weight of 50%, but is excluded in the LCR as a liquid asset. We suggest including gold and other precious metals as well as commodities in a wider definition of the liquidity buffers, subject to the application of an appropriate haircut. We would further argue that gold has a rich tradition in banking and that in times crisis there is normally a flight to gold, so we also question how the Committee arrived at the 50% treatment of gold under the NSFR.¹⁴

¹³ Similar pictures exist for FTSE100, CAC40, DAX and Nikkei225.

¹⁴ We note that the World Council in its response to BCBS 165 provides a wealth of empirical evidence showing that gold “...not only fits comfortably into this category, but that it would contribute to the counter-cyclicality of the new liquidity measures and that the application of a 50% RSF is wholly inappropriate and punitive in comparison to the historical treatment of gold in EU and US regulatory legislation.”

Bank Paper: Currently corporate bonds issued by banks, investment and insurance firms are excluded from the buffer. We appreciate that this exclusion is motivated by concerns that this could be a source of artificially inflated liquidity in the system and wrong way risk (where two or more banks issue assets to each other). Nevertheless, we believe there is an argument for smaller banks, at least, to be given value for holding the paper of larger banks. It is true that during the recent crisis such paper became difficult to sell, but for idiosyncratic stress scenarios smaller banks' holdings of larger banks paper have proved beneficial over a longer time horizon. Moreover, current efforts to strengthen the liquidity and capital positions of larger firms make it more likely that their paper will be marketable in a crisis. In Europe, the position of firms will be further strengthened by large exposure rules, being implemented as part of CRD 2, that will mitigate concentration risk arising from inter-bank funding. A similar logic can be applied to the use of bank bonds to collateralise the payment systems, as the LCR determines the survivability of the banks issuing these bonds.

Net Cash Outflows (38-40)

We are concerned with the level of prescription embedded in the standardised net cash outflow assumption and question whether these present realistic levels of severity and segmentation of retail and wholesale funding flows. In particular we are concerned that pricing will follow the segmentation and that flexibility to design products with a risk/reward payoff reflecting liquidity risk will be reduced. Re-pricing of asset classes may result in some products no longer being offered, notwithstanding that they are useful to companies and retail clients. A further impact to consider is the effect on funding of the mortgage market as haircuts will also drive markets for Mortgage Backed Securities (MBS).

So, especially if the liquidity buffer i.e. stock of high quality of liquid assets, cannot be widened we strongly urge the Committee to dampen the assumptions applied to the LCR's denominator for a standardised approach.

Severity of Assumptions

With regard to the severity of the flows we ask how the percentages were derived as these seem to surpass the experienced net outflows of the recent crisis. In particular, we question how the Committee derived the behavioural assumptions for the run off percentages and urge further assessment of past data that demonstrates how various types of deposits and wholesale funding actually behaved during the crisis to establish more realistic ratios. If the percentages are to be used as an industry standard then it is vital they reflect the recent experience and potential liquidity risks. The first question to be asked is: what is the threshold between a survivable stress scenario and test to destruction. Then firms need to assess what their liquidity risk appetite is.

Segregation of Funding

In terms of the segregation of funding there is no simple split that gives justice to the diverse behaviour and liquidity risk of deposits and wholesale funding. While any greater granularity increase prescription, any less granular segregation ignores varying degrees of liquidity risk and thereby limits pricing and the design of products to fewer categories.

More appropriately, we suggest that firms be required to justify to regulators their behavioural assumptions for their net cash outflows to their respective supervisors. Firms themselves are best placed to set out the basis on which they segment their liquidity categories. We do accept however that supervisors have the right to challenge, and to apply standardised

factors if a firm is unable to justify its own behavioural overlays, appears to be clearly out of line with industry benchmarks and/or is unable to estimate their own behaviour overlays.

Retail deposit run-off (para 41-44)

We are concerned with the prescriptive minimum outflow levels being suggested. We appreciate that the Committee is looking to provide a simple way of calculating this metric but suggest that 7.5% and 15% form a starting point for a discussion on behavioural assumptions. Again we urge further assessment of realistic run-off levels based on past data. The assumptions with respect to deposit run-offs are unrepresentative of any major market and all the more unrealistic and damaging in markets where banks are still able to rely to a substantial degree on retail deposits.

We suggest that supervisors and firms be left to agree how best to break up their categories of retail deposits according to varying degrees of stickiness. We recommend that the Committee should not set the minimum for each class of deposit but leave that to be agreed between supervisor and firm. International consistency should then be achieved in the process and review criteria of an individual firms' approach.

We appreciate that not all firms may have the capability to produce their own behavioural estimates, and a simple option is needed. Such an option would be useful as a benchmark against a firm specific analysis.

We note that paragraph 42 appears to conflict with the statement in paragraph 41 that an effective insurance scheme is not sufficient to consider a deposit "stable", as it suggests that a bank should be able to determine which deposits are covered by insurance in order to identify stable deposits. We agree with the Committee that deposit insurance is neither necessary nor sufficient to represent stability and we would welcome the clarity here.

With regard to paragraph 43 on time deposits we argue that 15 days is sufficiently material as a minimum stress. Any further add-on should be to the supervisory discretion and individual bank's stress testing.

With regard to paragraph 44 on foreign currency deposits we argue that firms should use their own behavioural assessments rather than a supervisor's metric.

Unsecured wholesale funding provided by small business customers: 7.5%, 15% and higher (para 48-50)

Here we make the same arguments about splitting the deposits (between stable and less stable) as we did for retail. But we are further concerned that the Committee have included an aggregate limit (less than € 1 million – see para. 49). Quite often customers will use different products for different purposes and may not therefore move all funds at the same time; particularly they may not move transmission or nostro accounts.

Unsecured wholesale funding provided by non-financial corporate customers, sovereigns, central banks and public sector entities with operational relationships (para 51-53)

We note the recognition that operational (transmission or nostro) accounts should be treated differently from other types of accounts for these types of customers. The fact that the Committee has identified this type of product separately demonstrates the complexity of dividing up funding streams into categories.

Specifically here we disagree with the run-off factor of 25% as it does not at all reflect the average behaviour of non-financial customers. We argue that more professional counterparties are likely to run down their balances quickly as they will have options to use alternative accounts for their operational accounts. On the other hand SMEs will be more reluctant to move such business elsewhere as they are less likely to be multi-banked. Further it is worth noting that more sophisticated corporates will run their operational accounts at minimum levels using cash management systems which need related non-operational accounts which are less likely to be moved.

Again we caution against supervisory prescription and guidance on the segmentation of the liquidity categories as this will impact the liquidity value firms' ascribe to these types of funding and also to their pricing.

Unsecured wholesale funding provided by non-financial corporate customers (para 54)

We caution that by grouping together all these funding types the Committee is in danger of ignoring a wide variety of different behaviours. Firms themselves are best placed to set out the basis on which they segment their liquidity categories. Furthermore, we are of the view that the Committee should not set the minimum for each class of deposit but leave that to be agreed between supervisor and firm dependent upon the way in which the degrees of run-off are broken down and in line with a firm's behavioural assumptions and judgements made by business managers on client relationships.

This approach would avoid any unnecessary granularity and allow firms and regulators the maximum flexibility to reflect true liquidity risk.

Unsecured wholesale funding provided by other legal entity customers (para 55-56)

This category covers a wide variety of counterparties. We agree that 100% is a reasonable factor for some in the group but we suggest that further consideration needs to be given to this group and in particular the treatment of sovereigns and central banks. A framework that allows firms to use internal estimates would provide the flexibility needed. If this route is not adopted we suggest that this category be refined and the run-off factors reviewed.

Secured funding run-off (para 57-59)

As currently drafted under the proposals, it is our understanding that repurchase, reverse repurchase and secured lending are treated on a transaction basis. If the transaction is backed with illiquid assets, it is assumed that both the cash and the security are lost and the transaction attracts an outflow factor of 100%. However, if backed by liquid assets, it is assumed that the transaction gets rolled over and attracts an outflow factor of 0%.

We strongly recommend that the rules for these transactions be reformulated to recognise both legs of these transactions, separating the flow of cash from the flow of the underlying security. We suggest that at the maturity, a repo of high quality assets should be treated as an outflow of cash and an inflow of the security (similarly a reverse repo would show the outflow of a security and an inflow of cash). The cash outflow can then be treated as an unsecured outflow whilst the return of the collateral can be reviewed dependent upon the nature of that collateral. Similarly we would suggest that, at maturity, reverse repo transactions be split between the return of cash and the delivery of collateral. By netting the cash positions and collateral positions and separating them, firms and supervisors would obtain a more comprehensive view of the firm's changing liquidity risk patterns.

We also suggest that the cash be split out by security and the securities be split out by issuer. This would introduce greater risk sensitivity into the framework.

We also note that a long position in a security would need to be split between the cash returned at maturity in the cash ladder and the surrender of the bond in the security ladder.

Additional requirements (para 60-70)

Downgrade triggers: With regards to **'Increased liquidity needs related to downgrade triggers embedded in short term financing transactions, derivatives and other contracts'**, we suggest that the framework needs to shape the rules to reflect the actual triggers in the contracts, to avoid the outcome of rules applying to contracts where a trigger has not been activated. We recognise that banks must be able to identify downgrade levels where any significant additional liquidity is required and that this information should be shared with the bank's supervisor (and, of course, through its risk management governance). For this purpose firms should identify factors such as locality of markets and its current credit rating as impacts will differ.

Increased liquidity needs related to market valuation changes on derivative transactions. It is not clear why there should be national discretion on this potential outflow when other overlays have been prescribed by the Committee.

Increased liquidity needs related to the potential for valuation changes on posted collateral securing derivative transactions. We ask the Committee how the 20% figure was calculated given that collateral could be anything from cash to commercial paper. The Committee appears to be treating derivatives, under the LCR, on a contract basis. We suggest that derivatives need to be treated on a mark-to-market and margin posted and received basis.

Draws on committed credit and liquidity facilities. We accept that a firm should consider the possibility that at least some of their undrawn committed facilities will be drawn down in normal circumstances and that the pattern of drawdown may change in differing stress scenarios. As the possibility to raise funds in the markets dries up in the stress scenario then a bank will need to be able to liquidate a proportion of its liquidity buffer if it is to meet those commitments.

Whilst we therefore agree that liquidity facilities (which we take to be facilities of a revolving nature) may not be repaid during the course of a scenario of the type envisaged, we do not, however, agree that there will necessarily be an additional draw on such facilities of the magnitude envisaged. The experience for use of such facilities by non financial corporate customers has been that drawings were well short of the proposed 100% level. Non-financial organisations use such facilities as working capital and the stress scenario does not lead to increased drawdown of such facilities to any great extent.

On the other hand, for credit facilities, a higher level of drawdown may be expected as they represent drawings for specific purposes. In normal (let alone stress scenarios) it is plausible that at least some of these draw in full over defined periods. For example, where the facilities relate to pipeline risk firms would expect a higher level of drawdown as illustrated by mortgage pipelines which tend to be drawn over a 3-6 month period. We therefore question the basis on which the percentages suggested by the Committee have been calculated.

Turning to facilities granted to finance companies we would make a distinction between those relating to banks (or bank SPVs) and those relating to other financial businesses. We agree that those relating to banks should carry a 100% draw. The scenario is clear that

there is stress in the market and all banks are likely to fully draw their lines. Of course, the corollary to this is that writing of such lines is likely to be unattractive to banks. For other financial firms a similar argument can be made as for facilities to corporate clients.

Finally, we note inconsistencies in paragraph 66 a) to d) which has weightings of 10 -100% for the expected outflow of various credit and liquidity facilities. But paragraph 76 states that the inflows from similar facilities held with other banks are taken as 0%, as it is assumed the other bank may not be in a position to honour credit lines.

As above, we recommend that assumptions should be set by firms based on their own experience and subject to supervisory approval. There is also a need to clearly distinguish between credit and liquidity facilities.

Cash Inflows

Retail inflows (para 73)

We believe there is a need to make adjustment to contractual flows particularly in respect of products offering revolving credit. For example overdrafts in the UK are contractually repayable on demand but in practice are not demanded. Credit card receivables have contractual minimum repayments but some customers pay more than this. We suggest that the answer is to allow some national discretion.

Wholesale inflows (para 74)

See below under reverse repos and secured lending.

Reverse repos and secured lending (para 75)

As per our comments on paragraphs 57 - 59, we suggest that reverse repos and secured lending be considered in terms of their separate legs rather than on a transaction basis. This would allow credit to be given for cash coming into the firm at the maturity date of the reverse repo or securities lending agreement and avoid the following counter intuitive result implied by the proposal, i.e. that a loan maturing in one month and secured with government debt will not be treated as an inflow, whereas an unsecured loan due to mature within a month will be treated as an inflow.

Lines of credit (para 76)

We note that the treatment of undrawn liquidity facilities is asymmetric. If a firm is a drawer of a liquidity facility it cannot include this as an inflow. We argue a firm should be able to include undrawn liquidity facilities with risk weights and net positions based on their own assessments and subject to supervisory approval.

Other cashflows (para 77)

Note in reference to paragraph 63 the Committee appears to be treating derivatives, under the LCR, on a contract basis. We suggest that that derivatives need to be treated on a mark-to-market and margin posted and received basis.

3.2 Comments on Net Stable Funding Ratio (NSFR)

Objective (para. 78-79)

We support the Committee's overall aim to encourage more medium and long term funding and we welcome a measure that considers stable funding and liabilities. However, the current formulation of the NSFR (ratio of available stable funding over required stable funding) presents a number of outcomes that we question. To this end, we draw the Committee's attention to the below examples recognising that the final example maybe be an intended result. These examples are based on our interpretation of the available stability (ASF) and required stable funding (RSF) tables appearing in Annexes 2 and 3 and Tables 1 and 2 (pages 21 and 23) of the document.

- According to Annex 3 and paragraph 88 a corporate bond rated AA and financed with three month commercial paper sold to a non-financial corporate has an NSFR of 250% (50% available stable funding (ASF) for commercial paper/ 20% RSF for the corporate bond), while the same asset financed with nine month repo has an NSFR of 0% (0% as per paragraph 88/20% RSF for the corporate bond). So, the NSFR makes it more advantageous for a bank to finance an AA-rated corporate bond with the sale of three month commercial paper than nine month securities repo, while the commercial paper can be sold back and the repo cannot be unwound early. It is counter intuitive that locked in funding is treated more harshly.
- In reference to Annex 2, a blue chip equity security requires more stable funding (50% or 100% depending on whether the criteria laid out for the 50% bucket is met) than an equivalently sized unsecured nine month loan to a hedge fund (0%). This result is counter intuitive as the treatment appears unaligned to the risks associated with these assets.
- Under Annex 3, a renewable nine month unsecured loan to a hedge fund (which the bank has an irrevocable right to call) is assigned a 0% RSF while an identically termed loan secured with blue chip equities attracts either a 50% RSF or 100% RSF (depending on whether the criteria outlined in Annex 2 for the 50% RSF are met). As a consequence of the treatment of collateral, a financial services firm may find that it prefers to extend the loan to the hedge fund over the secured loan although a secured loan is more prudent from a credit and financing risk management perspective.
- Under Annex 3, it would appear that secured borrowings are penalised attracting an ASF of 0% (for the cash borrowed by the firm) and an RSF ranging from 5% (for governments) to 100% (for most non-government assets) for the securities lent to finance the borrowing. This treatment could mean the end of secured borrowing as it ignores the true stability of funding offered by certain types of secured borrowing and overstates the stickiness of many assets that are regularly liquidated in the normal course of business.
- Under Annex 2, unencumbered marketable securities (representing claims or governments or alike) with residual maturity of 1 year or greater attracts a required stability factor (RSF) of 5% factor whereas a mortgage with say 7 years left on it would attract a 100% RSF (as it would fall into the 'all other assets category'). So, it appears that the securities dealing business is favoured over straight retail lending which requires more stable funding. The result is the same for commercial lending

where the securities dealing business also appears to be favoured. This indicates to us that precise calibration is important and required.

The above examples point to a number of possible outcomes. Namely, funding will be available from fewer sources/counterparties; less prudent credit activity will be incentivised; and secured borrowing could disappear; and, in some instances investment banking will be encouraged over retail or commercial banking although retail deposits are favoured from a stability of funding perspective (i.e. under Annex 2, we can also see that retail deposits of < 1 year are treated more favourably than wholesale funding);

We may have misunderstood the NSFR Tables and Annexes. However, we would suggest that this points to a need for the Committee to engage with the industry on the NSFR in terms of its formulation and calibration.

The definition of the metric (para. 80-86)

In addition to the odd outcomes intended or unintended by the Committee, the proposed NSFR is overly complex and spuriously inaccurate. In regard to the Available Stable Funding (ASF) factors, why have 5 categories and not 10, why 85% for retail deposits and not 80%? Similar comments could be made about the Required Stable Funding (RSF) factors.

To assess the NSFR with regard to individual business models and stable funding needs, we suggest that Committee develop an appropriately calibrated and sophisticated risk sensitive measure that could better reflect firm specific factors. In setting its liquidity risk appetite an institution is balancing between prudence on the one hand and the level of maturity transformation on the other. We see this measure adding value in incentivising firms to better understand their long term liquidity risk and innovate and update their liquidity risk management practices.

We note that paragraph 83 suggest that the NSFR "...is to ensure stable funding on an ongoing, viable entity basis, over one year in an extended firm-specific stress scenario..." Thus, we argue it is necessary to subject the NSFR to different and varying scenarios to show how maturity transformation changes under institution specific stress. We also stress that the scenario needs to allow for mitigating actions (e.g. phase out of non-core businesses and the use of normal central bank facilities) and be appropriately calibrated

Definition of available stable funding/Table 1 Components of Available Stable Funding and Associated ASF Factors (para.82-86)

As implied above, with regard to paragraph 83, we believe that the stress assumptions (e.g. a potential downgrade in a debt, counterparty credit or deposit rating) are misplaced because they distort the snapshot of the funding relationship.

Also we note that paragraph 84 states that term central bank crisis funding should be excluded from this measure. We agree that reliance on central bank funding is to be discouraged, outside the regular market operations undertaken by the central banks in normal times; however, with the market as it is, we believe it would be unrealistic for institutions to replace such crisis funding in the near term by funding from the market. We therefore suggest some form of grandfathering. Also, we note again that paragraph 83 suggests that the NSFR "...is to ensure stable funding on an ongoing, viable entity basis, over one year in an extended firm-specific stress scenario..." Thus we would argue that normal central bank funding should be assumed.

Turning to the proposed ratios for ASF in Table 1 Components of Available Stable Funding and Associated ASF Factors we again question the Committee on how they derived the factors.

We also note following points:

- On the application of the factors, we assume that they are applied before the LCR run-off factors. It would be helpful for the Committee to confirm.
- On category 2 (ASF 85%), we note that:
 - This is just double the 7.5% used for such deposits in the LCR.
 - We would welcome an explanation of the basis for the weighting which implies 7.5% of such deposits might run off in the 1 month to 1 year period after 7.5% ran off in the 1 month period.
 - Would it not be simpler to recognise these are stable deposits and not introduce stress test assumptions at all?
- On category 3 (ASF factor 70%) we would again make the point that introducing stress test percentages for this relatively sticky funding gives the ratio a possibly misleading degree of accuracy.
- On category 4, non financial corporate clients cover a large range of entities covering small corporate businesses with less sophisticated treasury functions and larger corporates with advanced cash management functions. Indeed many large corporate companies operate professional treasuries and this form of funding would better be treated as volatile. The exact nature of non-financial corporates would be better assessed with the help of historical data and judgement of senior account managers.
- On category 5, see our discussion of repos and reverse repos and derivatives.

Definition of required stable funding for assets and off-balance sheet exposures/Table 3 (para. 87-91)

As stated above we suggest that the RSF in the denominator needs to consist of the unstressed amounts of balance sheet assets which require term funding.

With regard to paragraph 87, where it states that the "...RSF factor applied to the reported values of each asset or OBS exposure is the amount of that item that supervisors believe should be supported with stable funding," we are concerned about potential divergence of RSF factors and national discretions. It would be useful if the Committee could clarify how they intend to progress harmonised definitions of RSF factors.

In Table 2 we question where the Committee has drawn their figures from. With regard to the RSF factors and their respective composition of asset categories we make the following points:

On the 0% RSF factor line we note that clearing and settlement accounts should be included.

On the 20% RSF factor as under the LCR with regard to covered and corporate bonds, we urge the Committee to re-assess criteria of stable funding for these categories. The treatment should be consistent with their treatment under the LCR.

On the 50% RSF factors we are not clear why loans to non-financial clients require 50% stable funding. We assume this may be based on the assumption that some loans represent

working capital and are of a non maturity nature, some will roll at maturity and some will be non-performing. We would welcome details on how the 50% figure has been calculated.

Also we see, as mentioned under the LCR, that there is a case for other precious metals, commodities, equities (i.e. part of a major index) and precious metals as well as reverse repos with non-financial corporates to be included, with a suitable weighting.

We would welcome an explanation on how the 85% figure for retail loans has been derived.

The treatment of repos and reverses

A more explicit discussion of the proposed treatment of repos and reverse repos is required. Paragraph 88 appears to state that 'repo-like' transactions are excluded from the NSFR's encumbrance definition. We ask that the full scope of 'repo-like' needs clarification including whether the exemption applies to reverse repos.

The scope of these exemptions is important particularly given our current understanding of how secured borrowing and lending are treated under the NSFR tables. As already stated, it would appear that secured borrowings are penalised attracting an ASF of 0% (for the cash borrowed by the firm) and a RSF ranging from 5% (for governments) to 100% (for most non-government assets) for the securities lent to finance the borrowing. Similarly, consider that secured lending to financials for a period less than a year appears to attract a 0% RSF for the loan plus and RSF percentage for the collateral (which is held by the firm as 'unencumbered marketable securities' available to the firm for financing requiring an RSF) which is 100% for most non-government assets.

The treatment of derivatives

The proposed framework lacks an explicit discussion of derivatives and we suggest that a full discussion is needed. It would appear that under the NSFR derivatives fall into the 'all other liabilities and equities' 0% ASF bucket and 'all other assets' 100% RSF bucket implying that they have no value as source of stable funding and require 100% support. We suggest that this treatment needs to differentiate between types of derivative transactions (e.g. interest rate products and FX products). The framework is also silent on whether netting is permitted, although it would seem from the BCBS QIS FAQs document that netting on a counterparty basis is allowed.

Similar to our comments on the treatment of derivatives for the purposes of the LCR, we think it would be sensible if the RSF applies to the derivative receivables on a netted basis (by counterparty) and net of any rehypable collateral received (i.e. collateral to which a firm has rehypothecation rights).

Off balance sheet activities

In regard to Table 3 and the treatment of off balance sheet (OBS) activities, we note that (paragraph 87) that the RSF factors to be applied are to be determined by national supervisors. This is in stark contrast to the treatment of other instruments in the proposals. Moreover (paragraph 90) suggests that an extra reserve is being required for these activities.

3.3 Comments on Monitoring Tools

We welcome the Committee's proposal for a consistent set of monitoring metrics. This will assist colleges of supervisors in looking at the liquidity risk in global banks and create a common language, reducing the risk of misinterpretation of information by boards and senior management, commentators and supervisors. It will also have the added advantage of reducing systems costs in reporting liquidity risk being run by such entities.

Against this backdrop, we particularly welcome the initiative taken by the CEBS Task Force on Liquidity Risk Management to develop a "Liquidity Identity Card" which is meant to help supervisory colleges to develop a common language and consistent processes in this area. This will improve mutual communication amongst the members of supervisory colleges and contribute to a more efficient treatment of cross-border firms. The final version of the Committee's paper should draw inspiration from this initiative and expand its use on a global level.

We urge national regulators and the Committee to develop and agree a standard reporting template from which supervisors can request individual firm relevant information. This would help to guard against an outcome whereby firms are faced with different reporting requirements across jurisdictions and are faced with building multiple reporting platforms. It would also encourage transparency and support supervisors and senior management awareness of the liquidity position of a firm.

Thus, we welcome the Committee's recognition that the monitoring, management and control of liquidity requires institutions and regulators to look at a number of metrics, to review the trends within those metrics and to review the inter-relationship of the differing metrics.

When considering a list of common liquidity indicators we acknowledge that there is a wide array of liquidity metrics to choose from. However, some metrics will be more or less relevant for each individual firm. Thus, we propose that a starting point would be to develop a maximum harmonised list of liquidity measures that would serve as a menu for regulators to choose from when considering a cross border group. The first discussion of a college of supervisors then could be to focus on identifying relevant liquidity metrics for the cross-border bank in question. We envisage that a harmonised liquidity reporting menu would cover:

- (i) Loan-to-Deposit ratio
- (ii) Liquidity risk factor (also known as maturity transformation) average tenor of assets to average tenor of liabilities
- (iii) Inter-entity funding report for Group and consolidated banking entities
- (iv) Pricing data
- (v) Currency analysis
- (vi) Funding Concentration Report, indicating extent of reliance on single sources of funds (e.g., top 5 biggest single sources, by sector and individual firm/customer, and if within limits if the firm had set a limit of no more than (say) 10% of funds from one single source)
- (vii) Report on the amount of funding capacity that exists after taking into account the headroom required to survive a stress event (whether firm-specific or market-wide), the extent that existing liabilities and assets will be rolled over and the amount of new business put on, over a given period of time. We call this metric the "Surplus Funding Capacity" for a bank
- (viii) Weekly Qualitative Report – A descriptive summary of any material detrimental changes to the above metrics (e.g. significant changes in: 1-week and 1-month

liquidity ratios; cash and liquidity gap in Cumulative Liquidity model; the Liquidity Risk Factor; intergroup borrowing/lending position.

We suggest that the BCBS's QIS would be a particular good starting point in the development of a comprehensive list of monitoring tools.

We accept that the development of granular data items is useful for harmonised reporting, but remind the Committee that there is no single approach to assigning any metric or limit to one firm. Supervisors need to be flexible in considering specific metrics on a case by case basis to take account of specific firm liquidity risk. Therefore any harmonised list should only be a starting point for a discussion between a firm and its supervisor.

However, we remain concerned that BCBS 165 includes no discussion of harmonised reporting formats. It is suggested (Paragraph 100) that banks will provide raw data to supervisors but it can not be assumed that banks will provide data in the same way (see Application issues for standards and monitoring tools section).

Concentration of Funding (para 104—116)

With regard to concentration of funding we note that it would be more useful to measure liquidity risk exposures relative to funding of liquidity rather than to the total balance sheet. Also, we note that there is no metric to measure the concentrations of liquid assets in the LCR. We propose a measure as above under the alternative metrics for NSFR which suggests the following:

Unsecured wholesale funding < 1 year

Total deposits + debt securities in issue + capital

With regard to significant counterparties (paragraph 106), we suggest that it would be better to segregate secured vs. unsecured borrowings.

With regard to significant currencies in paragraph 111 we note that significant currencies as defined by 1% of the banks total liabilities would easily qualify all currencies for firms. 15% would be a far more relevant ratio to consider currencies as significant.

Application Issues for standards and monitoring tools

Scope of application

The application of the new framework – i.e. on a consolidated and, potentially, on a legal entity basis as well – is a cause of concern, particularly to cross-border banks which do not tend to organise their management of liquidity risk beyond a legal entity basis.

As outlined in Section 2 of this document, we urge the Committee to develop a harmonised reporting language and format. This would enable cross border firms to provide one single consolidated report that can be shared among supervisors.

In any case we would welcome further clarification on the intended level of reporting. In particular, more clarification would be welcomed on (i) the possibility to off-set liquidity excesses across convertible currency jurisdictions and (ii) how intra-group transactions need to be treated. The Committee should ensure the following:

- Within a single country, the requirements need to be met at a consolidated level only;

- Double counting needs to be avoided across countries, particularly where third-party deposits are concerned.

We recognise that governments will need time to agree on arrangements which foster an optimal flow of liquidity within cross-border banking groups and which would, in particular, lift restrictions to intra-group exposures which are an obstacle to organising liquidity transfers within a banking group in conformity with banks' best practices. Regulators should be aware that the absence of such arrangements may encourage banks that are active across borders to provide services by means of branches instead of subsidiaries.

However, introducing harmonised reporting would be a first step in providing a cross-border supervision framework that could aid the coordination or delegation of task in between supervisors.

Frequency of calculation and reporting

The cost and systems implications of the requirement that metrics should be reported monthly with the flexibility to scale up to weekly or even daily in stressed situations should not be underestimated. Harmonisation in reporting standards and baseline metrics is important for firms. Without harmonised standards, firms are faced with reporting similar information in multiple formats and potentially having to upgrade and / or replace reporting systems as jurisdictions change their requirements. We would encourage the Committee to consider the extent that CEBS's work on Liquidity Identity Cards or the Basel QIS (see monitoring tools) might be used to standardise reporting. Most cross border firms will agree that it would be preferable to have granular and frequent reporting to one format at a group wide level rather than submitting similar data in multiple reporting formats.

Public disclosure (para 135)

As already mentioned, Basel public disclosure requirements are far-reaching. Obviously, disclosing detailed quantitative information on liquidity positions could have negative consequences for the firm, and potentially the financial services sector. The European Central Bank in its discussion paper *EU Banks' Liquidity Stress Testing and Contingency Funding Plans (2008)* has rightfully pointed out:

...public disclosure could have negative repercussions on the liquidity situation of some banks under certain circumstances. While more disclosure, in particular on banks' liquidity risk management, is generally to be encouraged, the BSC considers that, in the case of liquidity stress test results, the detrimental effects of mandatory public disclosure are likely to outweigh the benefits.¹⁵

For example, consider a rumour circulating in the market about a bank which has discovered a "rogue trader". There will be a period when the bank needs to marshal all its liquidity resources whilst it investigates the rumour, confirms or otherwise its truth, quantifies the level of loss and communicates to the market what it means for the firm. During that period the buffer may well be used. A variation on that might be that the rumour has identified the wrong bank.

Furthermore normal flows of cash through the firm due to seasonal and other factors may well see fluctuations in the LCR. Publication of the LCR at specific dates could well show a decrease between one date and another (whilst still showing levels above the minimum) which merely reflect those normal movements but could create unnecessary concern among

¹⁵ <http://www.ecb.int/pub/pdf/other/eubankliquiditystressstesting200811en.pdf>

the uninformed. Moreover, disclosures made on a routine basis under normal conditions provide institutions with less flexibility once the market is under stressed conditions.

For these reasons we believe that the liquidity information (and in particular information relating to the LCR and a firm's use of its liquidity buffer) should only be shared with the regulator and not made public to the wider community. If it is viewed as essential to the Committee, we suggest that these metrics be disclosed in arrears and based on rolling averages computed over an extended time period rather than point-in-time metrics. This would remove contextual information from users of the disclosure and would provide firms with flexibility to use the buffer without raising undue market concern.

4 Other comments

Glossary of terms

The final version of the BCBS 165 paper should include a comprehensive glossary which provides clarity on the terminology used throughout the Paper. This is essential. Items that could be included are:

- Liquidity facilities
- Credit facilities
- Retail notes –are they included as retail deposits
- Marketable assets
- Difference between normal and transferable loans
- Inflows
- Outflows
- NSFR
- Repos
- Reverse Repos
- Derivatives
- Off Balance Sheet

Letters – Tab 5



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Washington, D.C. 20220

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal
Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

The Honorable Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation
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Mr. John G. Walsh
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
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Mr. John E. Bowman
Acting Director
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Mr. William C. Dudley
President
Federal Reserve Bank of New York
33 Liberty Street
New York, New York 10045

Re: Reform of Capital and Liquidity Regulation as Applied to U.S. Banks

Dear Sir or Madam:

The Clearing House Association L.L.C. (“TCH”), an association of major commercial banks,¹ is deeply interested in the U.S. and international initiatives to reform capital and liquidity regulation.² We respectfully submit for your consideration a number of critical issues

¹ Established in 1853, TCH is the United States’ oldest banking association and payments company. It is owned by the world’s largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. TCH is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs, and white papers the interests of its member banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. See TCH’s web page at www.theclearinghouse.org

² See our comment letters dated: (i) April 16, 2010 (responding to the Basel Committee’s consultative document entitled *Strengthening the resilience of the banking sector* (referred to herein as the “December capital proposals”)); (ii) April 16, 2010 (responding to the Basel Committee’s December 2009 consultative

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that we believe require further consideration – some in the context of continuing international negotiations, others in the context of the ensuing national implementation.

To be clear from the outset – *TCH strongly supports current capital and liquidity reform efforts that enhance the quality and quantity of loss absorbing capital and that prescribe rules to prevent over-reliance on short-term funding and encourage more stable funding over a longer time horizon.* We support implementation of these reform efforts promptly after an international agreement is reached, taking into consideration reasonable transition periods that are necessary to mitigate transitional shocks and the negative macroeconomic consequences that might occur.³

document entitled *International framework for liquidity risk measurement, standards and monitoring* (referred to herein as the “**December liquidity proposals**”)); (iii) September 10, 2010 (responding to the Basel Committee’s consultative document entitled *Countercyclical capital buffer proposal*); and (iv) October 1, 2010 (responding to the Basel Committee’s consultative document entitled *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*). We refer herein to the July 26, 2010 release (including the annex) of the Group of Governors and Heads of Supervision (“GHOS”), the oversight body of the Basel Committee, as the “**July Release**”, and the September 12, 2010 release (including annexes) of the GHOS as the “**September Release**”.

TCH has made substantial effort to inform its views with independent analysis. TCH funded a paper by prominent academics to examine the impact of heightened capital requirements on large financial institutions and their customers (Anil K. Kashyap, Jeremy C. Stein and Samuel Hanson, *An Analysis of the Impact of “Substantially Heightened” Capital Requirements on Large Financial Institutions* (May 2010)). We also retained McKinsey & Company, Inc. (“**McKinsey**”) to assist TCH in its analysis of the impact of Basel III on U.S. banks. McKinsey had access to the quantitative impact studies and other confidential data provided by 11 large financial institutions, accounting for 59% of U.S. banking assets at June 30, 2010. References in this letter and the annexes to the “**sample**” mean those 11 banks and the data they provided. The sample data was used to extrapolate certain estimates for the U.S. banking industry at large.

³ Our research suggests that the U.S. banking industry’s Tier 1 common shortfall to full target levels under Basel III is in the \$500 billion to \$600 billion range, with most banks able to address that shortfall reasonably well over the agreed upon transition periods. Our research has further suggested an LCR shortfall to full target levels that is approximately \$1.1 trillion. Bank mitigation efforts to achieve compliance in our view will likely focus on (1) generating and retaining earnings, (2) reduction in “type” of risk weighted assets (*i.e.*, “balance sheet repositioning”), and (3) reduction in overall size of balance sheet (“balance sheet reduction”). It is undeniable that the proposed capital and liquidity rules will have some dampening effect on the economy or shift activity to the unregulated shadow banking system (*e.g.*, securitizations) – both undesirable outcomes. Attempting to quantify or predict the overall impact on the economy was not within the scope of our research or the assistance we sought from McKinsey. Instead our research has been focused on the impact to the banking industry, and the dynamic modeling of the capital and liquidity

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To the extent consistent with published reports and official pronouncements, TCH believes that the Basel III agreements relating to capital are generally on the right track and should overall be a net positive for our financial and capital markets. In our view, the Basel III agreements relating to liquidity, however, require substantially more analysis, consideration and debate. We fully support the observation periods proposed by the Basel Committee, particularly for the new liquidity ratios.

TCH appreciates the efforts of U.S. regulators in the context of international negotiations to achieve the proper trade-off between stability and growth and to promote international consistency. Despite these best efforts, however, there remains a significant number of areas where we continue to have concerns, especially with respect to the details of the LCR and, insofar as capital is concerned, the sanctions that apply to a bank that falls into its capital conservation buffer zone. Moreover, consistency with international standards developed by the Basel Committee should be a desired goal, but not if prescriptive rules, arrived at with the understandable goal of achieving consensus, are unsupported by sound economic analysis, and not if they strike an improper balance or fail to take into account the particular circumstances of U.S. banks, whether as to market and business practices, the infrastructure of our financial system or unique features of our laws, regulations and accounting conventions.

The capital and liquidity framework applicable to banks is a principal driver underlying the safety and soundness of these institutions, and the recent reform efforts have rightly focused on strengthening this framework. When modifying this framework, it is vital to consider the competitive landscape these institutions operate within, the critically important credit intermediation and lending functions they perform, and the impact their efforts to mitigate the effects of changes to the capital and liquidity framework may have on their ability to perform these functions.

To assist in your appreciation of the issues raised, we have summarized our thoughts around three themes – transparency, coordination and consistency. Set forth in the attached annexes is a more detailed discussion of liquidity (Annex 1) and capital (Annex 2) issues that we

proposals. However, it is critically important that the broader task of assessing the consequences for the economy at large be addressed by national regulators and other governmental bodies, with dedication of appropriate resources.

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believe should be re-visited, either in the Basel agreements or in the national implementation process (and, accordingly, the summary below should be read together with the annexes).

We look forward to continuing the dialogue, sharing our quantitative impact analysis⁴ and responding more specifically as the final proposals take shape.

* * *

Summary of TCH Areas of Concern⁵

1. The quantitative analysis and calibration assumptions of the official sector underlying capital and liquidity reform should be more transparent, with quantitative metrics supporting each proposed reform established in advance of implementation to facilitate the monitoring of the macroeconomic effect of these initiatives. In particular:

1.1 The Basel Committee's release of aggregated results of its quantitative impact study in connection with Basel II was critical to market participants' understanding of the impact of Basel II's implementation and the issues it addressed. We believe it is important that the same step be followed for Basel III. Having regulators and market participants work from a common database to the extent possible, taking into account confidentiality concerns, and having regulators clearly explain their thinking in applying the data to the proposals,⁶

⁴ Using data from the sample and other resources, TCH is undertaking further analysis of the impact of Basel III on the banking industry.

⁵ Capitalized terms are used in this summary with the meanings assigned to them in the attached annexes.

⁶ We appreciate the Basel Committee's explanations and discussion in its paper, released on October 25, 2010 and entitled *Calibrating regulatory minimum capital requirements and capital buffers: a top-down approach*. Our members, and industry participants more generally, have been concerned with the quality and consistency of data available to the Basel Committee in calibrating the new standards. This paper candidly acknowledges the data challenges (*e.g.*, "[t]he shortcomings of using cross-country historical data is that they are not perfectly consistent across jurisdictions" (paragraph I.F, page 4); and "... sample sizes vary significantly across countries, as did the number of business cycles included in the data" (paragraph II.A, page 7)). The paper reinforces our concerns as to the quality of the data supporting decision-making.

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enhances communication and, we believe, significantly contributes to a better and more readily accepted outcome.

- 1.2 Our members' experience suggests that the proposed run-off factors for the net cash outflow component of the LCR's denominator may be substantially more conservative than is warranted, particularly in the case of corporate and financial institution deposits. The Basel Committee should publish the data used in establishing the proposed run-off factors and explain the considerations underlying the Committee's decisionmaking (*e.g.*, how differences in run-off experience for similar deposit types in different countries were analyzed or whether the run-off factors were developed using only the experience of banks perceived to be under stress and, if so, how the Committee distinguished between banks whose experience is a good precedent versus those operating under non-precedential circumstances (*e.g.*, Northern Rock)). We look forward to working with the U.S. banking agencies to add more clarity and detail around the deposit and other funds outflow experience of U.S. banks during the financial crisis.
- 1.3 Under the LCR, banks as borrowers are assumed not to be able to draw under facilities provided by other banks, but banks as lenders are required to assume in their LCR calculations that facilities extended to other banks are 100% drawn. The asymmetry does not appear to be supported by quantitative or historical data, but rather appears to reflect a qualitative policy bias against inter-bank borrowing. If international regulators are focused on a broader issue (*i.e.*, whether interbank lending is a good or a bad thing), their concerns should be addressed in that context and not as part of the LCR.
- 1.4 The LCR as currently proposed requires banks to assume that liquidity facilities are 100% drawn. Our members' experience during the financial crisis does not support an assumed draw-down rate anywhere close to 100%. As in the case of run-off factors, the Basel Committee should publish the data used in establishing the assumed 100% draw-down rate and explain the considerations underlying the Committee's decisionmaking. TCH will explore with its members what data may be developed that demonstrates the experience of U.S. banks. These facilities are important to a broad range of borrowers, including states, municipalities, hospitals and other not-for-profit organizations, and corporations. We are concerned with the larger consequences for those

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end-users of limiting the availability of, or raising the cost of, these facilities (discussed further in Section 3 of Annex 1).⁷

- 1.5 The July Release addressed PSE obligations as a liquid asset for LCR purposes by permitting them (with haircuts), but subject to a cap set at 40% of total liquid assets. We believe the cap, as applied to Fannie Mae and Freddie Mac securities, is unnecessary and inappropriate (particularly once the proposed haircut is taken into account). We urge the U.S. banking agencies and other national regulators to explain the rationale for the cap (including the derivation of the 40% limitation, particularly as applied to Fannie Mae and Freddie Mac securities, for which there is a deep market) and, more fundamentally, we believe the cap should be eliminated.
- 1.6 Market participants cannot, of course, evaluate the consequences of a bank falling within its capital conservation buffer zone, or the related need for banks to maintain a capital “cushion” above the buffer zone (and, if so, how large of a cushion),⁸ without knowing the sanctions. The calibration of the buffer and the sanctions must be considered together. We wish to make two fundamental points in this regard. First, we urge the U.S. banking agencies and their international counterparts on the Basel Committee, in considering the appropriate sanctions, to permit national regulators to address sanctions as a Pillar 2 supervisory matter for so long as a bank maintains capital ratios that include the most substantial part of the capital conservation buffer (designated as a threshold level that is a specified percentage of, or a specified percentage below, a fully compliant capital conservation buffer), with mandatory sanctions applying only if a bank’s capital ratios fall below that threshold. Second, the sanctions should be limited to constraints⁹ on capital distributions and should

⁷ The leverage ratio in its current form raises the same issue by requiring that liquidity facilities be converted to an asset equivalent for the denominator in the leverage ratio, using a 100% conversion factor.

⁸ During the period 1998-2009, U.S. bank holding companies with more than \$100 billion in total assets maintained Tier 1 capital ratios on average approximately 170 basis points above the 6.0% “well capitalized” level. Our analysis indicates that each additional 1.0% of Tier 1 common equity that banks may feel compelled to maintain above the minimum requirements (inclusive of the capital conservation buffer) contributes approximately \$78 billion to the U.S. banking industry’s current Tier 1 common shortfall.

⁹ This seems to be what the Basel Committee contemplated in the December 2009 capital proposals (see paragraphs 256-258).

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not include operational constraints of the type included in the U.S. banking agencies' prompt corrective action regulations.

- 1.7 The leverage ratio included in Basel III includes a number of assumptions that seem arbitrary, partly because they were not covered by the data collected in the quantitative impact study. The assumed 100% drawdown on liquidity facilities, discussed above in paragraph 1.3, is an example. Another is the credit conversion factors that will be applied to off-balance-sheet items. The July Release indicates that the Basel Committee agreed to "use uniform credit conversion factors" but, except for the 10% credit conversion factor specified for unconditionally cancellable commitments, did not address how they would be derived or what they would be. As the U.S. banking agencies move to implementing the Basel III leverage test for U.S. banks, our members will be very focused on the many details that have not yet been released and how the U.S. banking agencies address the interplay between the Basel III leverage test and the existing U.S. leverage test. That test should not be combined with the Basel III definitions for the numerator and denominator (and, as a practical matter, cannot be combined given the differences between the two), particularly in view of the language in Section 171 of the Dodd-Frank Act implying that the existing U.S. leverage test may operate as a floor going forward.
- 1.8 Although TCH supports measures to encourage more stable funding over a longer time horizon than is addressed by the LCR, the NSFR as an approach for doing this is deeply flawed. We addressed this at length in our April 16, 2010 letter commenting on the December liquidity proposals. We appreciate the receptivity of the Basel Committee to the concerns we and others raised, reflected in the decision announced as part of the July Release to re-propose the NSFR at year-end and, presumably after a comment period and consideration of industry comments (which we think is very important given the likely magnitude of the changes), target implementation commencing January 1, 2018.¹⁰ We urge U.S. banking agencies and their international counterparts on the Basel Committee, when they re-propose the NSFR, to be as explicit and transparent as

¹⁰ The July Release also provides for an "observation phase" before finalizing and implementing the NSFR, which we fully support, "to address any unintended consequences across business models or funding structures".

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possible in explaining the reasons for the components and the Basel Committee's anticipation of their effects. As part of the revised proposal, they should outline the steps they propose national regulators take to evaluate the NSFR during the observation phase, addressing at least conceptually the types of observations or consequences that may arise that, in the Basel Committee's view, may warrant revisiting the proposal.

2. **Reform of liquidity and capital regulation should proceed in a coordinated fashion and holistically, informed by not only the Basel III proposals but also their interplay with existing capital standards and other sources of capital and liquidity regulation that bear upon their ultimate application, such as Basel II and Basel II.5, Dodd-Frank, newly implemented and proposed changes in accounting standards and the prudential supervisory framework in the U.S. Although our concerns in this area bear more directly on capital reform than liquidity reform, those reforms are conceptually linked and should be considered together. TCH believes that:**
 - 2.1 The treatment of SIFIs, and reconciliation of the Dodd-Frank requirement for "more stringent" capital standards for SIFIs and the Basel Committee's deliberations on the same issue, are among the most difficult largely unresolved areas arising out of capital regulatory reform. Although we look forward to further refining our views on this issue during the coming weeks, we would like to note now a fundamental point – namely, that the mandate for "more stringent" capital standards for SIFIs does not require an additional capital surcharge for SIFIs. Capital stringency should be evaluated in the context of the entire framework of capital regulation, including Basel II, the market risk rules being further revised in Basel II.5, possible differences in the application of parts of the Basel III standards to internationally active banking organizations versus the banking industry as a whole, and possible requirements for contingent capital, bail-in debt or other loss-absorbing instruments that may apply to SIFIs or some other category of large banks but not to all banks.
 - 2.2 The U.S. banking agencies' prompt corrective action regulations will have to be revised to accommodate Basel III, taking into account not only the new definitions of capital and the new calibrations, but also the enhanced focus on Tier 1 common equity. Redefining the PCA rules using new Basel III standards will almost certainly raise challenging issues. We look forward to refining our views on the interplay between Basel III and the U.S. banking agencies' PCA rules

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and would be pleased to discuss this area further with the U.S. banking agencies as our views develop.

2.3 We believe there are at least two aspects of Basel II that should be re-visited and revised as part of the Basel III process, as follows:

2.3.1 The 1.06 multiplier in the Basel II definition of “credit-risk-weighted assets” was added after an early quantitative impact study showed a fall in risk-weighted assets under the Basel II calculations as compared to Basel I. That study had been done very early in the process, before most banks had developed and validated their methods for calculating the credit risk parameters (PDs and LGDs for wholesale and return portfolios). Given the extensive experience that regulators and banks have now had with Basel II’s PD and LGD calculations, we believe the 1.06 multiplier should be revisited and is no longer necessary, particularly in view of the more robust capital standards being implemented through Basel III in any event.

2.3.2 The practical application of the Basel II PD estimates under the A-IRB approach is procyclical. There are two reasons for the procyclicality. First, PDs are calculated through a two-step process that involves categorizing retail and wholesale credits based on credit ratings (which may be internal or external), and then multiplying the categories by an estimated probability of default for each particular ratings category. Ratings are definitionally procyclical, tending to be higher during good periods and lower during bad periods (albeit with some lag as the economy changes). Second, many banks have relatively short-term databases for certain types of credit (particularly retail) that do not yet include a sufficient period to adjust for the disproportionate impact of recent experience (as of today, the financial crisis years) on a truly “through the cycle” basis. There is no single correct solution to the current problems with Basel II’s A-IRB PD estimates. One possible solution, at least as to the limited data point issue, would be to permit a bank to use Basel II’s standardized approach to PDs instead of the A-IRB approach to PDs when the bank’s database is not otherwise sufficient. TCH looks forward to working with the U.S. banking agencies to address this concern more fully.

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- 2.4 Bank regulators should continuously monitor newly implemented and proposed changes to accounting standards that impact capital and liquidity regulation. These include, for example, the FASB's (1) movement in the direction of a lifetime allowance model for loan losses, (2) proposed changes in the classification of investment in debt and equity securities, which will result in all equity securities and many more debt securities being required to be accounted for at fair value with changes in fair value recorded in earnings, and (3) new leasing proposals, all of which will have a significant impact on a bank's capital.
3. **A consistent approach among international banking institutions is critically important to ensure the competitiveness of U.S. banks, with appropriate flexibility for national regulators to mitigate provisions in Basel III that, unless taking into account unique circumstances applicable to U.S. banks, have an unduly harsh impact on our economy. We believe these can be addressed without detracting from the robustness of the new capital and liquidity regime. TCH believes that:**
 - 3.1 The role of the FHLB system, as a liquidity source and a vital component of mortgage finance, is unique to the United States and U.S. banks. A bank's unused FHLB borrowing capacity should be recognized in the LCR, either by including assets pledged to FHLBs in the numerator (with appropriate haircuts) up to the unused borrowing capacity or by giving banks credit for FHLB availability in the denominator.
 - 3.2 The July Release's discussion of the LCR includes language that seems to imply an expectation that there must be single centralized management of a single liquidity pool for LCR purposes. That would not be workable for complex U.S. banks engaged in a broad spectrum of financial activities (*e.g.*, consumer banking, commercial banking, investment banking and securities activities and derivatives). The U.S. banking agencies, as they work with the Basel Committee to refine the LCR's operational requirements, should make clear that oversight of an institution's liquidity position must be addressed and analyzed holistically for the entire institution, but that management of liquid assets need not be concentrated in a single area within the institution.
 - 3.3 The Basel Committee has chosen to recognize as a liquid asset for LCR purposes bank-issued covered bonds. Covered bonds are a common security construct in Europe, Canada and Australia (essentially full recourse debt obligations of a bank

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that are secured by a collateral pool, typically consisting of residential mortgages). Presently, there is no analogous covered-bond market in the United States. U.S. banks primarily finance their mortgage originations through issuances of mortgage-backed securities in securitization transactions. If covered bonds are to be included as liquid assets for LCR purposes, then we urge the U.S. banking agencies to include securities unique to the U.S. market that we believe are equally liquid (*e.g.*, high-quality mortgage-backed securities and municipal obligations).

- 3.4 MSR are valuable assets that reflect entitlement to real cashflow (identical, as to substance, to non-credit-enhancing interest only securities) and have ascertainable value. We believe the Basel III limitation on MSRs should follow the current U.S. standards (under which MSRs and certain other servicing assets and account relationships includible in capital are limited to the lesser of 90% of fair value or 100% of book value but, subject to that limitation, may be included in capital up to 100% of Tier 1 capital) or, at the least, be relaxed from the 10%/15% “bucket” approach outlined in the July Release. As discussed further in Annex 2, we also believe Basel III’s proposed limitations on DTAs and investments in non-consolidated financial entities should not be more restrictive than current U.S. standards.
- 3.5 The phase-out of trust preferred securities and cumulative preferred stock as components of Tier 1 capital, required both by Basel III and Dodd-Frank, should be implemented during the three years commencing January 1, 2013 on the Basel III basis set forth in the July Release (*i.e.*, by increments of 10% on January 1, 2013 and 2014) so as not to disadvantage U.S. banks with respect to disqualified instruments, as compared to banks in other jurisdictions, any more than is necessary during that period.
- 3.6 TCH continues to believe that the existing filter of unrealized gains and losses of financial instruments from regulatory capital components should be maintained and that paragraph 96 of the December capital proposals should not be implemented. Because of the current U.S. GAAP requirement that banks mark to market their available for sale investment securities portfolios, eliminating the filter will introduce substantial volatility in capital ratios with respect to changes in fair value that are unlikely to ever be realized in net income. The U.S. banking agencies should re-address this issue with their international counterparts as the Basel Committee proceeds to finalize the Basel III capital proposals.

The Honorable Timothy F. Geithner
The Honorable Sheila C. Bair
Mr. John E. Bowman
The Honorable Ben S. Bernanke
Mr. John G. Walsh
Mr. William C. Dudley

November 5, 2010

* * *

If you have any questions, or need further information, please contact Paul Saltzman, President and General Counsel of TCH, at 212-613-0318 (e-mail: paul.saltzman@theclearinghouse.org) or Joseph R. Alexander, Senior Vice President and Deputy General Counsel of TCH, at 212-612-9234 (e-mail: joe.alexander@theclearinghouse.org).

Respectfully submitted,



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cc: Hon. Jeffrey A. Goldstein
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Ms. Norah M. Barger
Board of Governors of the Federal Reserve System

Mr. James Embersit
Board of Governors of the Federal Reserve System

Mr. Patrick M. Parkinson
Board of Governors of the Federal Reserve System

Mr. Michael K. Krimminger
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Mr. Kevin J. Bailey
Office of the Comptroller of the Currency

Mr. Timothy W. Long
Office of the Comptroller of the Currency

The Honorable Timothy F. Geithner -13-
The Honorable Sheila C. Bair
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November 5, 2010

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Basel III Liquidity Proposals

1. The Liquidity Coverage Ratio's ("LCR") asymmetric treatment of inter-bank¹ borrowings should be eliminated.

Under the LCR, banks as borrowers are assumed not to be able to draw under facilities provided by other banks, but banks as lenders are required to assume in their LCR calculations that facilities extended to other banks are 100% drawn. Insofar as liquidity regulation is concerned, the asymmetry does not appear to be supported by quantitative or historical data, but rather appears to reflect a qualitative policy bias against inter-bank borrowing. International regulators may well, we realize, be focused on broader issues – whether inter-bank lending is a good or a bad thing, whether there should be constraints on inter-bank lending, and whether inter-bank lending contributed to the financial crisis. We believe that inter-bank lending is in fact an important aspect of a functioning market and urge the U.S. banking agencies and other national regulators to engage market participants in discussing this issue on its merits. We strongly believe that, for LCR purposes, banks as borrowers should be assumed to be able to draw on inter-bank facilities to the same extent that banks as lenders are assumed to fund inter-bank facilities.²

2. The minimum run-off factors for the LCR's denominator, even as revised by the July Release, do not reflect the experience of U.S. banks in many cases. We urge the U.S. banking agencies to preserve flexibility to approve or require different run-off factors, and to permit different or more granular funding classifications, upon an appropriate showing.

Run-off factors varied significantly among banks during the financial crisis, even within the same broad category as “stable” or “less stable” deposits. Our members’ experience suggests that the proposed run-off factors may be much more conservative than is warranted, particularly in the case of corporate and financial institution deposits. The Basel Committee should publish the data used in establishing the proposed run-off factors and explain the considerations underlying the Committee’s decision-making (*i.e.*, how differences in run-off experience for similar deposit types in different countries were analyzed or whether the run-off factors were developed using only the experience of banks perceived to be under stress and, if

¹ For purposes of this Section 1, we are using the term “bank” to mean not only depository institutions and their holding companies but also to include the broader definition of “financial institutions” used in paragraph 66 of the December liquidity proposals.

² An analysis of our sample indicates that, across the range from 0% to 100% of assumed funding percentages for inter-bank borrowings, the impact of asymmetric treatment of those borrowings would increase the LCR by as much as 9.5%.

so, how the Committee distinguished between banks whose experience is a good precedent versus those operating under non-precedential circumstances (*e.g.*, Northern Rock)). We look forward to working with the U.S. banking agencies to add more clarity and detail around the deposit and other funds outflow experience of U.S. banks during the financial crisis.

Furthermore, based on a preliminary analysis of available data, we believe that the current funding classifications – for example, operational versus non-operational – do not sufficiently capture important differences within funding types to the extent desirable (and possible). Additional funding segmentation will provide further accuracy and nuance to the net cash outflow calculation in the LCR's denominator. Possible categories for additional segmentation include the number of relationships the bank has with the funding source as well as the duration of the relationships, distinctions between high-net-worth and private banking clients, and whether the relationship includes lock-box banking.

If differences among jurisdictions result in the consequence that the U.S. experience as to certain categories of deposits defined in the LCR is not representative of other jurisdictions or the Basel Committee ultimately includes in Basel III run-off factors for certain kinds of deposits that are higher than is appropriate for the United States, it is very important that the U.S. banking agencies, in their implementation of Basel III, permit U.S. banks to use lower run-off factors for certain kinds of deposits upon a proper showing that those lower run-off factors are appropriate.

3. The LCR's assumed 100% draw-down on liquidity facilities does not comport with the experience of U.S. banks.

The LCR as currently proposed requires banks to assume that liquidity facilities are 100% drawn. Our members' experience during the financial crisis does not support an assumed draw-down rate anywhere close to 100%. As in the case of run-off factors, the Basel Committee should publish the data used in establishing the assumed 100% draw-down rate and explain the considerations underlying the Committee's decision-making. TCH will explore with its members what data may be developed that demonstrates the experience of U.S. banks.

These liquidity facilities are important to a broad range of borrowers, including states, municipalities, hospitals and other not-for-profit organizations, and corporations. The borrowings supported by these facilities include variable demand notes as well as commercial paper facilities. Banks will have no choice but to reduce their exposures under these facilities and, to the extent they continue to provide these facilities, adjust pricing to accommodate the impact on earnings that will result from the need to increase low-yielding liquid assets. We are concerned with the larger consequences for end-users that will result from the reduced availability of, or raising the cost of, these facilities. Further, if banks reduce liquidity-facility availability, as likely will occur without revision to the Basel III proposals, systemic liquidity will

reduce because key sectors will not have access to back-up funding – a perverse and undesirable consequence of the proposal.³

4. Federal Home Loan Bank (“FHLB”) facilities are a very important liquidity source for many U.S. banks that should be accommodated within the LCR framework.

The LCR in its current form gives no liquidity credit to U.S. banks’ ability to borrow from FHLBs. We think the LCR, when ultimately implemented for U.S. banks, should give liquidity credit for FHLB borrowing capacity.

The FHLB system and the role of the FHLBs as a liquidity source for banks is unique to the United States. The FHLB system has proven itself vital not only to mortgage finance over the decades, but also to providing emergency liquidity support during the most recent financial crisis, when FHLB advances grew to \$1.01 trillion at the height of the crisis.⁴ This was essential to banks of all sizes in the U.S., but especially to mid-size and smaller ones for which access to capital markets is principally effected through the FHLB system. Implementation in the U.S. of the Basel III liquidity standards without due regard for the value of this facility and the liquidity it provides will undermine, not advance, Basel III goals.

Specifically, members of the FHLB system such as TCH member banking organizations may use their capital investment in a FHLB to derive liabilities (known as “advances”) from an FHLB. As required by law,⁵ these advances must be collateralized by mortgages (advancing the FHLB system’s housing-finance goals), similar collateral for other lending categories, or Treasury/agency obligations. We believe that a bank’s unused FHLB borrowing capacity should be recognized in the LCR, either by including assets pledged to FHLBs in the numerator (with appropriate haircuts) up to the unused amount or by giving banks credit for FHLB availability in the denominator.

If the U.S. banking agencies are concerned that a bank may over-rely on its FHLB borrowing capacity, that concern can be addressed separately as a supervisory matter. The principal concern of regulators to date has not been the liquidity of FHLB funding – proven as noted in the crisis. Rather, it has been the statutory prior lien⁶ provided to collateral pledged to support FHLB advances. Upon failure by an insured depository, this collateral may not be available to an FDIC receivership, increasing resolution costs. However, this is a separate

³ The leverage ratio in its current form raises the same issue by requiring that liquidity facilities be converted to an asset equivalent for the denominator in the leverage ratio, using a 100% conversion factor.

⁴ FHLB Quarterly Combined Financial Report For the Nine Months Ended September 30, 2008, available at http://www.fhlb-of.com/ofweb_userWeb/resources/08q3end.pdf.

⁵ 12 U.S.C. § 1430(a)(3).

⁶ 12 U.S.C. § 1430(e).

matter apart from the proven liquidity value of FHLB advances and their vital importance to a robust U.S. housing market.⁷

TCH's discussions with its members as well as other banks in its data sample indicate that, absent modification of the LCR to recognize FHLB borrowing capacity, the likely consequence is that banks will simply fully draw on their FHLB facilities, invest the drawn amounts in U.S. treasury securities or other liquid assets, and incur the consequences of doing so (principally a further dampening of return on equity). Implementing the LCR in a manner that forces that consequence is not, in our view, sensible or desirable, either for U.S. banks or the FHLB system.

5. "Level 2" liquid assets includible in the LCR's numerator should not be capped at a percentage of total liquid assets includible in the numerator.

TCH strongly supports the permitted inclusion of 20% risk-weighted public sector entity ("PSE") obligations in the numerator of the LCR. For U.S. banks, the most important category of liquid assets in this regard is debt of Fannie Mae and Freddie Mac. Any constraint on U.S. banks' ability to hold debt of Fannie Mae or Freddie Mac needs to be carefully analyzed, not only with respect to the consequences for the investing banks but also insofar as the constraint may affect Fannie Mae's and Freddie Mac's abilities to fund themselves, which is critically important to the U.S. mortgage market. The 40% limitation proposed in the July Release would be unworkable for many banks for one simple reason – they do not maintain large portfolios of U.S. Treasury securities that the 40% may be applied against (i.e., 40% of a small number is a small number).

An analysis of our sample indicates that eliminating the 40% cap on 20% risk-weighted PSE obligations would result in a 1.7% increase in the sample's combined LCR. However, the 40% cap has a disproportionate effect among the banks in the sample. The impact on the LCR of lifting the cap varies by individual bank in our sample, from less than 10% to greater than 100%. We expect that the disproportionate impact applies not only among large banks but also among smaller banks.

We urge the U.S. banking agencies and other national regulators to explain the rationale for the cap (including the derivation of the 40% limitation, particularly as applied to Fannie Mae and Freddie Mac securities, for which there is a deep market) and, more fundamentally, we believe the cap should be eliminated. Any concern with respect to Fannie Mae or Freddie Mac debt as a component of liquid assets is, we respectfully submit, adequately addressed by the 15% haircut proposed in the July Release.

⁷ Our preliminary analysis of publicly available data indicates that allowing FHLB collateral to be counted in the numerator of the LCR without a haircut would increase the aggregate LCR for our sample by 18.7%. Although our sample comprises mostly large banks (accounting for 59% of U.S. banking assets, as mentioned in the letter to which this annex is attached), FHLB borrowing capacity is equally important to smaller banks.

6. The U.S. banking agencies should ensure that the final formulation of the LCR does not impose operational constraints on the management of a bank’s stock of liquid assets that are counter-productive to Basel III prudential goals.

Our members are concerned with the statements in the July Release that “[a]ll assets in the liquidity pool must be managed as part of that pool” and the “Committee will finalize these operational requirements by the end of this year”. That language seems to imply an expectation that there must be a single centralized management of a single liquidity pool for LCR purposes, including perhaps that decisions with respect to purchases and sales of liquid assets must be centralized within a single manager or management group. That will not be practical for complex institutions, nor is it necessary. Indeed, centralization may well create risks; it is essentially a bottom-line approach instead of a granular, risk-based one, increasing the risk of methodological mistakes (*e.g.*, because expertise derived in one area may be applied without discipline to other areas where not only are the risks different, but even the rules are different (banking versus securities activities, for example)). Different areas within a complex institution – *e.g.*, consumer banking, commercial banking, investment banking and securities activities and derivatives – have different liquidity needs. Prudent management of those operations requires that liquidity management for those operations, including management of the related liquid assets, be addressed in the first instance by the hands-on managers for those areas. Moreover, liquid assets within one corporate subsidiary or jurisdiction may be subject to substantial constraints or prohibitions on the commingling of those assets with assets of, or transfer of those assets to, other subsidiaries or in other jurisdictions (for example, in the United States because of Sections 23A and 23B of the Federal Reserve Act⁸). What is important, we believe, is that prudential oversight of a complex institution’s liquidity profile be analyzed holistically for the entire institution by senior management and not simply on a segment-by-segment (or subsidiary-by-subsiary) basis. The U.S. banking agencies, as they work with the Basel Committee to finalize the LCR’s operational requirements, should make clear that oversight of an institution’s liquidity position must be addressed and analyzed holistically for the entire institution, but that management of liquid assets need not be concentrated in a single area within the institution.

7. The LCR’s accommodation of covered bonds as a liquid asset needs to be matched by recognition of equally liquid U.S.-type securities, including high-quality mortgage-backed securities and municipal obligations.

The Basel Committee has chosen to recognize as a liquid asset for LCR purposes bank-issued covered bonds. Covered bonds are a common security construct in Europe, Canada and Australia (essentially full recourse debt obligations of a bank that are secured by a collateral pool, typically consisting of residential mortgages). Presently, there is no analogous covered-bond market in the United States. U.S. banks primarily finance their mortgage originations through issuances of mortgage-backed securities in securitization transactions. If covered bonds are to be included as liquid assets for LCR purposes, then we urge the U.S. banking

⁸ 12 U.S.C. §§ 371c and 371c-1.

agencies to include securities unique to the U.S. market that we believe are equally liquid (*e.g.*, high-quality mortgage-backed securities and municipal obligations).

8. TCH members still have very serious concerns with the Net Stable Funding Ratio (“NSFR”).

The NSFR as initially proposed is seriously flawed. We appreciate the receptivity by the U.S. banking agencies and national regulators more generally to a reasoned consideration of the NSFR’s flaws, including the decision announced in the July Release to re-consider the NSFR and, instead of seeking to finalize it by year-end and implement it on the same timeline as the other Basel III initiatives, to re-propose the NSFR or some other longer-term structural complement to the LCR. The July Release indicates that the target implementation date for the NSFR, presumably after a comment period on the new proposal and consideration of industry comments (which we think is very important given the likely magnitude of the changes), is on January 1, 2018.⁹ Our fundamental concerns were set forth at some length in our April 16, 2010 comment letter on the Basel Committee’s liquidity proposals. We are concerned that the NSFR needs more fundamental revision, however, than the types of changes alluded to in the July Release – for example, adjusting the “available stable funding” and “required stable funding” factors. The basic approach of the LCR is familiar to most U.S. banks, with most banks having applied an approach similar to the LCR as a liquidity management tool for a number of years. Approaches to longer-term liquidity management among banks have been much more diverse. We estimate that the U.S. banking industry’s shortfall in long-term funding that would need to be addressed to reach an NSFR calibrated at 100%, even after taking into account the changes addressed in the July Release, would be approximately \$3.7 trillion. We urge the U.S. banking agencies to consider with their international counterparts implementing the NSFR, as ultimately revised, as a Pillar 2 approach, without any presumption that it ultimately will become part of Pillar 1.

⁹ The July Release also provides for an “observation phase” before finalizing and implementing the NSFR, which we fully support, “to address any unintended consequences across business models or funding structures”.

Basel III Capital Proposals

- 1. We urge the U.S. banking agencies and their colleagues on the Basel Committee, in considering the appropriate sanctions for banks whose capital ratios fall into the capital conservation buffer zone, to permit national regulators to address sanctions as a Pillar 2 supervisory matter for so long as a bank maintains capital ratios that include the most substantial part of the capital conservation buffer.**

The September Release addressed the calibration for the capital conservation buffer as well as capital ratios more generally, but did not address sanctions for dipping into the buffer zone. The reasons why we urge bank regulators not to impose formal sanctions as long as a bank maintains at least the most substantial part of its buffer (designated as a threshold level that is a specified percentage of, or a specified percentage below, a fully compliant capital conservation buffer), and our thinking on implementation of the capital conservation buffer more generally, are as follows:

The December capital proposals explain that the purpose of the capital conservation buffer is “to ensure that banks follow common sense best practice procedures to avoid breaching their minimum capital requirements”.¹⁰ In short, the minimum requirement plus buffer is not intended to become the new minimum requirement. Indeed, the Basel III capital requirements so strengthen existing standards, both with higher required ratios and more rigorous definitions of capital, that falling into the buffer range does not indicate an immediate institution specific capital weakness that warrants immediate and automatic sanctions.

A great deal of discussion has been devoted to whether banks will or should maintain voluntary capital “cushions” above minimum capital requirements (including buffers), going forward. The answer depends in part on what regulatory expectations are established for managing capital while in the buffer zone. The premise behind Basel III’s enhanced capital standards is that banks that meet the minimum standards without regard for buffers are sufficiently robust to survive a financial crisis. Absent some leeway to address falling into the buffer zone as a Pillar 2 matter without the automatic application of sanctions, banks will *de facto* be required to maintain cushions above minimum requirements (including buffers). We think that is inappropriate and unnecessary.

If the “filter” from regulatory capital measures of unrealized gains and losses on financial instruments (as proposed in paragraph 96 of the December capital proposals)

¹⁰ December capital proposals, para. 247.

ultimately is eliminated, Tier 1 common equity will become a very volatile measure. If sanctions apply to any invasion of the conservation capital buffer, banks will have no choice but to maintain sufficient capital cushions to preclude falling within the buffer zone merely because of the volatility of its Tier 1 common equity.

If a bank dips into its buffer zone but maintains the most substantial part of its buffer, we believe that, instead of automatic and immediate sanctions, the buffer should be implemented as a Pillar 2 matter so as to inject counter-cyclicality into the system over the business cycle, separate from any counter-cyclical buffer, which we understand would generally apply only in the most extreme circumstances like the recent crisis. During “normal” times, banks ordinarily should be expected to meet the full Basel minimum requirements plus the buffer. But in periods of general macroeconomic downturns (or in supervisory modelings of such scenarios), the focus should shift to the capital minima and institutions should be permitted to fall into the buffer zone.¹¹ The Pillar 2 supervisory evaluations of the consequences of a bank falling into the buffer zone should take into account the reasons why that happened (e.g., a temporary factor, an acquisition of a troubled institution, or market changes that are not within the bank’s control).

Finally, sanctions for falling into the buffer zone should be limited to constraints on capital distributions and should not include operational constraints of the type included in the U.S. banking agencies’ prompt corrective action regulations. This seems to be what the Basel Committee contemplated in the December 2009 capital proposals (see paragraphs 256-258).

2. TCH continues to believe that the existing filter of unrealized gains and losses of financial instruments from regulatory capital components should be maintained and that paragraph 96 of the December capital proposals should not be implemented.

We discussed this issue at length in our April 16, 2010 comment letter on the December capital proposals and referenced it in item 2 of this Annex, above. For U.S. banks the consequence of reflecting in Tier 1 common and Tier 1 capital unrealized gains and losses on investment securities that the bank has classified as available for sale will introduce substantial volatility in capital ratios with respect to changes in fair value that are unlikely to ever be realized in net income.

The September Release did not address the Basel Committee’s thoughts with respect to this issue. The U.S. banking agencies should re-address this issue with their international counterparts as they proceed to finalize the Basel III capital proposals.

¹¹ The Basel Committee appears to agree with this premise. See, e.g., December proposals, para. 248 (“These buffers should be capable of being drawn down through losses and large enough to enable banks to maintain capital levels above the minimum requirement throughout a significant sector-wide downturn”).

3. TCH continues to believe that more flexibility should be permitted in the treatment of Mortgage Servicing Rights (“MSRs”), Deferred Tax Assets (“DTAs”) and investments in non-consolidated financial entities.

Treating MSRs as “lesser assets” subject to the limitations proposed by the Basel Committee, even after the modifications reflected in the July Release, is not appropriate. MSRs have ascertainable value and reflect entitlements to real cash flows. There is a significant volume of MSR trades observed by banks in establishing their value. MSRs are indistinguishable, as to both financial substance and risks, from non-credit-enhancing interest-only securities (“IOs”). Those securities have never been treated as “lesser assets” for capital purposes. Taking the view that MSRs must be treated as intangibles for capital purposes because they are intangibles for accounting purposes elevates form over substance.

Mortgage servicing as an activity that is separate and apart from the ownership of mortgage loans, and the MSRs that result, are an important and ingrained component of the U.S. mortgage market. Efficient mortgage servicing in the United States requires large volumes in order to achieve economies of scale that benefit both borrowers and lenders. As discussed in our prior comment letters, MSRs as a significant asset class are unique to U.S. banks.¹² We urge the U.S. banking agencies to treat MSRs more flexibly in the U.S. implementation of Basel III than is contemplated by the Basel Committee’s capital proposals in their current form. One (and our preferred) alternative would be to preserve the current U.S. standards (under which MSRs and certain other servicing assets and account relationships includible in capital are limited to the lesser of 90% of fair value or 100% of book value but, subject to that limitation, may be included in capital up to 100% of Tier 1 capital). Other alternatives include (i) establishing a separate Tier 1 common-based limitation on MSRs that is higher than 10% and is not aggregated with DTAs dependent upon future taxable income or investments in non-consolidated financial entities, or (ii) as contemplated by the July Release, creating an exception for MSRs, DTAs and investments in non-consolidated financial entities, but doing so by retaining a single aggregate limit (that might be higher than 15% -- we propose 25%) and eliminating the separate 10% sub-limit for each component. If national regulators or the U.S. banking agencies determine that an aggregate limitation on identified types of “lesser assets” is appropriate, we do not see the logic of imposing a separate sub-limit on each type of asset subject to the limitation, whether as applied to MSRs, DTAs or investments in non-consolidated financial entities.

Similarly, we believe that the proposed Basel III treatment of DTAs is unduly conservative and that, at the least, the new Basel III standards should not be more restrictive than the existing U.S. standards (i.e., the lesser of 10% of Tier 1 capital or the amount of DTAs dependent upon future taxable income that the bank reasonably expects to use within one year). We also believe that, for U.S. banks, the existing treatment of investments in non-

¹² At December 31, 2009, the banks in our sample held approximately \$47.3 billion of MSRs on their balance sheets. The aggregate deduction of MSRs due to the 10% cap for the banks in our sample is \$13.2 billion; we estimate the aggregate deduction for the U.S. banking industry to be \$20.6 billion.

consolidated financial entities should be preserved (with no automatic deduction). We discuss both of these issues at length in our April 16, 2010 comment letter on the December capital proposals.

4. **It is very important that any capital surcharge ultimately applied to U.S. systemically important financial institutions (“SIFIs”), whether under Dodd-Frank Section 165(b) or pursuant to the U.S. implementation of Basel III, not disadvantage U.S. SIFIs as compared to SIFIs in other jurisdictions.**

The treatment of SIFIs for a variety of regulatory purposes, including the “more stringent” capital standards required by Dodd-Frank (which may include capital surcharges), is among the most difficult largely unresolved issues arising out of regulatory reform. We appreciate the decision, reflected in the Basel Committee’s report to the G20 released on October 19, 2010¹³, not to force resolution of this issue by year-end but, instead, address the issue during the first half of next year on a timeframe that is roughly consistent with the 18-month timeframe permitted under Dodd-Frank to implement Section 165(c).

We look forward to further refining our views on this issue during the coming weeks. We would like to note now, however, one fundamental point – namely, that the mandate for “more stringent” capital standards for SIFIs does not require an additional capital surcharge for SIFIs. Capital stringency should be evaluated in the context of the entire framework of capital regulation, including Basel II, the market-risk rules being further revised in Basel II.5, possible differences in the application of parts of the Basel III standards to internationally active banking organizations versus the banking industry as a whole, and possible requirements for contingent capital, bail-in debt or other loss-absorbing instruments that may apply to SIFIs or some other category of large banks but not to all banks.

5. **Financial reform must be addressed holistically, taking into account not only the Basel III proposals but also their interplay with existing capital standards and other sources of capital and liquidity regulation that bear upon ultimate standards.**

As the U.S. banking agencies and their counterparts in other jurisdictions move to finalize Basel III, it is critically important that they do so keeping in mind other areas – some already part of the regulatory regime; some merely prospective, with varying degrees of uncertainty; and some relevant to some jurisdictions but not others (Dodd-Frank in the United States, for example) – that may affect implementation and its consequences and may need to be modified. We have commented below on four particular areas most important to U.S. banks. Although they bear more directly on capital reform than liquidity reform, those two areas of reform are conceptually linked and, accordingly, considerations of the type described below should be kept in mind as to both areas.

¹³ *The Basel Committee’s response to the financial crisis: Report to the G20 (October 2010).*

1. Overlay of Basel II and Basel II.5. Basel II mostly addressed the denominator in the risk-based capital ratios and deferred revising the definitions of the components of capital – the numerator – to a later date. Basel III is, of course, the later date. However, these endeavors, along with the market-risk rules referred to by some as “**Basel II.5**”, inevitably overlap and require combined analysis. We believe that at least two aspects of Basel II should be re-visited and revised as part of the Basel III process, as follows:
 - (a) *1.06 Multiplier in the Definition of “Credit-Risk-Weighted Assets”.* The U.S. banking agencies, in implementing the advanced-internal ratings based (“**A-IRB**”) approach of Basel II for core banks, included the 1.06 multiplier (or “scaling factor”) applied to risk-weighted assets and exposures otherwise calculated under the A-IRB approach, implementing the multiplier within the definition of “credit-risk-weighted assets”. The multiplier was added after an early quantitative impact study showed a fall in risk-weighted assets under the Basel II calculations as compared to Basel I. That study had been done very early in the process, before most banks had developed and validated their methods for calculating the credit risk parameters (PDs and LGDs for wholesale and return portfolios). Given the extensive experience that regulators and banks have now had with Basel II’s PD and LGD calculations, we believe the 1.06 multiplier should be revisited and is no longer necessary, particularly in view of the more robust capital standards being implemented through Basel III in any event. Accordingly, we urge that the 1.06 multiplier be eliminated effective January 1, 2013 when the phase-in of Basel III begins.¹⁴
 - (b) *“Through The Cycle Data Sets”.* We urge the U.S. banking agencies, together with their international counterparts on the Basel Committee, to re-examine the treatment, as a supervision and examination matter or otherwise in a way that ensures international application of a common standard, of probability of default (“**PD**”) estimates used for Basel II’s A-IRB approach. Basel II requires that PD estimates for wholesale obligor and retail segments must be based on at least five years of default data, and loss given default (“**LGD**”) estimates must be based on seven years (for wholesale) and five years (for retail) of loss-severity data. The objective of those standards, we understand, is to derive through-the-cycle estimates of PD and stress-period

¹⁴ We estimate that eliminating the 1.06 scaling factor for the Basel II banks in the sample would result in a decrease of approximately \$220 billion, or 4.5%, in risk-weighted assets.

estimates of LGD. The practical application of the Basel II PD estimates under the A-IRB approach is procyclical. There are two reasons for the procyclicality. First, PDs are calculated through a two-step process that involves categorizing retail and wholesale credits based on credit ratings (which may be internal or external), and then multiplying the categories by an estimated probability of default for each particular ratings category. Ratings are definitionally procyclical, tending to be higher during good periods and lower during bad periods (albeit with some lag as the economy changes). Second, many banks have relatively short-term databases for certain types of credit (particularly retail) that do not yet include a sufficient period to adjust for the disproportionate impact of recent experience (as of today, the financial crisis years) on a truly “through the cycle” basis. There is no single correct solution to the current problems with Basel II’s A-IRB PD estimates. One possible solution, at least as to the limited data point issue, would be to permit a bank to use Basel II’s standardized approach to PDs instead of the A-IRB approach to PDs when the bank’s database is not otherwise sufficient. TCH looks forward to working with the U.S. banking agencies to address this concern more fully.

We commented at length on the counterparty credit risk (“**CCR**”) provisions in the December capital proposals and their interplay with the market-risk rules. Although the amendments to the CCR provisions described in the July Release alleviate the most serious aspects of the proposals as announced in December 2009, TCH members (and industry groups working on this area with national regulators) still believe that there is substantial work to be done before long-term provisions are finalized. We note the Basel Committee’s discussion of this issue in its paper, released on October 19, 2010, entitled *The Basel Committee’s response to the financial crisis: report to the G20*, including that a fundamental review of the trading book would be completed by the end of 2011. We look forward to working with the U.S. banking agencies and other national regulators in connection with that review.

2. The Dodd-Frank Act. The Dodd-Frank Act overlaps to a substantial extent with Basel III, albeit for the most part with general principles to be implemented through regulations as opposed to with the granularity of Basel III. The most important areas of overlap in this regard are:
 - Dodd-Frank Section 165’s requirement that the FRB, in consultation with the Financial Stability Oversight Council (the “**Council**”), establish more stringent capital requirements for bank

holding companies with \$50 billion or more of consolidated assets and non-bank entities brought under FRB supervision by Title 1 of Dodd-Frank;

- Dodd-Frank Section 616(c)'s requirement that the U.S. banking agencies seek to make capital rules countercyclical;
- Dodd-Frank Section 171's (i) phase-out of trust preferred securities and cumulative perpetual preferred stock as components of bank holding company capital¹⁵ and (ii) apparent requirement that Basel I capital requirements act as a floor for Basel II banks, requiring parallel calculations;
- Dodd-Frank's Section 939A's requirement that U.S. regulatory agencies remove references to ratings as a measure of creditworthiness from their rule, including capital rules;¹⁶ and
- Dodd-Frank Sections 115(c) and 165(c) provisions dealing with contingent capital, the former requiring the Council to do a study of contingent capital by July 2012 and the latter authorizing (but not requiring) the FRB, after submission of that report, to issue regulations requiring that SIFIs to maintain a minimum amount of contingent capital convertible to equity in times of financial stress.

All of these items are important and, of course, must be addressed by the U.S. banking agencies as required by Dodd-Frank. The most critical and sensitive area is Dodd-Frank Section 165(b) and the requirement of "more stringent" capital requirements for SIFIs and its interplay with the Basel Committee's considerations of a capital surcharge applicable to

¹⁵ We urge the Federal Reserve Board, in adopting regulations under Section 171, to rationalize the phase-out of impermissible instruments as implemented for Basel III purposes, addressed in the September Release, and Dodd-Frank Section 171's requirement for an incremental phase-out for banks with \$15 billion or more in total assets at December 31, 2009. An appropriate reconciliation would, we submit, be to disallow 10% of the principal amount of the subject instruments commencing January 1, 2013, 20% commencing January 1, 2014, 30% commencing January 1, 2015 and 100% commencing January 1, 2016.

¹⁶ See our comment letters, each dated October 12, 2010, one addressed to the OCC, OTS, FDIC and FRB with respect to their advance notice of proposed rulemaking relating to Section 939A as applied to risk-based capital guidelines and the other addressed to the OCC with respect to Section 939A as applied to the OCC's investment securities and other regulations.

SIFIs.¹⁷ We have commented more extensively on this issue in Section 1 of this Annex 2.

3. Basel III Needs to Allow National Regulators to Adjust for Revisions to Accounting Standards. In May 2010, the Financial Accounting Standards Board (the “**FASB**”) released for comment its Proposed Accounting Standards Update, Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815), *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. In August 2010, the FASB released for comment its Proposed Accounting Standards Update, Leases (Topic 840) (together with Topics 825 and 815, the “**FASB Proposals**”). The FASB Proposals illustrate the fluidity of developments in accounting standards and the importance of their interaction with capital. The FASB Proposals move in the direction of a lifetime allowance for loan losses. This would materially increase loan loss allowances and reduce capital, even in good economic times, for all banks. Were the FASB proposals to be implemented, it would be necessary to recalibrate capital ratios inasmuch as the proposed accounting change does not change the underlying economics or risks associated with loans and other financial instruments held by banks in their banking books and there would be no change in the “loss absorbing” capacity of the bank. Absent a recalibration, reported capital ratios relative to minimum requirements would drop materially. A related impact is that higher loan loss allowances for a given level of risk will create higher deferred tax assets (resulting from the difference between the timing of provisions recognized for GAAP purposes and charge-offs recognized for tax purposes), further reducing capital. Other proposed changes would result in all equity securities, many more debt securities, and a much greater portion of a financial institution’s own debt being required to be accounted for at fair value, with changes in value recorded in earnings, and in virtually every operating lease being reported on the balance sheets of both the lessee and the lessor. It will be important that national regulators have in place a framework that implements, in a timely way, adjustments capital and liquidity regulation to accommodate changes in other areas – particularly accounting changes (as illustrated by the FASB Proposals – that have important impacts on capital).

¹⁷ Paragraph 47 of the Basel Committee’s December capital proposals raised this subject. The GHOS, in the September Release focused on the issue, stating:

“The Basel Committee and the [Financial Stability Board] are developing a well integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt.”

4. Prompt Corrective Action. The capital definitions in the U.S. banking agencies' prompt corrective action ("PCA") regulations will need to be revised as Basel III is implemented.¹⁸ The revisions will need to take into account not only the new definitions of capital and the new calibrations, but also the enhanced focus on Tier 1 common equity and, more broadly, the more robust capital regulation reflected in Basel III. Redefining the PCA rules using new Basel III standards will almost certainly raise challenging issues. We look forward to refining our views on the interplay between Basel III and the U.S. banking agencies' PCA rules and would be happy to discuss this area further with the U.S. banking agencies as our views develop (including prior to the publication of a notice of proposed rulemaking, if that would be helpful).

6. TCH members have a number of unresolved concerns with the leverage ratio proposal to be included in Basel III.

The leverage ratio included in Basel III includes a number of assumptions that seem arbitrary, partly because they were not covered by the data collected in the quantitative impact study. The assumed 100% draw-down on liquidity facilities, discussed further in Section 3 of Annex 1, is an example. Another is the credit conversion factors that will be applied to off-balance-sheet items. The July Release indicates that the Basel Committee agreed to "use uniform credit conversion factors" but, except for the 10% credit conversion factor specified for unconditionally cancellable commitments, did not address how they would be derived or what they would be. As the U.S. banking agencies move to implementing the Basel III leverage test for U.S. banks, our members will be very focused on the many details that have not yet been released and how the U.S. banking agencies address the interplay between the Basel III leverage test and the existing U.S. minimum leverage test. The existing U.S. leverage test should not be combined with the Basel III definitions for the numerator and denominator (and, as a practical matter, cannot be combined given the differences between the two), particularly in view of the language in Section 171 of the Dodd-Frank Act implying that the existing U.S. leverage test may operate as a floor going forward.

¹³ The FRB's PCA regulations are at 12 CFR 208.40 et seq., the FDIC's at 12 CFR 3.200 et seq., and the OCC's at 12 CFR Part 6.

Letters – Tab 6

August 26, 2011

Submitted electronically to baselcommittee@bis.org

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

Re: Consultative Document: *Globally systemically important banks: Assessment methodology and the additional loss absorbency requirement*

Ladies and Gentlemen:

The American Bankers Association (ABA)¹ appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (the **Basel Committee**) July 2011 consultative document, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement* (the **Consultation Document** and, the proposed changes set forth therein, the **Proposal**).

ABA has consistently voiced strong support for ongoing regulatory reform efforts that aim to make international financial systems safer and more robust, with the broader goal of enhancing the ability of banks to serve customers. For those reasons, we have fundamental reservations regarding both the underlying concept of a significant additional capital surcharge on globally systemically important banks (**G-SIBs**) as well as the design of the indicator-based methodology described in the Consultation Document. We believe that as proposed they will in fact reduce the ability of the banking industry to serve customers. We do not accept the view that more capital is always the answer and strongly believe that excessive capital requirements are economically inefficient, permanently reducing the economic growth potential of the nation. Moreover, while they can inhibit the ability of banks² to support the economy, they can also create competitive discrepancies. Nor do we agree with the view that it is not feasible to end too-big-to-fail. We believe that it is possible and necessary to end the too-big-to-fail notion, a position that was also reinforced by the United States executive and legislative leaders at the time of the enactment of the Dodd-Frank Act.³ We also note that the Financial Stability Board (the **FSB**) is currently working on a parallel effort to ensure that member nations adopt resolution protocols that clearly and effectively enable orderly liquidation of any failing institution without taxpayer support. This effort underscores the conclusion that the negative consequences associated with institutions perceived as too-big-to-fail can be effectively addressed without a punitive add-on capital requirement.

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13 trillion banking industry and its 2 million employees.

² The term "**banks**" here refers to both bank holding companies and depository institutions.

³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203 (2010).

The U.S. banking sector is well-capitalized by any regulatory definition, with capital ratios at historically high levels. The industry's three regulatory capital ratios—the leverage capital ratio, tier 1 risk-based capital ratio, and total risk-based capital ratio—were at all-time highs at the end of the 2nd quarter 2011.⁴ This well-capitalized sector is in a position to aid the world's economic recovery if it is allowed to. Continual demands for banks to raise excess capital, significant regulatory policy uncertainty, and examination overkill in the U.S. have made it difficult for banks to lend. The proposed increase in required levels of capital is expected to result in a substantial reduction in the ability of large banks to perform their core intermediation functions and provide funding to the broader economy through loans, investments, and trading activities. This will impact large bank customers and counterparties through a reduction in available financial resources, reducing the pool of funds readily accessible for borrowing, investing, and trading and, thus, erode the ability of banks to serve as engines of economic recovery from the deep recession.

In view of recent national and international bank regulatory reform efforts, the uncertain benefits and potentially significant costs of an additional capital surcharge, and the significant flaws in the Proposal's concept and design, we believe that the Proposal is at best premature. This rushed proposal poses considerable risks to the international financial system and the global economy by requiring a major additional capital surcharge on G-SIBs. Furthermore, numerous and serious gaps in the Consultation Document prevent fully adequate analysis and comment on the Proposal at this time.

For these reasons, ABA strongly believes that the current proposal should be withdrawn and reconsidered. Any re-proposal should contain a transparent and empirically supported methodology; take into account the domestic regulatory environment in which banks operate, including resolution regimes; demonstrate that the benefits exceed the costs of reduced economic growth; and address other concerns highlighted in this letter. The current fragile condition of the global economy will not well tolerate such a risky experiment as that offered in the current proposal.

I. Policy Concerns

A. The Proposal creates a “black box” for calculating surcharges, rendering banks unable to determine their capital surcharge.

It would be essential that the determination of any surcharge be conducted in a transparent manner for at least two reasons. First, banks should have the information necessary to adjust their risk profiles and business models in order to adapt to the new regulatory capital regime. Second, without transparency, a cloud of uncertainty is created over each potential G-SIB, which adversely affects the market price for its securities and thereby affects the availability of capital. The Proposal, however, provides little if any transparency regarding the assessment and calculation of the surcharge. Instead, it effectively creates a “black box” for determining the surcharge, rendering a bank unable to calculate its own surcharge or to take steps to reduce its systemic importance scores, and thereby injecting substantial uncertainty into the capital

⁴ FDIC's Quarterly Banking Profile, 2nd quarter 2011.

planning process. This additional uncertainty comes at a particularly inopportune time given the already acute uncertainty under which banks currently operate as a result of a multitude of new, complex rules adopted, and pending, following the financial crisis. ABA is deeply concerned that this uncertainty will have adverse consequences not just for banks but also for their customers, investors, and the general economy.

Because the G-SIB capital surcharge described in the Proposal effectively punishes size and global footprint, banks should have the ability to evaluate their structure and operations and proactively determine the potential magnitude of the applicable surcharge in order to manage and/or mitigate its potential impact. However, data for many of the indicators do not at present exist, as acknowledged by the Basel Committee, making it nearly impossible for banks to estimate the magnitude of the surcharge.⁵ Creating a cross-jurisdictional uniform aggregated database that earns the confidence of the markets will involve substantial challenges that require addressing different business and reporting practices, different accounting regimes, and currency conversion. If this database is not successfully created, the surcharges will almost certainly be unreliable and inequitable.⁶ The present lack of such a database obviously creates a great deal of uncertainty in the capital and business planning of banks potentially subject to the proposed surcharge.

Moreover, even if this database existed, a bank still could not determine its systemic importance score – and thus its surcharge – with any degree of accuracy over time because of two features of the Proposal’s methodology for determining the surcharge. First, systemic importance scores are determined on a relative basis. As a result, in order for a bank to calculate its individual systemic importance score, it will need the ability to calculate and forecast not just the amount of each of the individual indicators for itself, but also the denominators of each of the respective indicators. However, the metrics chosen for the indicators are difficult to model even internally for an individual bank; modeling them for a subjective sample of 73 banks is not feasible. Second, even assuming a bank could accurately model the indicator values for itself and the 72 other banks and thereby estimate its systemic importance score with a reasonable amount of confidence, the thresholds for the buckets are adjusted every three to five years, making long-term capital planning nearly impossible.

The inability of a bank to estimate its surcharge with any accuracy frustrates bank management’s ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held. In general, given the potentially severe supervisory consequences of holding too little capital, uncertainty regarding the magnitude of the

⁵ Consultation Document, ¶ 71 (“The Basel Committee acknowledges that the data used to construct the indicator based measurement approach currently may not be sufficiently reliable or complete. . . [T]he Basel Committee will address any outstanding data issues and re-run the indicator-based measurement approach using updated data well in advance of the implementation . . . This includes issues such as providing further guidance on the definition of the indicators, how to standardise further the reporting across the sample banks and how to address data that are currently difficult to collect or not publicly available”). Although rerunning the data and approach at a later date may prove helpful, it will be too late to mitigate the impact of the interim uncertainty.

⁶ We strongly believe that the surcharge should not be implemented – whether formally or informally – prior to the completion of this database, regardless of whether this database is completed before the beginning of the proposed phase in period (*i.e.*, January 1, 2016).

regulatory surcharge will require banks to hold a much higher amount of capital in the form of an “uncertainty surcharge.” Although this result may seem to some like an acceptable, or even desirable, regulatory outcome, capital is not free, and the incidence of the costs of holding more capital than is necessary or appropriate will not fall solely on banks, but also on customers of the banks and on the general economy. The lack of transparency surrounding the calculation of a bank’s systemic importance score also makes the banking industry more difficult to understand for investors by introducing volatility and uncertainty in capital and associated profitability and investor return projections. Moreover, this lack of transparency seriously undermines the Proposal’s credibility and hinders banks’ ability to provide meaningful comment. Finally, it unnecessarily exposes regulators to the likelihood of public criticism for demonstrating presumed favoritism or acting punitively, undermining public credibility of the regulators.

B. The proposal should take into account the current regulatory environment and recent regulatory reforms.

Over the past two years, significant regulatory reforms have been introduced both by the Basel Committee and domestic regulators in order to address a wide variety of regulatory concerns, including capital adequacy, liquidity risk, loss absorbency, market risk, stress testing and resolution, and capital planning. Many of these measures will require, or have in practice already required, potential G-SIBs to make major changes to their capital structures, balance sheet composition, and liquidity and operational risk management functions, calling into question the need to impose an additional capital surcharge at this time.

Late last year, the Basel Committee finalized the Basel III capital requirements. 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. The net effect was to quadruple (or more) the required level of common equity for most large banks, which have since raised enormous amounts of capital (and in many cases shed assets) to begin complying with the new rules. In light of the Basel III requirements, and the current capital levels of large banks, ABA believes the surcharge is unnecessary for the purpose of ensuring adequate capital positions.

The imposition of significant additional capital surcharges on G-SIBs is premised on the assumption that these higher requirements are necessary to address the negative externalities and moral hazard costs associated with institutions with perceived implicit guarantees of governmental support.⁷ As a logical matter, therefore, the need for such a capital surcharge

⁷ See, e.g., Consultation Document, ¶¶ 2, 3 (“The rationale for adopting additional policy measures for G-SIBs is based on the cross-border negative externalities created by systemically important banks which current regulatory policies do not fully address. . . . The negative externalities associated with institutions that are perceived as not being allowed to fail due to their size, interconnectedness, complexity, lack of substitutability or global scope are well recognized. In maximizing their private benefits, individual financial institutions may rationally choose outcomes that, from a system-wide level, are sub-optimal because they do not take into account these externalities. Moreover, the moral hazard costs associated with implicit guarantees derived from the perceived expectation of government support may amplify risk-taking, reduce market discipline and create competitive distortions, and further increase the probability of distress in the future.”)

would be mitigated to the extent that such negative externalities and moral hazard costs are eliminated or reduced.

The U.S., for example benefits from the Federal Deposit Insurance Corporation's robust and tested bank resolution scheme. The very existence of this resolution regime informs the market place that depository institutions can fail. This resolution regime is unmatched in any other jurisdiction and it is funded by the industry. In addition, new orderly liquidation authorities were enacted pursuant to Title II of the Dodd-Frank Act. The U.S. has supplemented this regime with numerous other rules designed to limit financial institutions' risk taking and reduce systemic risk, including regular stress tests, living wills, concentration limits on expansion, the migration to centrally cleared swaps and related margin and capital requirements, the ability to require the prudential supervision of systemically important non-bank financial entities, new regulations on securitizations markets (including enhanced disclosures and risk retention requirements), reforms of credit rating agencies, and the establishment of the Financial Stability Oversight Council to coordinate detection of and response to systemic risks. While none of these measures are without fault or controversy, they are an important part of the context in which the Proposal must be considered, particularly with regard to their intention of reducing systemic and individual bank risk as well as their likely impact on bank costs and ability to serve customers.

The very logic behind the imposition of a significant capital surcharge on G-SIBs rests on the existence of substantial negative externalities and moral hazards. Regulatory reforms which reduce such problems and otherwise decrease systemic risk must be taken into account in order for such a proposal to be consistent with its foundational goals. Nevertheless, and quite paradoxically, the Consultative Document indicates that such considerations should not play a role in the G-SIBs' additional capital surcharge equation.⁸

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

C. G-SIB capital surcharges reduce economic and job growth.

Imposing higher capital requirements on G-SIBs is not a cost-free proposition. The trade-off between safety and growth is well recognized, primarily in the form of increased capital holdings resulting in reduced credit availability and banking activity. The Basel Committee has itself recognized these potentially negative consequences. The Consultative Document 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. While the provisional estimate shows only a modest

⁸ See Consultation Document, ¶ 56.

reduction in growth,⁹ that minimalist estimate is not empirically supported, because the MAG's full analysis of the projected 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, ABA strongly believes that the Basel Committee should withdraw the proposal until it has better understanding of the economic impact. It is important that the Committee benefit from public comment on the potential impact of the proposed surcharge before finalizing its views. ABA makes these requests based on the conviction that the risk to growth from the surcharge is likely to be significant. ABA has serious concerns about the potential macroeconomic impact of the Proposal over the long run, and deep worries about its short-term impact given the current state of the economies of the nations most affected by it. A precipitous increase in required levels of capital would be expected to result in an immediate, substantial, and enduring reduction in the ability of banks to perform their core intermediation functions and provide capital to the broader economy through loans, investments, trading activities, and other banking services. This will impact bank customers and counterparties through higher costs of borrowing, investing, and trading. These increased costs and the lower supply of bank intermediation activities will translate into lower levels of domestic and global economic growth, reducing the growth potential for the economies affected for as long as the requirements remain in effect.

Finally, we believe the MAG should evaluate the economic impact as if the surcharge were applied immediately and without a transition period. If the reaction to the Basel III requirements is any guide, banks will be pressured by markets (which demand immediate financial recognition of planned regulatory mandates) to adjust to the new standards quickly, at exactly the same time that the financial system is adjusting to an unprecedented number of regulatory initiatives, further undermining the fragile economic recovery.

D. There are significant uncertainties in the theoretical and policy foundations of a G-SIB surcharge, including the appropriate calibration of such surcharge. Given these uncertainties, the imposition of a G-SIB surcharge could have unintended consequences and risks that are not readily apparent.

Even accepting, for argument's sake, the appropriateness of a G-SIB surcharge, there are significant uncertainties and open questions concerning the theoretical and policy foundation of a G-SIB surcharge, including, as the Basel Committee itself readily acknowledges, questions regarding the appropriate method to calibrate such a surcharge.¹⁰ Depending on the assumptions

⁹ 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.

¹⁰ See Basel Committee on Banking Supervision, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirements* (July 2011), at 23 (regarding its empirical analysis undertaken in support of the assessment of the magnitude of additional loss absorbency that "[i]t is important to note that there is no single correct approach that is reliable enough to inform the assessment of the magnitude of additional loss absorbency All the approaches suffer from data gaps and the results are sensitive to assumptions made The estimates of the magnitude of additional loss absorbency based on the expected impact approach, assessment of

selected and measurement method chosen, the “systemic importance” of a bank can vary widely. The empirical measurement of systemic importance is in its infancy, and academic commentators pursuing this research regularly caution against directly adopting their work as part of a regulatory framework.¹¹ There has been limited research regarding capital surcharges affecting only the largest institutions. The majority of research focuses on the impact of Basel III or system-wide optimal capital levels. Finally, and perhaps most significantly, the full potential combined impact of the current financial-services regulatory reforms has not yet been comprehensively analyzed.¹² The cumulative effects of these complex rules could have economic costs and other unintended consequences and risks that are not readily apparent but nevertheless significant.

E. A capital surcharge on G-SIB’s could encourage the growth of the unregulated shadow banking system and therefore serve to increase systemic risk by feeding regulatory inconsistencies and anomalies.

Demand in the economy for the products and services that G-SIBs are no longer willing or able to provide because of the higher costs imposed by a G-SIB surcharge will not, of course, simply evaporate. The provision of some of these products and services is likely to shift to the unregulated shadow banking sector.¹³ The Proposal particularly exacerbates this problem by imposing a surcharge on certain banks well in advance of even considering the imposition of a similar surcharge on other systemically important financial institutions. In view of the unregulated shadow banking system’s role in events leading up to the recent financial turmoil,¹⁴ a migration of financial activity and market share to those market participants would do little to ward off future systemic problems.¹⁵ In addition, the unregulated shadow banking system can exhibit volatile and intermittent flows compared with the traditional banking system’s credit intermediation function. This lack of reliability as a source of funding would subject borrowers

the long-term economic impact and too-big to-fall [*sic*]. . . subsidies are based on imperfect models and involve numerous assumptions and judgments.”).

¹¹ Cf. John B. Taylor, *Systemic Risk in Theory and Practice*, at 51 (stating that systemic risk is still not well defined and that reform proposals relying on systemic risk to determine in advance whether a firm should be deemed systemically significant “are not ready for prime time”) (2010), http://www.stanford.edu/~johntayl/Onlinepaperscombinedbyyear/2010/Defining_Systemic_Risk_Operationally.pdf.

¹² Public sector officials have acknowledged that the aggregate impact of the current financial-services regulatory reforms in the U.S., including the Dodd-Frank Act and Basel III, have not yet been fully analyzed. See, e.g., Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke’s Speech on the U.S. Economic Outlook (June 7, 2011) (transcript available at <http://video.cnbc.com/gallery/?video=3000026289>) (noting that no one had yet done an analysis of the impact of the recent financial reform on credit and stating, “It’s just too complicated. We don’t really have the quantitative tools to do that.”).

¹³ This transfer of business to the shadow banking sector is of course already underway. See, e.g., Kate Berry and Jeff Horwitz, *Regs Push MetLife Out of Banking, into Shadow System*, *American Banker* (July 2011) (discussing MetLife’s decision to sell its bank but to continue writing mortgages).

¹⁴ See Financial Stability Board, *Shadow Banking: Scoping the Issues: A Background Note of the Financial Stability Board* (April 12, 2011), at 3, available at http://www.financialstabilityboard.org/publications/r_110412a.pdf.

¹⁵ Cf. Zoltan Pozsar, Tobias Adrian, Adam Ashcraft and Hayley Boesky, *Federal Reserve Bank of New York Staff Reports: Shadow Banking*, Staff Report no. 458, at 69 (July 2010) (questioning whether the economically viable parts of the shadow banking system “will ever be stable through credit cycles in the absence of official credit and liquidity puts”).

and investors to marketplace vagaries. Both of these outcomes would actually increase systemic risk – quite the opposite of the ultimate goal of the Proposal.

F. The G-SIB surcharge will lead to unjustified competitive inequities among firms.

Imposing a significant capital surcharge on G-SIBs will lead to competitive inequities both between G-SIBs and other large nonbank financial institutions and between G-SIBs and other large banks that are not subject to the surcharge. Under the Proposal, only 28 of the 73 presumably large international banks selected for analysis (and whose data is aggregated for purposes of the denominator used for the indicator-based approach) will be subject to a capital surcharge. In addition, the 28 G-SIBs themselves will be subject to differentiated surcharges based on the yet to be defined buckets to which they ultimately are assigned. Although we do not yet know the cut-off scores for surcharge versus no surcharge or for the various surcharge buckets, inherent in the very nature of a formula-based approach, such as the Proposal, is the probability that such scores will have arbitrary effects among banks, especially those whose scores are just below and just above a particular cut-off score. Nevertheless, fine numerical distinctions on the Proposal's normalized scale could have dramatically different effects on institutions with essentially very similar risk profiles in practice. This will necessarily lead to unjustified competitive inequities among firms, where small statistical differences substantially increase a firm's capital requirements in relation to those of its competitor or competitors under the Proposal by way of regulatory fiat rather than genuine risk realities.

In addition, the G-SIB surcharge will exacerbate competitive inequities arising from jurisdictional differences in accounting, definitions of capital, and the calculation of risk-weighted assets;¹⁶ further affecting G-SIBs based in jurisdictions with more conservative accounting and supervision standards.

G. Capital should serve as a buffer in case banks suffer unexpected losses; it should not be set at levels and assessed pursuant to a methodology where business decisions are effectively made for G-SIBs by regulatory fiat or formula.

The combination of the Proposal's indicator-based methodology and the high capital charges it imposes would mean that asset allocation and business mix decisions will be dictated to a significant degree by the potential assessment of regulatory capital charges. Thus, fundamental decisions regarding which businesses to conduct and assets to hold, as well as organic growth or other expansion, will to some degree be made by regulators. We do not believe that this is desirable or appropriate or economically efficient; capital should serve as a buffer in case banks suffer unexpected losses; it should not be set at levels and assessed pursuant to a methodology where business decisions are effectively made for G-SIBs by regulatory fiat or formula.

¹⁶ It is unclear how U.S. regulators will adopt portions of the Basel Accord in light of section 171 (which establishes a risk based capital floor) and section 939A (which requires the removal of regulatory references to ratings) of the Dodd-Frank Act. As a result, it is unlikely that capital requirements will be harmonized across jurisdictions in the near future.

H. Numerous aspects of the Proposal’s indicator-based methodology are seriously flawed.

ABA generally agrees with the Basel Committee that no measurement approach will perfectly measure systemic importance across all global banks,¹⁷ and perfection should not be demanded of any methodology. Nevertheless, we have serious concerns with numerous aspects of the Proposal’s indicator-based methodology, including the following:

1. The Proposal’s indicator-based methodology should not be a relative measure.

ABA is concerned 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 would occur if the average scores for all the banks change – in either direction. 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 incentivize major, industry-wide risk reduction.

Moreover, well-managed banks would be disadvantaged by rising scores if, by virtue of their safety and soundness, they maintain or grow their market shares during periods when the industry shrinks, regardless of how well-managed the growth was or how it may have added to the safety of the institution. Additionally, if such well-capitalized and managed institutions should engage in loan growth or stabilizing acquisitions during times of distress, they could be penalized for doing so. We do not believe it is at all sensible to penalize these banks under such circumstances.

2. The Proposal does not account for the benefits of diversification. Instead it punishes banks that diversify their assets across jurisdictions and business lines.

All else held equal, an undiversified portfolio of assets is riskier than a diversified portfolio. The Proposal, however, not only fails to provide any offsetting benefits for banks with diversified assets but actually penalizes banks for diversifying their assets geographically and across business lines. This approach is inherently flawed, because it fails to accord recognition to the risk mitigations of geographic and business line diversification. That approach is inconsistent with best risk management practices.

3. Basing the “size” indicator on the Basel III leverage ratio total exposure measure aggravates existing industry concerns.

¹⁷ See Consultation Document, ¶ 13.

Under the Proposal, the “size” category is measured using total “exposure” as defined in the denominator of the Basel III leverage ratio. ABA believes that this exposure test would provide a seriously inaccurate evaluation of size unless it is adjusted to address the concerns already voiced by the industry in other comments.¹⁸ These concerns include (i) the inclusion of gross “sold” credit derivative positions without recognition of off-setting hedges and (ii) the failure to use reasonable conversion factors for off-balance sheet commitments (*e.g.*, an assumed 100% draw-down on liquidity facilities and trade finance commitments, which is not justified by the available empirical data). Until these issues are resolved, the Basel III definition of exposure is an aberrant indicator of size.

4. Contrary to best risk management practices, the cross-jurisdictional indicators encourage banks to fund foreign claims with home country liabilities.

The focus of the cross jurisdictional activity category is to capture the “global footprint” of banks, and it is based on the assumption that the “greater the global reach of a bank, the more difficult it is to coordinate its resolution and the more widespread the spillover effects from its failure.”¹⁹ Contrary to sound risk management practices, the proposed methodology actually promotes funding structures that could result in a more complicated resolution process and hence entail higher resolution risk. This methodology creates an incentive for banks to fund local assets with home country liabilities, rather than with local liabilities – an objectively riskier practice in view of exchange rate and exchange control risks, interest rate risks, ring fencing, and other regulatory mandates that could prevent the transfer of local currency assets to home country liability holders in the event of an insolvency. To illustrate this issue, consider the following hypothetical bank structures:

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

Assume the size of the local currency assets in each of the 25 branches or subsidiaries are identical in structures 1 and 2. All else held constant, Structure 2 would be the riskier and more difficult structure of the two to resolve. However, according to the methodology for determining a G-SIB’s score for the cross jurisdictional activity, Structure 2 would have the smaller indicator score, because in Structure 2 the bank holding company does not have any “cross-jurisdictional liabilities” for purposes of this indicator.²⁰ In other words, the proposed methodology would penalize a G-SIB for funding locally held assets with local liabilities, and instead encourage it to

¹⁸ See, letter to the Basel Committee, from the ABA, dated April 15, 2010. Available at http://www.aba.com/NR/rdonlyres/DC65CE12-B1C7-11D4-AB4A-00508B95258D/66804/cl_BCBS_2010Apr15.pdf.

¹⁹ Consultation Document, ¶ 18.

²⁰ Structure 1 and Structure 2 are equivalent with respect to the other individual indicator for this category – cross-jurisdictional claims.

fund those assets with liabilities in its home country, even though match funding with local liabilities is far less risky. Thus, the methodology would incentivize cross-border funding of foreign operations, a practice that is objectively riskier as described above.

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

Each of the cross-jurisdictional activity, size, interconnectedness, and complexity categories contains an indicator or indicators that attempt to quantify the amount of assets, derivatives, or other exposures held by a bank. None of these indicators, however, takes into account the risk profile of those assets, derivatives, or exposures for purposes of determining a bank's indicator-score. This failure to account for the riskiness of the assets, derivatives, and other exposures of G-SIBs is not consistent with the goal of reducing the probability of default of G-SIBs, another serious flaw in the Proposal's methodology.

6. A bank's score for the wholesale funding ratio is erroneously inflated, because it does not measure the term of the wholesale funding.

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

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

The OTC derivatives indicator in the complexity category calculates the value of OTC derivatives on a gross notional basis. Most OTC derivatives activity is conducted, however, pursuant to legally enforceable netting arrangements. As a result, the exposure of such derivatives is limited to a net obligation. The Proposal's failure to recognize legally enforceable netting arrangements overstates the risks associated with holding such derivatives. It also effectively penalizes the banks that spent the time and resources to establish such netting arrangements, by failing to take account of the success of efforts to reduce risk. For example, if one were to assume two banks with 1000x of gross notional exposure on the same book of business and one has netted down to 10x and the other to 1x, the OTC indicator would treat the 10:1 difference in risk as between the two banks in this example as non-existent—clearly an absurd result from a risk perspective.

Moreover, basing the OTC derivatives indicator in the complexity category on the gross notional amount also fails to take into account important differences which exist within the derivative markets. For example, the primary risk in FX transactions is settlement risk, a concern largely

addressed via the development and use of a well-functioning international settlement process, namely Continuous Link Settlement (CLS). In order to ensure consistency in the treatment of FX transactions within the G-SIB framework, we recommend that transactions executed via CLS should be excluded from the definition of OTC derivatives notional value. Similarly, OTC derivatives that are centrally cleared should be excluded from the measure.

8. The Proposal appears to assume custody accounts would become inaccessible to customers as a result of failure.

The Proposal states that the failure of a large custodian bank holding assets on behalf of customers could disrupt the operation of financial markets. The Proposal thus appears to assume that assets held under custody at a failed bank would become inaccessible to the customers as a result of the failure. We do not believe that assumption is warranted. To the extent there is uncertainty regarding the status of assets upon a custodian's failure, the Basel Committee should undertake the research necessary to establish the systemic significance of custodial relationships. We do not believe that assets under custody is inherently indicative of systemic importance.

II. Other Concerns and Requests for Clarification

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

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

B. ABA requests that the Basel Committee clarify how often the denominator used to calculate the systemic importance score will be updated.

The Proposal notes that “bank scores will be updated annually based on new data applied to the numerator in calculating the score.”²¹ However, the Proposal does not state whether the denominator will also be updated at that time. This omission could be interpreted to imply that the denominator will be updated every three to five years, at the time the threshold scores are updated. ABA would appreciate the Basel Committee clarifying how often the denominator will be updated. ABA also requests clarity about the long term engagement the Basel Committee will have with national regulators to ensure internationally consistent application.

C. ABA requests that the Basel Committee clarify its use of the term “weighting” as it applies to the determination of a bank’s indicator scores.

²¹ Consultation Document, ¶ 69.

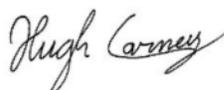
We note that the Proposal states that the score for a particular indicator is calculated by “dividing the individual bank amount by the aggregate amount summed across all banks in the sample for a given indicator. The score is then weighted by the indicator weighting within each category.”²² However, when giving an example of this calculation, the Proposal states that if the size indicator for a bank accounts for 10% of the sample aggregate size variable, it will contribute 0.10 to the total score for the bank, and does not multiply the .10 by 20%²³ – that is, it fails to multiply the score by the weighting of the indicator, but rather appears to be multiplying the indicator score by a fraction equal to one over the number of indicators in the category (which in the case of the size indicator equals 1) and adding that to the total systemic importance score. ABA would appreciate the Basel Committee clarifying its use of the term “weighting” and providing additional examples regarding how the indicator scores are supposed to be calculated.

III. Conclusion

ABA strongly believes that the current proposal should be withdrawn and reconsidered. Any re-proposal should contain a transparent and empirically supported methodology; take into account the regulatory environment in which banks operate, including resolution regimes; demonstrate that the benefits exceed the costs (particularly the costs of reduced economic growth); and address other concerns highlighted in this letter.

Thank you for the opportunity to comment. If you have any questions or need additional information, please contact the undersigned at 202.663.5324 or via email at hcarney@aba.com.

Sincerely,



Hugh Carney
Senior Counsel

²² Consultation Document, ¶ 17.

²³ Consultation Document, ¶ 17.

Letters – Tab 7



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 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%.

(continued...)

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

Letters – Tab 8



August 26, 2011

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

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

Ladies and Gentlemen:

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

The Associations have consistently voiced strong support for ongoing regulatory reform efforts that aim to make international financial systems safer and more robust. Nevertheless, we have fundamental reservations regarding the assumptions underlying a significant add-on capital surcharge for globally systemic important banks² (“G-SIBs”), as well as the design of the Proposal and the indicator-based methodology described in the Consultative Document. We do not accept the view that more capital is always the answer and strongly believe that excessive capital requirements can inhibit the ability of banks to support economic activity and can create unjustified competitive inequities. Nor do we agree with the simplistic view that size alone creates prudential concerns, or, more broadly, that large banks are inherently problematic and do not provide important economic and other benefits or that it is not feasible to end “too big to fail.” Indeed, we note that the Financial Stability Board (the “FSB”), in consultation with the Basel Committee, is currently embarked on a parallel effort to ensure that member nations adopt resolution protocols that clearly and effectively enable orderly liquidation without taxpayer support. The Associations strongly endorse this effort. In our view it further underscores the conclusion that the “negative externalities” associated with banks perceived as “too big

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

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

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

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

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

I. Executive Summary

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

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

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

- The imposition of a significant capital surcharge on G-SIBs explicitly rests on the assumption that such a surcharge is necessary to address the negative externalities and moral hazard costs associated with banks that are perceived to be “too big to fail.” However, substantial reform efforts have in fact been made in some countries to end too big to fail and implement effective and credible recovery and resolution regimes. The United States, for example, has adopted a comprehensive and effective resolution regime (*i.e.*, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”) as well as living will requirements) that end too big to fail as well as other systemic reforms which impose substantial costs on subject banks.
- Imposing a significant additional capital surcharge on G-SIBs will impose costs not just on banks, but also on their customers and the global economy. These costs include a potential reduction in the economic benefits that larger banks provide to businesses and consumers. Such a surcharge will also encourage business to migrate to the shadow banking sector, thereby increasing, rather than decreasing, systemic risk.
- There are significant open questions regarding the purported theoretical and policy foundations, as well as the appropriate calibration, for a G-SIB surcharge. Given these uncertainties, the imposition of a G-SIB surcharge could have economic costs and other unintended consequences and risks that are not readily apparent.

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

- The Consultative Document’s lack of supporting empirical analysis concerning how the various indicators and the resultant capital surcharges are linked to a reduction in the probability of failure of G-SIBs seriously undermines the Proposal’s credibility and generally hinders banks’ ability to analyze it in a meaningful way.⁴
- There is a lack of transparency surrounding the assessment and calculation of the proposed surcharge that makes it impossible for a bank to calculate its surcharge or determine what steps to take to reduce its surcharge. This lack of transparency frustrates bank management’s ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held. Given the potentially severe supervisory

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

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

- G-SIBs may be discouraged from conducting the activities measured by the indicators, including many that are beneficial from a systemic perspective (*e.g.*, making stabilizing acquisition of institutions in financial distress) and cannot be readily assumed by smaller institutions.
- The Proposal discourages banks from diversifying their assets across jurisdictions and business lines.
- The G-SIB surcharge will lead to unjustified competitive inequities between large banks subject to the surcharge, on the one hand, and other large banks and nonbank financial companies not subject to the surcharge, on the other. It also has the potential to create competitive inequities among G-SIBs given that small numerical differences in systemic importance scores could result in G-SIBs with similar real-world risk profiles being assigned to different surcharge “buckets.”
- The Proposal inherently creates the incentive for G-SIBs to concentrate their activities in business lines that are not penalized under the indicator-based methodology, thereby amplifying the potential for systemic disruptions if those business lines turn out to be a primary source of problems in a subsequent financial crisis.
- Numerous specific aspects of the Proposal’s indicator-based methodology are flawed, including:
 - If the G-SIBs all reduced their indicator-based risks substantially and proportionally, the surcharges would nonetheless remain the same. This aberrant result is illustrative of the analytical defects in the Proposal as described in the Consultative Document.
 - The manner in which the wholesale funding indicator is calculated will materially distort the total systemic importance score of banks whose wholesale funding ratio is higher than average.
 - Many of the indicators are inaccurate measures of systemic importance. For example, the value of underwritten transactions or of assets under custody (at least in the United States) is not indicative of systemic importance.

- The methodology creates perverse incentives to increase instead of decrease risk. For example, the cross-jurisdictional indicators encourage banks to fund foreign claims with home country liabilities, an objectively riskier practice than funding these claims with local currency liabilities.
- There is no mechanism to lower the capital surcharge as the global systemic importance of G-SIBs in the aggregate is reduced.
- Size is dubious as a separate indicator and, in any event, is significantly over-counted in determining a bank's systemic importance score.
- The Proposal may penalize well-managed banks with rising scores if they maintain or grow their share of businesses measured by the indicators while the industry as a whole contracts or even remains the same.

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

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

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

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

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

Over the past two years, significant regulatory reforms have been introduced both by the Basel Committee and domestic regulators in order to address a wide variety of regulatory concerns, including capital adequacy, liquidity risk, loss absorbency, market risk, stress testing and capital planning. Many of these measures will require, or have in practice already required, G-SIBs to make major changes to their capital structures, balance sheet composition and liquidity and operational risk management functions, calling into question the need to impose an additional capital surcharge at this time. For example, the heightened capital requirements under Basel III alone will require U.S. banks to increase the amount of CET1 U.S. banks hold by *over 100%* from the amount held at December 31, 2007.⁶ In addition, as a result of the imposition of Basel III's quantitative, qualitative and risk-weighting requirements, the amount of capital a bank would need to hold to satisfy the 7% minimum CET1 ratio under Basel III is nearly *triple* the amount of CET1 it would need to hold to satisfy the "well-capitalized" requirements under U.S. prompt corrective action regulations.⁷ Moreover, Basel III and related enhancements to the capital framework made under Basel II.5 not only addressed aggregate capital

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

¹⁰ See Consultative Document, ¶ 56.

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

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

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

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

We believe the view that size alone creates prudential concerns, or, more broadly, that large banks are inherently problematic is not only simplistic in the extreme, but ignores the important economic and other societal benefits of large banks. Indeed, there are important benefits attributable to larger banks that will be reduced and potentially lost if a significant surcharge is imposed on G-SIBs, encouraging, or effectively requiring, these banks to reduce their size. The preliminary results of a study being conducted on behalf of TCH¹³ show that the benefits attributable to larger banks divide into three broad categories: the broad scope of products and services provided by large banks that cannot be credibly provided by other institutions, large banks’ economies of scale and the enabling of innovation across banking markets.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

* * *

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

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

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

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

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

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

A. The Proposal has fundamental flaws in its design.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

²⁴ See Consultative Document, ¶ 13.

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

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

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

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

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

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

²⁶ *Id.* ¶ 18.

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

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

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

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

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

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

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

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

The Proposal states that “[t]he maximum possible total score a bank could have (*i.e.*, if there were only one bank in the world) is 5” and that each of the five categories is normalized to a score of one.²⁹ However, the denominator used to determine the score for the wholesale funding ratio is defined as the average instead of the sum of all banks’ ratios. As a consequence, the score for this indicator could be larger than 1 for approximately half of the 73 banks, if their scores were symmetrically distributed around the average value. Independent of the shape of the distribution of scores, of necessity some banks will have a wholesale funding ratio greater than average and consequently will have an indicator score greater than 1, which could in certain circumstances violate the rule that the maximum category score for any bank is 1. In fact, if 72 banks had a wholesale funding ratio of zero and one bank had a non-zero wholesale funding ratio, then the average value of the ratio would be the ratio of that bank divided by 73, and this bank’s indicator score would be 73. As a consequence, the maximum total score of one bank would be approximately 29 (that is, 73 divided by 3, plus 4.67, which is the maximum total score for all of the other indicators), instead of 5.³⁰

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

²⁸ See *id.* ¶ 55.

²⁹ *Id.* ¶ 17.

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

³¹ *Id.* fn. 11.

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

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

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

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

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

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

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

³² See *Id.* ¶ 37.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

³⁷ Consultative Document, ¶ 27.

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

* * *

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

- The Proposal lacks transparency and does not permit for meaningful capital planning because banks cannot determine their capital surcharge or what steps to take to reduce their systemic importance scores. It also lacks internal consistency because it is premised on the existence of substantial negative externalities and moral hazard yet, paradoxically, explicitly forbids the consideration of reforms designed to address such issues when determining a G-SIBs' score. It therefore violates the first and fourth basic principles outlined above, which generally require that a regulatory capital proposal be transparent and internally consistent and enable a bank to undertake capital planning in accordance with the proposal's requirements, respectively.
- It fails to provide any substantive empirical analysis linking the indicator-based methodology of the Proposal to its intended purpose (*i.e.*, reducing the probability of default of G-SIBs) or justifying the Proposal from an economic perspective, thereby violating the second and third basic principles, which require that a regulatory capital proposal's quantitative measurements be commensurate with their intended purpose and that its calibration be justified economically, respectively.
- The Proposal increases risk taking by encouraging banks to fund local currency assets with home country liabilities and punishing banks that diversify across jurisdiction and business lines. It also may increase systemic risk by encouraging business to migrate to the shadow banking sector. As a consequence, it violates the fifth basic principle, which requires that a proposal not encourage increased risk taking.

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

IV. Other Concerns and Requests for Clarification

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

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

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

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

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

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

³⁸ *Id.* ¶ 69.

³⁹ *Id.* ¶ 78.

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

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

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

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

⁴⁰ *Id.* ¶ 17.

⁴¹ *Id.*

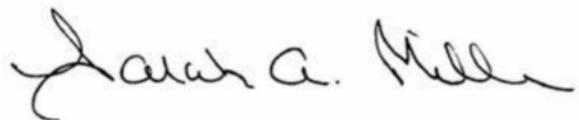
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Very truly yours,



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Secretary
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The Honorable Neal Wolin
Deputy Secretary
Department of the Treasury

The Honorable Jeffrey A. Goldstein
Under Secretary of the Treasury for Domestic Finance
Department of the Treasury

Mr. Lance Auer
Deputy Assistant Secretary
Department of the Treasury

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve

The Honorable Janet L. Yellen
Vice Chairman
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The Honorable Elizabeth A. Duke
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ANNEX A

The Associations

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

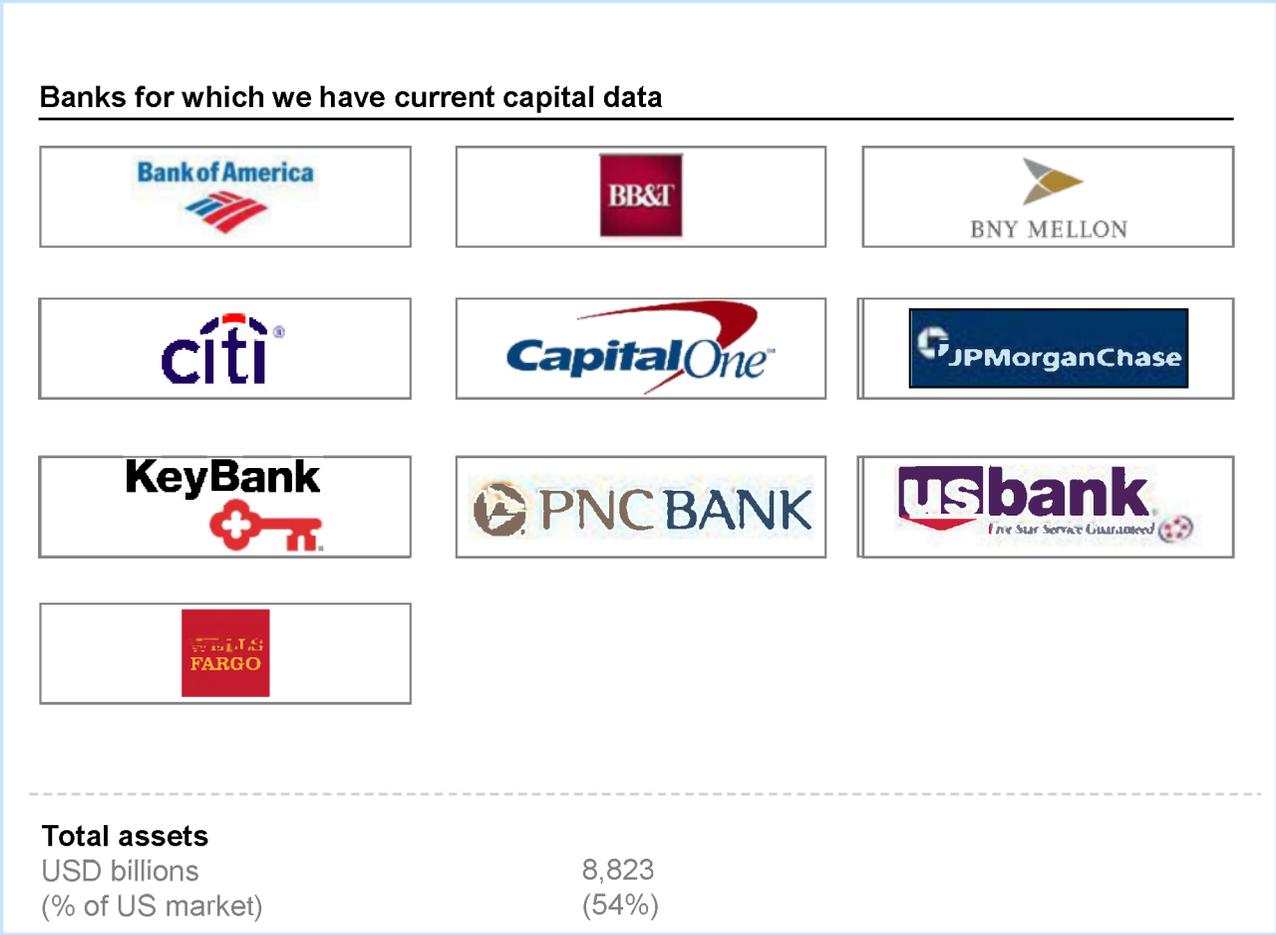
The IIB is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership is comprised of internationally headquartered banking and financial institutions from 38 countries around the world. The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

ANNEX B

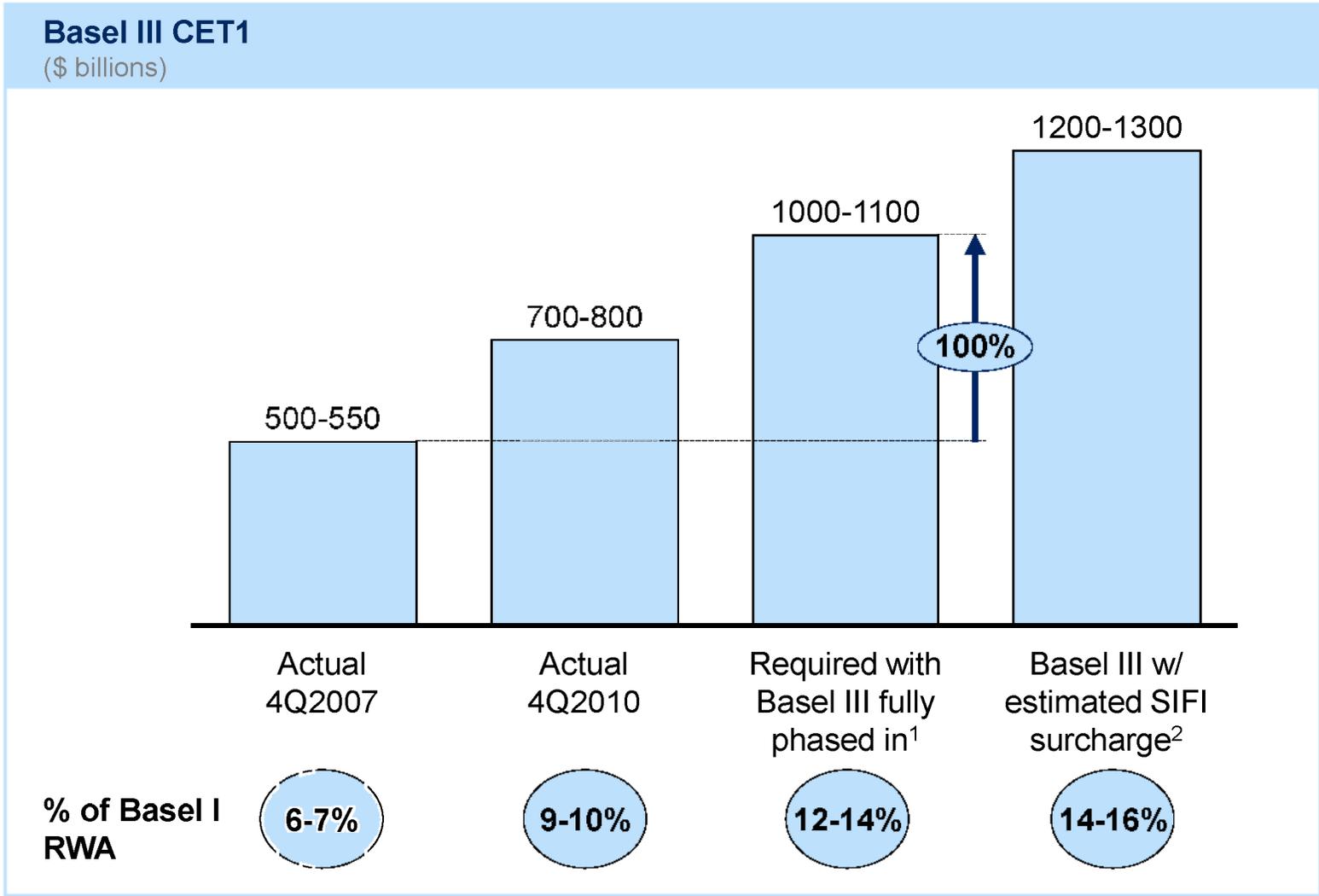
Contents

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

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



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



1 Fully phased in at CET1 as 7% of RWA

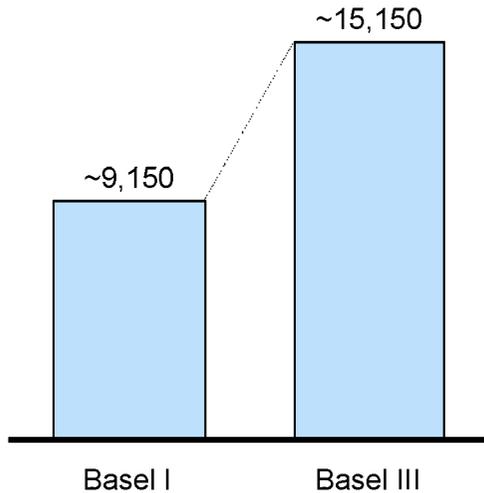
2 Estimated SIFI surcharge of 100-250bps for the industry

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

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

Industry RWA

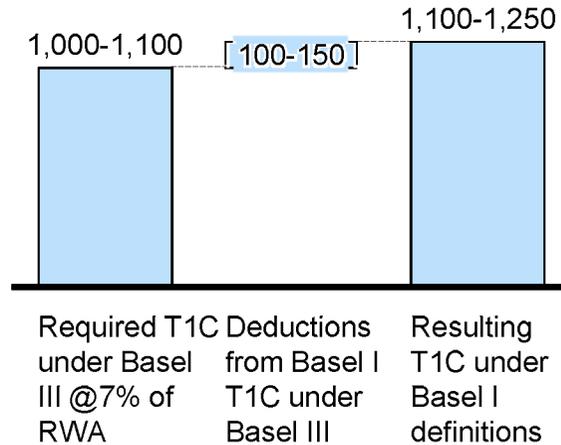
\$ billions, as of 12/31/2010



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

Industry Tier 1 common capital

\$ billions, as of 12/31/2010



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

Capital ratio calculations

Basel III CET1 (adjusted) as % of Basel I RWA

$$= \text{Basel III T1C with deductions} / \text{Basel I RWA}$$

$$= 1,100 / 9,150$$

$$= 12\%$$

$$= 1,250 / 9,150$$

$$= 14\%$$

Contents

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

Methodology for analyzing the relationship between pre-crisis bank capital ratios and the likelihood of a bank going into distress

Approach

- Analyzed the relationship between capital ratios of large global banks, at the onset of the financial crisis (defined as December 2007), and subsequent Bank distress during the crisis
 - Initial capital ratios as defined in both Basel III and Basel I terms used to study relationship to Bank distress

Banks in sample

- 123 large global banks with minimum asset size of \$30 billion
 - Represent \$68.2 trillion in total assets
 - About 85% of developed-market banking and 65% of total banking assets worldwide
 - Broker-dealers excluded as risk-weighted assets data unavailable in December 2007.

Definition of distress

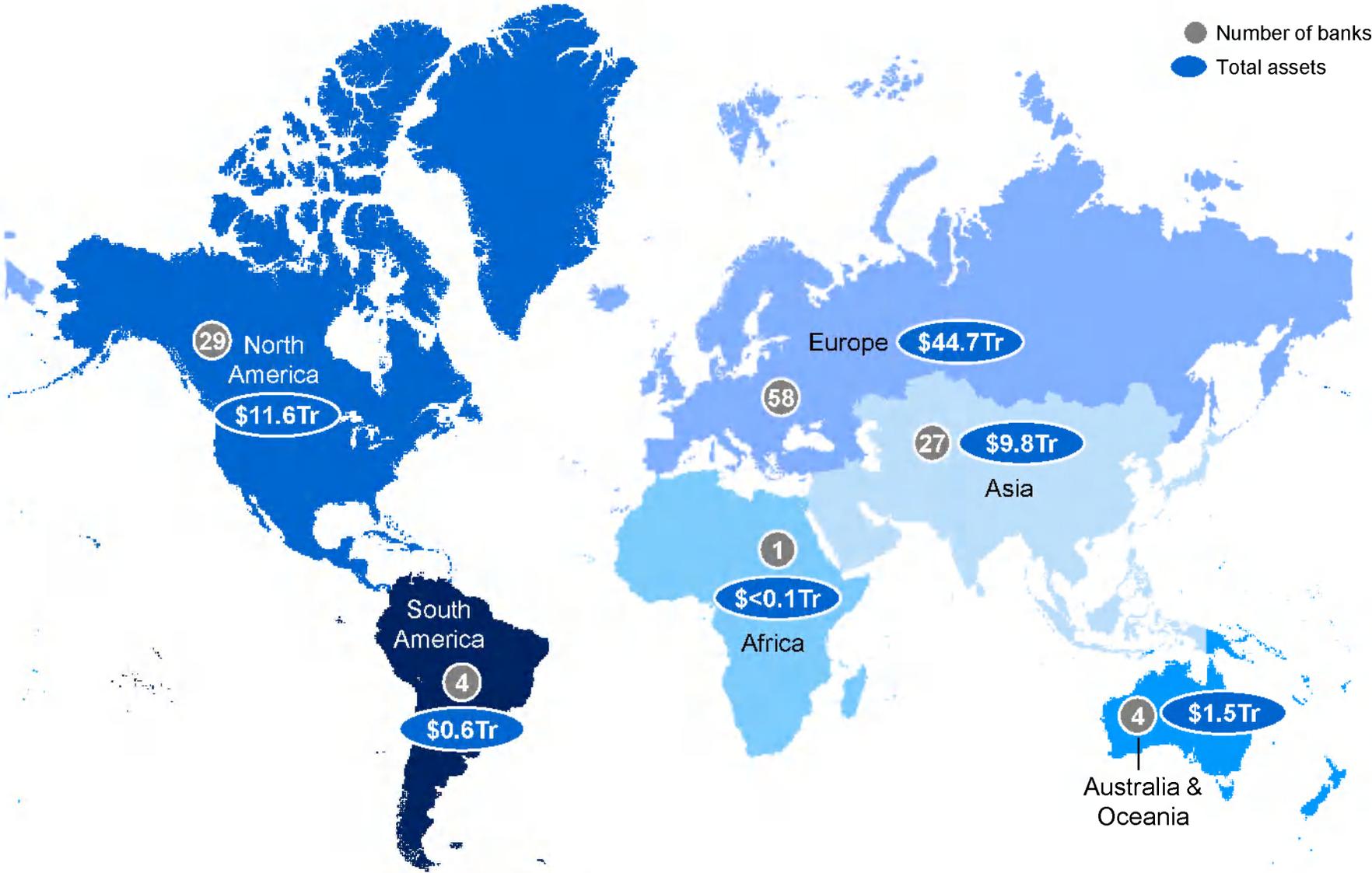
- An institution is defined as distressed if any of the following conditions was met 2007-09:
 1. Bankruptcy
 2. Government takeover or placement into government conservatorship
 3. Merger under duress with another bank
 4. Receipt of a substantial direct government capital investment or bailout¹
- Using the above definition, a total of 35 banks were deemed distressed (28% of banks in the sample, covering 30% of the assets)

Adjustments for Basel III

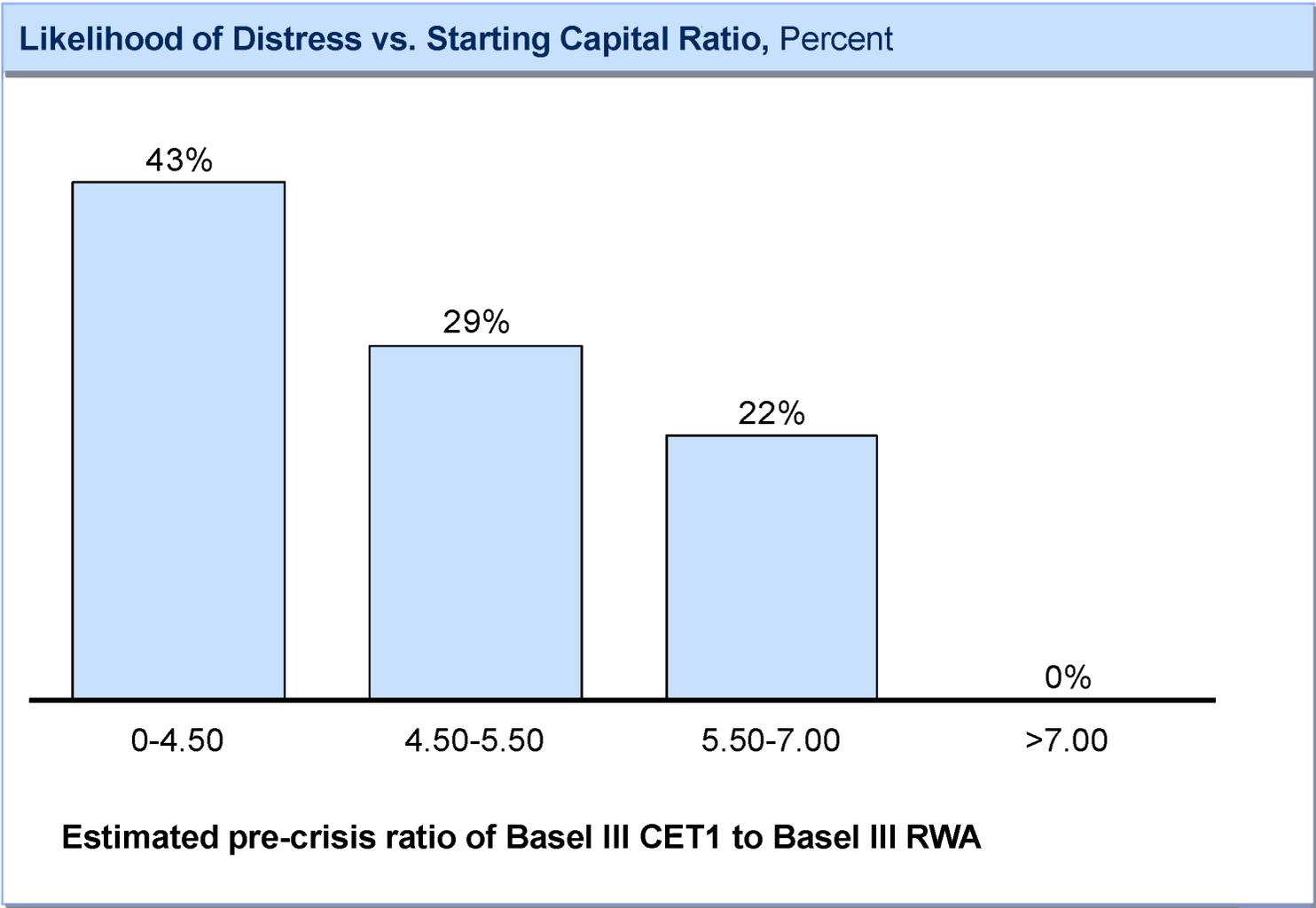
- Adjustments developed to convert December 2007 capital and RWA for each bank into estimates of what Basel III capital ratios would have been, had Basel III rules existed at the time
 - Adjustment factors estimated for different type of banks (e.g., by country, by mix of business such as wholesale vs. retail, trading assets)

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

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



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



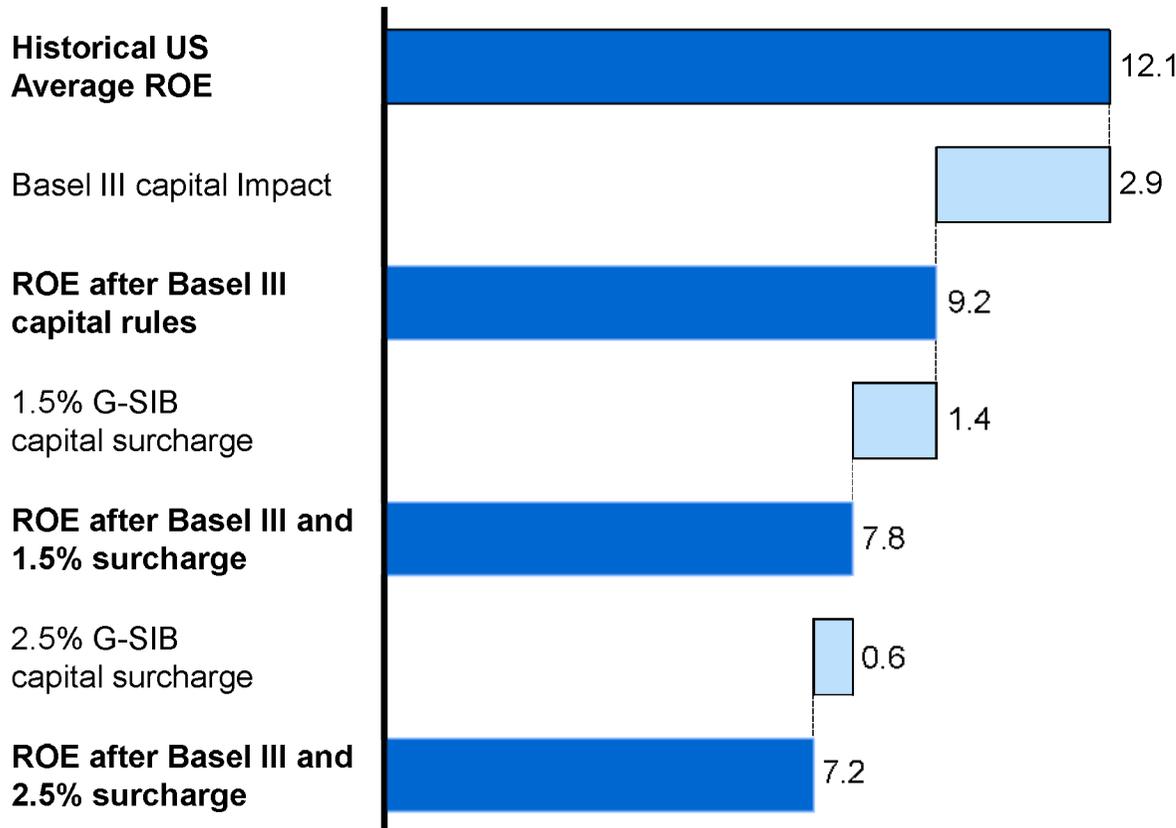
Contents

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

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

Unmitigated ROE impact of Basel III capital proposals, as of Q4 2010¹

Percentage points



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

¹ Not including ROE impacts of the LCR and NSFR

Letters – Tab 9



Paul Saltzman

President of the Association

EVP and General Counsel of the Payments Company

Phone 212.613.0138

paul.saltzman@theclearinghouse.org

November 2, 2011

The Honorable Timothy Geithner
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Geithner:

The Clearing House Association (TCH) recently provided you with our study on capital, which addressed the consequences of elevated capital requirements, including a surcharge for global systemically important banks. We hope you found that work to be constructive. Today, I am pleased to provide you with ***Assessing the Liquidity Coverage Ratio*** – our analysis of the Basel Committee’s recommended short-term liquidity requirements – and an accompanying white paper. We are confident that this empirical examination of the liquidity coverage ratio (LCR) represents the most comprehensive review of the rule and its potential impacts prepared to date.

Using a fact-based, analytical framework that draws on data from TCH’s member banks, our study addresses the relationship between the LCR’s calibrations and what actually occurred during the financial crisis. Likewise, these materials are geared toward discerning the impacts of implementing the LCR on end users, financial institutions, and market participants. *Our study finds that several of the LCR’s assumptions are flawed, most seriously affecting housing finance and private and public borrowers that rely on liquidity line back-stops (most commonly for commercial paper and variable rate demand notes).* We have briefed your staff on the results and would welcome the opportunity to provide further, more granular briefings to you and others at Treasury on on this issue.

TCH believes the LCR framework, as recommended by the Basel Committee, is largely well-crafted and represents meaningful regulatory progress. However, the prescriptive standards recommended by the Basel Committee are not a panacea, and as the Basel Committee itself has acknowledged, the LCR is a work-in-progress. Several of the critical calibrations are overly conservative and significantly understate the stock of liquid assets that firms could use to meet their short-term funding needs. These issues are of current importance given the new operational challenges to U.S. firms -- transitioning to a new LCR standard is already altering credit intermediation and forcing firms to hold excess liquidity. Equally troubling, from a

competitive standpoint, is that European regulators are providing themselves with the flexibility to separately address flaws in the LCR framework and to remedy policy defects that could provide beneficial treatment to European firms.

Our analysis indicates that these issues require the attention of the regulatory community before national implementation begins, even on a preliminary and non-binding basis. In its current form, the LCR would result in a liquid asset shortfall of \$1.4 trillion. Considering a reasonable management buffer and more normalized balance sheets, the liquidity shortfall imposed by the LCR is actually closer to \$2.0 trillion. This shortfall is so large that that if banks met the LCR by purchasing U.S. government debt, they could be forced to hold more than one quarter of all outstanding Treasuries. These impacts will be especially harmful alongside the Basel Committee's decision to remove the AOCI filter from regulatory capital requirements, which has resulted in significant balance sheet volatility and will exacerbate the LCR's negative consequences.

We urge U.S. banking regulators to recalibrate flawed LCR assumptions before they are implemented. It is important to note that if the following recalibrations are made, the industry average LCR would increase from approximately 60% to an LCR of between 105-110%, and the current liquid asset shortfall would be eliminated. Our recommended changes include:

- **Government-sponsored enterprise (GSE) debt and GSE mortgage-backed securities (MBS) should be treated as Level 1 assets** – The LCR recommendation does not give adequate liquidity credit to GSE debt or MBS, subjecting them to a 15% haircut and capping them at 40% of total liquid assets. In addition to potential negative impacts on the U.S. housing finance system, this treatment has significant negative effects for U.S. firms and requires many firms to substantially reorganize their balance sheets to meet the LCR.
- **Federal Home Loan Bank (FHLB) borrowing capacity should be recognized** – The ability of U.S. firms to draw on FHLB facilities is not given any credit under the Basel Committee's LCR framework. The FHLB system provided essential liquidity during the financial crisis and continues to be an integral part of the U.S. mortgage market. Credit should be given under the LCR for available FHLB borrowing capacity.
- **Non-operational wholesale deposit runoff calibration should be revised** – The recommendation's 100% implied outflow rate for non-operational wholesale deposits does not accurately reflect worst-case scenario experiences during the financial crisis and will significantly affect product availability and pricing. This will have the impact of disintermediating deposits out of the banking system. To address the incorrect calibration of non-operational wholesale deposits, the regulatory community should revise outflow assumptions to align them with actual worst-case scenario data from the crisis.

- **Liquidity line draw calibrations should be revised** – The LCR recommendation compels firms to assume that liquidity lines will be 100% drawn, increasing costs on commercial paper, variable rate demand notes, and liquidity lines extended to financial and non-financial firms. Significant cost increases will be concentrated in markets that are more than \$1 trillion in size. This treatment of liquidity lines will harm specific customers: municipalities, corporations, asset sellers, pension funds, and a variety of financial services enterprises. Products relied on by these customers will become unsustainably expensive or disappear entirely. Recalibrating the LCR to be more reflective of actual liquidity line draw-rates during periods of extreme stress would obviate these concerns.

Making these technical corrections before national implementation would also address important systemic risk concerns. As recommended, the LCR may actually increase systemic risk by encouraging the migration of traditional banking functions to the shadow banking system, constraining diversification in firms' liquid asset portfolios and funding, increasing banks' reliance on sovereign debt as a primary source of liquidity, and pressuring banks to compete for retail deposits in ways that make such deposits less stable. These negative consequences would be avoided by addressing the technical concerns outlined above.

On behalf of The Clearing House and our owner banks, I am confident that you and your staff will find this analysis useful. Should you have questions about this study or other work that The Clearing House has undertaken, please do not hesitate to contact me at (212) 613-0138 or paul.saltzman@theclearinghouse.org; Dan McCardell, Senior Vice President and Director of Regulatory Affairs, at (212) 613-0164 or dan.mccardell@theclearinghouse.org; or Eli Peterson, Vice President and Regulatory Counsel, at (202) 649-4602 or eli.peterson@theclearinghouse.org.

Respectfully,

A handwritten signature in black ink that reads "Paul Saltzman" with a long horizontal flourish extending to the right.

Paul Saltzman
President and General Counsel
The Clearing House Association

cc: The Honorable Neal Wolin
Deputy Secretary
Department of the Treasury

Mr. Lance Auer
Deputy Assistant Secretary
Department of the Treasury

Mr. Timothy Bowler
Deputy Assistant Secretary
Department of the Treasury

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve

The Honorable Janet L. Yellen
Vice Chairman
Board of Governors of the Federal Reserve System

The Honorable Elizabeth A. Duke
Governor
Board of Directors of the Federal Reserve System

The Honorable Sarah Bloom Raskin
Governor
Board of Governors of the Federal Reserve System

The Honorable Daniel K. Tarullo
Governor
Board of Governors of the Federal Reserve System

Mr. Patrick M. Parkinson
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

Ms. Mary Aiken
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

Mr. John G. Walsh
Acting Comptroller of the Currency
Office of the Comptroller of the Currency

Mr. Martin Pfinsgraff
Deputy Comptroller for Credit Risk
Office of the Comptroller of the Currency

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation

Mr. Kyle Hadley
Senior Capital Markets Specialist
Federal Deposit Insurance Corporation

The Honorable Gene Sperling
Director
National Economic Council

Mr. William C. Dudley
President and Chief Executive Officer
Federal Reserve Bank of New York

Mr. Marc R. Sidenberg
Senior Vice President, Banking Supervision
Federal Reserve Bank of New York

Letters – Tab 10



February 7, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R-1401
RIN 7100-AD61

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219
Docket ID OCC-2010-0003
RIN 1557-AC99

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Comments/Legal ESS
RIN 3064-AD70

Re: [Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions](#)

Ladies and Gentlemen:

The Clearing House Association L.L.C. (“**The Clearing House**”), the American Bankers Association (“**ABA**”), the American Securitization Forum (“**ASF**”), the Financial Services Roundtable (“**The Roundtable**”), the International Swaps and Derivatives Association, Inc. (“**ISDA**”) and the Securities Industry and Financial Markets Association (“**SIFMA**”) and, together with The Clearing House, the ABA, ASF, The Roundtable and ISDA, the “**Associations**”) ¹ are writing to comment on the joint notice of proposed rulemaking ² (the “**NPR**”) and, the proposed rule set forth therein, the “**Proposed Rule**”) issued by the Board of Governors of the Federal Reserve System (the “**Board**”), the Federal Deposit Insurance

¹ The Associations collectively represent financial institutions accounting for a substantial majority of banking and financial assets in the United States. Please see *Annex A* for a more detailed description of the Associations.

² 76 Fed. Reg. 79380 (Dec. 21, 2011).

Corporation (the “**FDIC**”) and the Office of the Comptroller of the Currency (the “**OCC**”, and together with the Board and FDIC, the “**Agencies**”) to incorporate into their proposed market risk capital rules (the “**Proposed MRC Rules**”)³ alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings.

Part I of this letter summarizes our overarching concerns with the Proposed Rule. Parts II and III of this letter address in additional detail our concerns with respect to the Proposed Rule’s methodologies applicable to exposures other than securitizations and to securitizations, respectively, and set forth our thoughts on alternatives to those methodologies; Part IV addresses substantive concerns with the treatment of correlation trading positions under the Proposed Rule as well as the Proposed MRC Rules; and Part V addresses other concerns with respect to the Proposed Rule. Part VI sets forth a list of certain of the Agencies’ questions from the NPR and cross references our responses in this letter.

I. Introduction and Summary

The Proposed Rule is being adopted in accordance with the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”). As noted in our comment letters on the Proposed MRC Rules,⁴ we continue to believe that, notwithstanding the perceived inadequacies in the issuance and use of credit ratings that contributed to the financial crisis, Section 939A’s requirement for a complete abandonment of ratings is both ill advised and an over-reaction.⁵ We appreciate the challenges facing the Agencies in their efforts to responding to Section 939A’s mandate. Moreover, we generally agree with the standards for alternatives to credit ratings outlined in Part I.C of the NPR – namely, that the alternatives, to the extent possible, should (i) appropriately distinguish the credit risk associated with a particular exposure within an asset class, (ii) be sufficiently transparent, unbiased and replicable, (iii) provide for timely and accurate measurements of negative and positive changes in creditworthiness, (iv) minimize opportunities for regulatory capital arbitrage, (v) be reasonably simple to implement and (vi) foster prudent risk management. We also think it is extremely important that the alternative methodologies not significantly diverge from Basel II.5⁶ in a way that sacrifices risk sensitivity or competitively disadvantages U.S. banking organizations *vis-à-vis* their international competitors.

³ 76 Fed. Reg. 1890 (Jan. 11, 2011) (proposed revisions to market risk capital rules).

⁴ See letter, from The Clearing House, the ABA, ISDA and SIFMA, dated April 11, 2011, to the Agencies (commenting on the Proposed MRC Rules) (the “**April 11th Letter**”); and letter, from The Roundtable, dated May 5, 2011, to the Agencies (commenting on the Proposed MRC Rules).

⁵ The Basel Committee on Banking Supervision (the “**BCBS**”) appears to be moving toward an expanded (as opposed to a more limited) use of ratings. See, e.g., *Basel Committee Considers Use of Credit Ratings and LCR Shake-Up* (Risk Magazine, Jan. 26, 2012) (reporting that the BCBS is considering using credit ratings as a factor for determining which sovereign bonds may be treated as highly liquid assets under Basel III’s liquidity coverage ratio). The international community’s expanded use of risk weightings will only exacerbate the problems posed by Section 939A for U.S. banks.

⁶ “**Basel II.5**” as used in this letter refers to the Basel Committee on Banking Supervision’s (the “**BCBS**”) framework for the assessment of capital charges for exposure to market risk, as revised in the following

Nevertheless, the Associations have significant concerns with a number of aspects of the Proposed Rule's alternative methodologies for determining specific risk-weighting factors. In many cases, we believe that the Agencies' objectives set forth in Part I.C of the NPR have not been optimally achieved by various aspects of the Proposed Rule – for example:

- the Proposed Rule's failure to appropriately distinguish the credit risk associated with particular exposures within an asset class (particularly securitizations, resulting from the rather blunt approach of the simplified supervisory formula approach (“**SSFA**”), which would substantially overstate the amount of capital required for certain securitization exposures);
- the underlying biases in the Organization for Economic Cooperation and Development's (“**OECD**”) Country Risk Classification (used in establishing risk-weighting factors for sovereign debt exposures and debt positions of depository institutions, foreign banks and credit unions (collectively, “**banking entities**”) and public sector entities (“**PSEs**”));
- the Proposed Rule's failure to accurately measure negative and positive changes in creditworthiness (as a result of, in the case of corporate debt, the three proposed metrics in general and the leverage indicator in particular, and, in the case of securitizations, the determination of K_G , K_{SSFA} and the ratio of cumulative losses to K_G and related issues); and
- implicit incentives that are contrary to prudent risk management (e.g., the general failure of the Country Risk Classification approach to sovereign debt to establish higher risk weight factors for instruments with greater risk and the SSFA's general risk insensitivity, in each case, creating perverse incentives, if capital costs were the only consideration, for banks to purchase higher-risk and higher-yielding sovereign debt and securitization positions).

More generally, in our view, the Proposed Rule's methodologies have important shortcomings, including that:

- they are not sufficiently risk sensitive, and therefore represent a step back from the more risk sensitive approach of Basel II.5. This concern is heightened by the Agencies' stated intention to revise the general risk-based capital rules applicable to positions held in the banking book by incorporating creditworthiness standards similar to those in the Proposed Rule;

publications: BCBS, *Enhancements to the Basel II Framework* (July 2009), available at <http://www.bis.org/publ/bcbs157.pdf>; BCBS, *Revisions to the Basel II Market Risk Framework* (July 2009), available at <http://www.bis.org/publ/bcbs158.pdf>; BCBS, *Guidelines for Computing Capital for Incremental Risk in the Trading Book* (July 2009), available at <http://www.bis.org/publ/bcbs159.pdf>; and BCBS, *Changes to the Revisions to the Basel II Market Risk Framework* (June 2010), available at <http://www.bis.org/press/p100618/annex.pdf>.

- with respect to securitizations, they (i) discourage banks from underwriting, purchasing, making a market in or engaging in secondary trading in less risky securitization positions and (ii) result in negative effects on the availability and liquidity of credit to American consumers and businesses that will have significant adverse effects on the recovery of the U.S. economy;
- they lead to different and, in some cases, more punitive risk weights than under Basel II.5's ratings-based approach and therefore could very well disadvantage U.S. banking organizations *vis-à-vis* their international competitors;
- they could require capital charges in excess of dollar-for-dollar capital for some institutions; and
- in certain cases, they are pro-cyclical.

In addition, the Associations have serious concerns regarding the appropriateness of using the SSFA in determining the capital requirements for correlation trading positions under the CRM as well as several aspects of the Proposed MRC Rules' treatment of correlation trading positions, including the imposition of the 15% surcharge under the CRM, the lack of an explicit cap on maximum losses and the failure of standard charges to properly measure the overall risk of the correlation trading portfolio.

The capital markets play a critical role in providing credit to the United States and global economy by bringing together issuers and investors. By doing so, capital markets increase the availability of credit to the economy and reduce over-concentrated reliance on banks to finance the economy. Banking organizations' securities underwriting, secondary trading and market-making activities are at the core of functioning capital markets. The Proposed Rule will have a direct effect on companies' ability to access the capital markets by virtue of the central role banking organizations serve in bringing issuers and investors together and providing liquidity to investors. Investors require banking organizations to be committed to trade a security in order to be comfortable to buy that security at new issuance. Issuers require banking organizations to underwrite and sell a security to investors. If the Agencies' market risk capital rules are not risk-sensitive and create uneconomic incentives for holding or not holding securities, they risk materially altering, and potentially harming, the systemic liquidity that allows issuers and investors to transact in the capital markets.

In light of our concerns, we have set forth in this letter our initial thoughts as to more appropriate, risk sensitive alternatives to the methodologies set forth in the Proposed Rule, to the extent feasible given the comment deadline. We would be delighted to work with the Agencies on an on-going basis to flesh out these proposals after the submission of this letter and join with the Agencies in developing solutions where they have deficiencies.

Our principal objective in developing alternatives to the Proposed Rule's methodologies for sovereign debt, bank, financial entity and corporate debt positions and securitizations is not to achieve lower overall capital requirements than what would otherwise be required under the Proposed Rule, but rather to increase risk sensitivity and to minimize potential competitive inequities relative to non-U.S. institutions. Indeed, the Associations' preferred alternative path for certain debt positions likely would increase the specific risk capital requirement for some exposures (*e.g.*, certain OECD

sovereign debt exposures).⁷ Furthermore, in developing these alternatives, we seek to promote transparency and to develop methodologies that banking organizations of varying sizes and levels of operational sophistication could effectively and efficiently utilize, consistent with the standards enumerated in Part I.C of the NPR.

Finally, we respectfully submit that the Agencies should not implement the final rule until potential alternative methodologies can be developed in detail and thoroughly considered and a quantitative impact study has been undertaken to determine the comparability of the Proposed Rule's alternative methodologies to Basel II.5's ratings-based approach as well as to assess the impact of the Proposed Rule on banking organizations, the availability and cost of credit and the U.S. economy. After potential alternatives have been more fully developed and a QIS has been undertaken, we urge the Agencies to re-publish the Proposed Rule for further comment.

II. Concerns with the Proposed Rule's Treatment of Non-Securitization Exposures

A. Sovereign Exposures

i. The CRC methodology has deficiencies and limitations that disqualify it as a credible approach.

Under the Proposed Rule, the specific risk-weighting factors of sovereign debt positions are to be determined based on the sovereign's classification under the OECD's Country Risk Classification (the "**CRC methodology**").⁸ The CRC methodology is also used under the Proposed Rule to determine the specific risk-weighting factors of debt positions of banking entities and PSEs. The CRC methodology consists of a quantitative assessment pursuant to the Country Risk Assessment Model ("**CRAM**") used to assess country credit risk and a qualitative assessment of the CRAM results by country risk experts from OECD members through which the CRC methodology integrates political risks and other risk factors not taken into account in the CRAM.

The Associations believe that the Proposed Rule's CRC methodology is problematic. First, there are significant potential conflicts of interest in the CRC process because OECD member countries are effectively assigning their own ratings. Replacing the judgment of third party credit rating agencies concerning sovereign debt, whatever their perceived shortcomings, with decisions made by functionaries of the very governments whose credit they are supposed to rate potentially raises more questions than are solved by the requirements of Section 939A of Dodd-Frank.

Second, the CRC methodology measures "country risk", which generally correlates with, but is not equivalent to, sovereign credit risk. For purposes of the CRC, "country risk" consists of

⁷ Attached as *Annex B* is a comparison of capital requirements under the Proposed Rule and under Basel II.5's risk-based approach for sovereign debt exposures and investment grade corporate debt positions. See, in particular, page 1 of *Annex B*, setting forth comparisons for sovereign debt. A more risk-sensitive approach will almost certainly result in higher capital requirements than those required by the Proposed Rule's methodology for many countries.

⁸ The CRC methodology is used for transactions covered by the OECD arrangement on export credits to determine the premium interest rate charged to cover the risk of non-repayment of export credits.

“transfer and convertibility” risk (*i.e.*, the risk that a sovereign imposes capital or exchange controls preventing an entity from converting local currency into foreign currency or transferring funds to creditors outside that country) and cases of force majeure (*e.g.*, war and natural disasters).⁹ Indeed, as the OECD itself states, “[t]he country risk classifications are not sovereign risk classifications and should not, therefore, be compared with the sovereign risk classifications of private credit rating agencies.”¹⁰ While “country risk” as measured by the CRC does bear some relationship to general economic conditions in a particular country and therefore appears to have a correlation with sovereign debt risk at some level, this correlation may be somewhat attenuated and therefore supplementing the CRC methodology with additional factors, as described below, is clearly warranted.

Third, as acknowledged in the NPR, the CRC ratings process has little transparency.¹¹ Ratings are assigned following a determination of CRAM results and meetings of country risk experts. These meetings and details of the CRAM are confidential however, and no official reports of the deliberations at the meetings are made publicly available.¹² The general lack of transparency makes the CRC classification process a “black box” from the perspective of banking organizations, thereby making capital planning more difficult and capital requirements less predictable.

Fourth, the CRC lacks risk sensitivity in practice. OECD members defined as “high-income countries” by the World Bank receive a CRC of zero, even if a country has recently experienced significant financial and budgetary distress and has actually had to request international aid because it was likely unable to pay its sovereign debts as they became due. For example, Portugal currently has a CRC rating of “0” and therefore its sovereign obligations would receive a risk weighing of zero for purposes of the CRC methodology despite the fact that Portugal is rated “B” or “below investment grade” for purposes of Basel II.5’s ratings-based approach (and thus receives a specific risk-weighting factor of 8%). The NPR has attempted to somewhat alleviate this type of concern by applying the highest specific risk-weighting factor (12%) to the debt positions of sovereigns that have “defaulted” on any exposure during the previous five years. However, this adjustment does little to address the overall risk insensitivity of the Proposed Rule given the small number of countries likely to experience an actual “default” for purpose of the Proposed Rule and the fact that this higher risk weight would only be applied after the fact of a default. More concretely, this element of the Proposed Rule would correctly assign a high risk weighing to Greece if and when it were to “default” (albeit broadly defined), but we note that Greece currently has a CRC rating of zero and therefore its debt, which under any standard is objectively quite risky, would have the same capital charge today under the Proposed Rule as the sovereign debt of Norway.

Finally, the capital requirements under the CRC methodology would differ from those under Basel II.5’s ratings-based approach in many instances, particularly for sovereigns that are OECD

⁹ See OECD, *Country Risk Classification*, http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html (Jan. 2012).

¹⁰ See *Id.*

¹¹ See 76 Fed. Reg. 79380, 79384.

¹² See OECD, *Country Risk Classification*, http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html (Jan. 2012).

members.¹³ In this instance, however, the CRC methodology results in more favorable capital treatment for OECD sovereigns than under the Basel II.5 ratings-based approach.¹⁴ Although it is possible to view this result as a beneficial side effect of the Proposed Rule, we believe it is symptomatic of the limitations of the CRC methodology and the fact that it can lead to this counterintuitive result in a world in which the sovereign debt of certain OECD countries, particularly in Europe, is broadly viewed by the market to be *more* rather than less risky. The Proposed Rule therefore may create a perverse incentive, absent other factors, to hold certain sovereign debt and other instruments that receive high marks under the CRC methodology as opposed to other asset classes that may indeed be objectively less risky.

ii. Sovereign debt exposures should be addressed using a more risk-sensitive approach that addresses the deficiencies of the CRC methodology.

The Associations urge the Agencies to replace the CRC methodology with a more risk-sensitive approach that does not suffer from conflicts of interest and is transparent. It is vital that any alternative approach to the CRC methodology be properly aligned with international standards for the capital treatment of sovereign exposures so as not to disadvantage U.S. banks.

We acknowledge and appreciate that, in the NPR, the Agencies have set forth two market-based alternatives as supplements to or replacements for the CRC methodology. As the Agencies undoubtedly recognize from their own deliberations in preparing the NPR, developing such suitable risk sensitive market-based alternatives that do not lead to competitive inequalities *vis-à-vis* non-U.S. institutions is time consuming and fraught with analytical complexity and practical difficulties. Given the short allotted comment period for the NPR, we have not had an effective opportunity to either fully analyze the proposed credit default swap and relative bond-spread alternatives in the NPR or fully develop one or more other suitable alternatives to the CRC methodology. As such, we hope to be able to work together with the Agencies in a cooperative manner with respect to these particular issues after the submission of this letter.

iii. Certain sovereign debt exposures funded with local currency assets should continue to be assigned a lower specific risk-weighting factor.

The Associations strongly support the Proposed Rule's notion that a banking organization should be permitted to assign a sovereign debt position a specific risk-weighting factor that is lower than the applicable specific risk-weighting factor otherwise assignable to that position if it is

¹³ See page 1 of *Annex B*.

¹⁴ *Annex B* contains the Associations' analysis of the treatment of certain sovereign debt exposures under Basel II.5's risk-based approach and the Proposed Rule. This analysis shows that the specific risk weighting factors of a number of OECD member sovereign debt exposures were significantly lower under the Proposed Rule than they were under Basel II.5's risk-based approach. Seventeen of the 36 exposures of sovereigns with a CRC of zero or one received lower risk weightings under the Proposed Rule (namely, zero) than they did under Basel II.5, under which their risk weightings varied between 20% and 150%. The exposures of the other 19 countries remained the same. In contrast, the CRC methodology resulted in a higher risk weighting for all but one of 48 countries with a CRC of 7 (specifically, increasing their respective risk weightings from 100% under Basel II.5 to 150% under the Proposed Rule). See page 1 of *Annex B*.

denominated in the sovereign entity's currency, the banking organization has at least an equivalent amount of liabilities in that currency and the sovereign entity allows banking organizations under its jurisdiction to assign the lower specific risk-weighting factor to the same position. We believe that this aspect of the Proposed Rule promotes sound risk management practices by encouraging banking organizations to fund local currency assets with local currency liabilities, a much safer practice than funding those assets with foreign liabilities.

B. Exposures to Government Sponsored Entities ("GSEs")

i. Exposures to GSEs should receive a specific risk-weighting factor of zero to the extent the exposure is backed by the full faith and credit of the United States.

The Proposed Rule defines a GSE to include any entity established or chartered by the U.S. government to serve public purposes specified by the U.S. Congress, but the obligations of which are not explicitly guaranteed by the full faith and credit of the United States. The NPR provides that the specific risk-weighting factors for GSE debt exposures would vary from 0.25 to 1.6%, based on maturity.¹⁵ The Associations urge the Agencies, in the final rule, to treat debt exposures of GSEs that are explicitly backed by the full faith and credit of the United States the same as sovereign debt positions backed by the full faith and credit of the United States. To the extent the U.S. government has provided an explicit guarantee of a GSE debt exposure, there is no reason to believe that a default on that exposure is more likely than any other debt issued directly by the United States. In addition, we urge the Agencies to treat the debt positions of Fannie Mae and Freddie Mac as having received an explicit guarantee from the U.S. government in light of the government conservatorships of Fannie Mae and Freddie Mac and the financing agreements put in place by the U.S. Department of the Treasury to ensure that these GSEs continue to meet their obligations to the holders of bonds that they issued or guaranteed. Should the government's relationship to Fannie Mae and Freddie Mac change, we would expect the treatment of their debt positions to change accordingly (*e.g.*, in the event of the sale of one of the GSEs' assets and liabilities to a private acquirer, treating its debt obligations as corporate debt positions).

C. Debt Positions of Banking Entities

i. The CDS spread methodology for assigning specific risk-weighting factors to corporate debt positions described in Part II.E should also be used to assign specific-risk weighting factors to the debt positions of banking entities.

Under the Proposed Rule, debt positions of banking entities would be assigned specific risk-weighting factors between 0.25% and 12% based on (i) the CRC of the sovereign entity in which the banking entity is incorporated and (ii) in certain instances, the residual term of the debt position. Although determining specific risk-weighting factors based on the credit risk of a sovereign may be sensible for PSE debt positions (discussed below), we do not believe that this approach is sensible for

¹⁵ We note that, although the preamble indicates that the specific risk-weighting factors of GSE debt exposures will vary from 0.25 to 1.6% based on the remaining maturity of the position, the Proposed Rule provides that banking organizations must assign a 1.6% specific risk-weighting factor to a debt position that is an exposure to a GSE. Proposed Rule, § 10(b)(2)(iii). It does not provide that the specific risk-weighting factor should vary based on remaining maturity.

debt positions of banking entities. The credit risk of individual banking entities can vary widely across the banking sector in a particular country and banks can, and often do, fail without any intervention from home country regulators. As such, we do not believe that a methodology that equates sovereign risk and banking entity risk is analytically justified. Moreover, such an approach is risk insensitive – contrary to the NPR’s stated goals – and is inconsistent with Basel II.5, irrespective of the use of credit ratings.

Although there are differences between the balance sheet compositions of banking entities and non-bank corporate obligors, we do not believe that these differences warrant the use of fundamentally different methodologies for determining the capital treatment of banking entity debt positions and corporate debt positions. After all, credit risk is credit risk, regardless of whether the institution in question makes widgets or loans. Accordingly, we urge the Agencies to apply the CDS spread methodology described in broad outline in Part II.E below for the reasons described in that Part, including increased risk sensitivity and decreased pro-cyclicality. In the event that the information necessary to apply the CDS spread methodology is unavailable, asset swap or bond spreads could be used as a proxy for CDS spreads. In the event that no reliable spread information¹⁶ is available, the Proposed Rule’s indicator-based methodology could be used, although the indicators would need to be recalibrated to account for differences in the balance sheet composition of banking entities and non-banking entities and to ensure that the capital requirements of the indicator-based methodology were generally comparable to those under Basel II.5’s ratings-based approach. For example, the calibration of the leverage ratio would need to be adjusted because banking entities generally are more leveraged than nonbanking entities with comparable credit profiles. As with sovereign debt positions, we would be happy to work further with the Agencies to develop a CDS spread methodology for banking entity debt positions and modifying the Proposed Rule’s indicator-based methodology so that it could be applied to banking entity debt positions when no reliable spread information is available.

D. Debt Positions of PSEs

i. A market-based approach should be used in place of the CRC methodology in assigning specific risk-weighting factors to debt positions of PSEs.

We generally agree with the Proposed Rule’s approach of closely aligning the specific risk-weighting factors of debt positions of PSEs with those of the PSEs’ home country. The likelihood of government support of these debt positions and general correlations among the credit risks posed by PSEs and their home countries supports this approach. However, our concerns with the CRC methodology as used for sovereign debt exposures, discussed in Part II.A, apply equally to its use for debt positions in PSEs. Accordingly, the Associations urge the Agencies to work with us to develop suitable risk sensitive market-based alternatives to the CRC methodology that do not lead to competitive inequalities *vis-à-vis* non-U.S. institutions.

¹⁶ We would be happy to work with the Agencies to define what constitutes “reliable spread information” for these purposes.

E. Corporate Debt Positions

i. As proposed, the indicator-based methodology for calculating the specific risk weighting factor for non-financial corporate debt positions is seriously flawed.

The NPR proposes an “indicator-based methodology” for assigning specific risk-weighting factors to corporate debt positions that are exposures to publicly traded, non-“financial institutions”.¹⁷ The Proposed Rule’s indicator-based methodology consists of three indicators: (i) leverage, measured by the ratio of total liabilities to the market value of assets of the applicable public company, (ii) cash flow, measured as the ratio of earnings before interest expense, taxes, depreciation and amortization to a market value of assets and (iii) stock price volatility, measured as the standard deviation of the corporate obligor’s monthly stock price as of the last trading day of each month over the immediate preceding 12 months.

Although the Associations generally commend the Proposed Rule’s use of market data in assigning specific risk-weighting factors to non-financial corporate debt positions, the indicator-based methodology has several serious flaws, including:

1. The methodology’s indicators and the calibrations of those indicators are extremely risk insensitive. As a consequence of this risk insensitivity, banking organizations have little incentive to hold high quality corporate debt instruments and the Proposed Rule’s treatment of non-financial corporate debt positions differs significantly from the treatment of these positions under Basel II.5’s ratings-based approach.

The excessively conservative calibration of the indicators (especially the leverage indicator), and the indicators themselves (which in our view are not generally indicative of credit risk, either alone or when considered together), cause the Proposed Rule’s approach to be highly risk insensitive and results in unfavorable capital treatment for many highly-rated (and high-quality) debt positions as a general matter and as compared with the capital treatment of these positions under Basel II.5’s ratings-based approach. The Associations analyzed the treatment of corporate debt under the Proposed Rule’s indicator-based methodology for corporate debt positions.¹⁸ The debt sample analyzed consisted of the investment grade corporate debt of the 125 issuers referenced in the CDX.IG.15 index. The debt obligations of 113 of these issuers would receive a higher risk weighting under the Proposed Rule (100%) than they would under Basel II.5’s ratings-based approach (20%).¹⁹ The capital treatment of the debt obligations of the other 12 issuers did not change. None of these debt obligations – even those

¹⁷ As an alternative to this indicator-based methodology, a banking organization would be given the option of assigning a flat 8% specific risk-weighting factor to all of its corporate debt positions.

¹⁸ More detailed information regarding the treatment of investment grade obligations under the Proposed Rule and Basel II.5’s ratings-based approach is contained on page 2 of *Annex B*.

¹⁹ The same result is obtained when comparing the capital treatment of these obligations under Basel I and the Proposed Rule – the investment grade debt obligations of 113 of the 125 issuers would receive a worse capital treatment under the Proposed Rule (100% risk weighting) than they do under Basel I (20% risk weighting).

rated AA and AAA – received a risk weighting other than 100% under the Proposed Rule’s indicator-based methodology. The Associations’ analysis revealed that the indicator-based methodology fails to distinguish even between BB-rated and AAA-rated debt obligations, assigning each a 100% risk weighting (based on an 8% specific risk-weighting factor). Moreover, based on the Associations’ analysis, it would appear that even some high yield corporate obligations rated as low as C would receive the same risk-weighting factor (*i.e.*, 8%) as the corporate debt obligations rated AA and AAA in the debt sample used by the Associations. As a consequence of its risk insensitivity, the indicator-based methodology would appear to fail both to measure relatively wide ranging positive and negative changes in creditworthiness and to distinguish appropriately the credit risk associated with investment grade corporate debt positions, contrary to the standards for ratings alternatives outlined in Part I.C of the NPR.

Our analysis found that the main driver of the foregoing results was the excessively conservative calibration of the leverage indicator, which causes the indicator-based methodology to be insufficiently risk sensitive, assigning the same specific risk weighting factor to corporate debt positions with widely different credit profiles (*e.g.*, as noted, a AAA-rated and C-rated debt obligation receive the same risk weighting). In most cases, the reason investment grade obligations received a specific risk-weighting factor of 8% was a leverage indicator score in excess of 0.2.

Moreover, as a general matter, the leverage indicator values will vary widely across industries and can give a misleading picture of the credit quality of a company. For example, utilities generally have high debt-to-asset ratios but the spreads of their corporate debt instruments generally reflect the markets’ perception of their generally low credit risk.

Regardless of whether one believes that ratings were a deficient tool for evaluating credit risk in the period leading up to the financial crisis, a methodology the results of which are so at odds with third-party credit ratings is highly dubious at best. The purpose of Basel II.5 and the U.S. market risk rules is to properly match capital requirements with actual risk on a proportionate basis. A methodology that, as per our analysis, results in all of the investment grade corporate debt of issuers in the CDX.IG.15 index receiving a 100% risk weighting achieves almost no risk sensitivity and therefore does not meet the Proposed Rule’s stated goals to “[a]ppropriately distinguish credit risk associated with a particular exposure within an asset class” and to “[p]rovide for the timely and accurate measure of negative and positive changes in creditworthiness”.²⁰

We recognize that the Agencies have sought to develop methodologies that result in “generally” the same risk weightings and related capital requirements as under Basel II.5’s ratings-based approach. However, although in some limited instances the Proposed Rule’s methodologies would result in potentially more favorable treatment than under Basel II.5,²¹ our analysis indicates that the aggregate impact of the Proposed Rule will be to increase capital requirements for impacted corporate debt positions relative to Basel II.5’s ratings-based approach.

²⁰ 76 Fed. Reg. 79382.

²¹ For example, a limited number of high yield corporate debt positions could receive more favorable capital treatment under the Proposed Rule.

The consequences of the risk-insensitivity of the Proposed Rule's approach, largely resulting from the leverage indicator, are potentially serious. If capital requirements were the only consideration, the methodology would cause banking organizations to have the perverse incentive to acquire objectively riskier corporate debt obligations with a higher yield instead of acquiring lower-yielding debt obligations of AAA rated issuers.²² Contrary to the apparent intention of the Proposed Rule in calibrating the leverage indicator, the Proposed Rule's conservatism in the leverage component may actually undermine the safety and soundness of banking organizations in practice. Moreover, the Proposed Rule would place U.S. banking institutions at a significant competitive disadvantage *vis-à-vis* their foreign peers subject to the more risk sensitive market risk requirements under Basel II.5's risk-based approach. In addition, because the Agencies have indicated that methodologies similar to the Proposed Rule's methodologies will be incorporated into the general risk based capital requirements in the future and those capital requirements will serve as the risk-based capital floor pursuant to Section 171 of Dodd-Frank, any competitive imbalances and perverse incentives are likely to be amplified for the U.S. banking industry more broadly.

2. The Proposed Rule's indicator-based methodology is pro-cyclical.

Because the stock volatility and leverage indicators will tend to increase, and the EBITDA indicator will tend to decrease, during economic downturns, capital requirements under the Proposed Rule's methodology for public non-financial corporate debt positions will also tend to increase during economic downturns. Conversely, during periods of economic growth, the stock volatility and leverage indicators will tend to decrease and the EBITDA indicator will tend to increase, resulting in decreasing capital requirements under the Proposed Rule's methodology. As a consequence, the Proposed Rule's indicator-based methodology is pro-cyclical; it will contribute to a contraction in the supply of credit during economic distress, potentially prolonging the economic distress, and will contribute to an expansion in the supply of credit during periods of economic growth, potentially exacerbating credit bubbles.

3. The indicators used in the Proposed Rule's methodology are backward-looking and do not take into account detailed debt characteristics.

The indicators used in the Proposed Rule's methodology are blunt financial measures that overlook many important factors in assessing creditworthiness. The indicators tend to be "backward looking" and only utilize historical financial information. In contrast, and as acknowledged by the Agencies in the NPR, an approach based on the market price of credit protection on a company's debt, for instance, would take into account information regarding the company's future prospects, and thus potentially be more risk-sensitive. Further, these indicators do not take into account detailed debt characteristics that bear on the credit risks of a given corporate debt position, such as seniority and term

²² We note that the Proposed Rule's proposed assignment of a specific risk-weighting factor of 8% to the corporate debt positions of non-banking entity financial institutions is, for obvious reasons, completely risk-insensitive and, similar to the Proposed Rule's indicator-based methodology for non-financial corporate debt positions, would provide banking organizations with a strong incentive to acquire high yield corporate debt positions of such financial institutions that generally would under both the indicator-based methodology (if such positions were non-financial corporate debt positions) and Basel II.5's ratings based approach receive a specific risk-weighting factor of 12%.

structure. Because of the Proposed Rule's indicators' backward-looking nature and their failure to account for more detailed debt characteristics, there is a substantial risk that the Proposed Rule's indicator-based methodology will overstate or understate the credit risk of a corporate debt instrument, as the case may be.²³

- ii. **The Proposed Rule's indicator-based methodology should be replaced with a forward-looking market-based methodology based on relative CDS spreads. If the CDS data necessary to apply the Associations' methodology is not available, asset swap or bond spreads could be used as a proxy for CDS spreads. In the event that no reliable spread information is available, a recalibrated version of the Proposed Rule's indicator-based approach could be used.**

The punitive aspect of the indicator-based methodology could, in theory, be mitigated by recalibrating the thresholds that define the specific risk-weighting factor buckets (*e.g.*, a doubling of the leverage indicator threshold and the stock price volatility threshold would cause a more reasonable percentage of investment grade corporate debt positions to be treated as such under the indicator-based methodology). However, these changes do not address the pro-cyclicality of the methodology or the general risk insensitivity of the indicators. Nor would a recalibration solve issues related to the cross-industry variation of indicator values that do not reflect credit quality, or the fact that the indicator-based methodology will be cumbersome to implement and monitor. To address these issues, the Associations urge the Agencies to use a modified version of the NPR's bond-spread approach based on relative CDS spreads in place of the Proposed Rule's indicator-based methodology. If the CDS data necessary to apply the Associations' methodology is not available, asset swap or bond spreads could be used as a proxy for CDS spreads. Although imperfect, in the event that no reliable spread information is available, a recalibrated version of the Proposed Rule's indicator-based approach could be used.

The NPR discussed, as an alternative to the indicator-based methodology, a bond-spread based approach that would assign both financial and nonfinancial corporate debt positions to general categories of "high risk", "medium risk" or "low risk" depending on whether the particular position is priced above or below certain market-based thresholds. The NPR proposed comparing the one-year average of the spreads of a financial institution's closest to five-year senior unsecured bond, to the one-year averages of two credit default swap indices, such as the five-year CDX.NA.IG.FIN index and the five year CDX.NA.HY.B. For non-financial companies, the one-year average spreads of corporate debt positions could be compared to the one-year averages of the CDX.NA.IG and CDX.NA.HY.B. The specific risk-weighting factor of a corporate debt position would then be assigned based on the spread of the corporate debt position relative to the relevant indices.

²³

In view of the deficiencies of the Proposed Rule's indicator-based methodology, we submit that the costs banking organizations would incur in implementing the systems necessary to calculate capital requirements in accordance with this methodology would not be justified.

Although we agree with the general bond-spread approach laid out in the NPR, we believe the NPR's bond-spread approach has the following deficiencies:

- It would be substantially misaligned with Basel II.5's risk-based approach. By defining low risk corporate debt positions as those with a one-year average bond-spread less than that of CDX.IG index the approach immediately treats a significant portion of investment grade corporate debt positions as non-investment grade.²⁴ As a consequence, it is inherently more punitive than Basel II.5's risk-based approach.
- As noted in the NPR, bond spreads can reflect factors other than credit risk. These factors include, among others, a bond's coupon, maturity, funding and liquidity.
- Not all companies have an actively traded five-year debt instrument or CDS.
- Although the use of one-year average spread should in principle improve the stability of classifications, the NPR's bond-spread approach was significantly less stable than the Associations expected, possibly because of the instability of the boundaries between the three categories (*i.e.*, "high risk", "medium risk" and "low risk") as the spread between CDX.IG and CDX.HY varies.²⁵
- Although we agree that, in principle, the use of a relative market-based spread should reduce pro-cyclicality, the NPR's bond-spread methodology was significantly more pro-cyclical than the Associations expected (again likely because of the instability commented on above).
- Two corporate debt positions with the same CDS spread may receive different specific risk-weighting factors. For example, a financial corporate debt position may be treated as "low risk" simply because CDX.NA.IG.FIN is wider than CDS.NA.IG.

At least some of these deficiencies in the NPR's bond-spread approach could be addressed if modified as follows:

- The bond-spread approach should not use separate indices for financial and non-financial entities. Two corporate debt obligations with the same CDS spread should have the same risk classification under the bond-spread methodology. The bond-spread methodology could compare the spread to just one CDX.IG index.
- Consistent with the general risk-based capital rules, we propose that corporate debt positions be divided into two, as opposed to three, categories, with investment grade corporate obligations receiving an up to 1.6% risk-weighting factor and non-

²⁴ See Figure 1 of *Annex C* for a graph showing the percentage of certain investment grade corporate debt positions that would not be categorized as "low risk" under the Agencies' bond-spread methodology.

²⁵ See the lines labeled as "NPR High Risk", "NPR Medium Risk" and "NPR Low Risk" in Figure 3 of *Annex C*, illustrating the volatility of classifications under the Agencies' bond-spread methodology.

investment grade corporate obligations receiving an 8% risk-weighting factor, pursuant to an indicator score tied to a relative spread.

- A relative spread could be defined, for example, as: $(\text{Average End of Month CDS Spread Over 12 Months}) / (\text{Average End of Month CDX.NA.IG Spread Over 12 Months})$. If this ratio is less than two, then the corporate debt obligation would be classified as investment grade and, if equal to or greater than two, it would be classified as non-investment grade.

Under this simplified approach, a more reasonable number of current investment grade names would be treated as investment grade, as illustrated in Figure 2 of *Annex C*.²⁶ As a consequence, the misalignment of the Proposed Rule's bond-spread approach with Basel II.5's risk-based approach would be reduced. This approach also yields a more stable classification than the NPR's bond-spread approach.²⁷ We note that this approach would also be more risk sensitive than Basel II.5's risk-based approach and significantly more risk-sensitive than the Proposed Rule's indicator-based methodology.

As noted above, when the CDS data necessary to apply the Associations' spread approach is available, that approach would be applied. For debt positions without actively traded CDS, asset swap or bond spreads could be used as a proxy for CDS spreads. In the event that no reliable spread information is available, a recalibrated version of the Proposed Rule's indicator-based approach could be used.

Again, we hope to be able to work together with the Agencies in a cooperative manner to more fully develop the details of our layered approach to debt positions of corporate issuers and banking entities.

F. The Proposed Rule's Alternative Methodologies

- i. The Proposed Rule's investment grade alternative methodology for determining the specific risk-weighting factors of corporate debt positions is not sufficiently risk sensitive and would result in capital requirements that differ sharply from those under Basel II.5's risk-based approach.**

Although the investment grade methodology would be simple and easy to implement, it has at least two significant drawbacks. First, the non-investment grade category would likely capture debt positions with a wide range of credit quality. As a consequence, banking organizations would be encouraged to acquire, other things equal, riskier debt securities in order to increase investment

²⁶ For example, the percentage of investment grade corporate debt obligations misclassified varies approximately between 7% and 20%, as opposed to approximately between 17 percent and 53% percent under the NPR's bond-spread methodology, in each case, over a six-year period.

²⁷ See Figure 3 of *Annex C*, comparing the lines labeled as "IG Spread" (representing the percentage of DTCC's 1000 most actively traded names, as of January 13, 2012, that would be treated as an investment grade name according to the Associations' proposed relative spread methodology at different points in time) and "IG" (representing the percentage of DTCC's 1000 most actively traded names, as of January 13, 2012, that were rated investment grade by S&P at different points in time).

returns. Second, this methodology would result in significantly different capital treatment for corporate debt positions from that required under Basel II.5's risk-based approach. For example, under Basel II.5's risk-based approach, debt positions rated investment grade by two nationally recognized credit rating services with residual terms to maturity exceeding 24 months would receive a 1.6% specific risk-weighting factor – significantly less than the 6% specific risk-weighting factor such positions would receive under the investment grade methodology (assuming they were “investment grade” securities for purposes of the OCC's investment securities regulations). As a result of this difference in capital treatment, U.S. banking organizations may be competitively disadvantaged. Accordingly, the Associations urge the Agencies not to adopt the investment grade methodology.

III. Concerns with the Proposed Rule's Treatment of Securitization Exposures

Consistent with the previous comment letter of the American Securitization Forum (“ASF”) regarding the advance notice of proposed rulemaking regarding alternatives to the use of credit ratings in the risk-based capital guidelines,²⁸ the Associations are of the view that the following “guiding principles” for credit ratings alternatives, which the Associations believe are well-aligned with the Agencies' policy objectives set forth in Part I.C of the NPR, should be embodied in any alternative creditworthiness standards for securitization exposures. Any alternative should:

- promote understanding by banking organizations of the risks associated with their securitization exposures;
- focus on (i) actual performance of assets, which is the primary driver of the performance of an asset-backed security (“ABS”), and (ii) the credit support available to a given risk position within an ABS structure after factoring in the assets' performance;
- function to facilitate dynamic and timely adjustment of capital in a manner that is consistent with and proportionate to changes in asset performance and the resulting risk profile of a given exposure; and
- be premised on data that are available to all market participants and should otherwise comport with standard market practices so that all participants have the option of performing the necessary calculations.

Although the Associations agree with the Agencies that any alternative should not be overly complex and that results should be replicable across banking organizations, simplicity should not override the factors set forth above.

We believe the Proposed Rule's SSFA methodology fails to optimally address either the Agencies' own objectives set forth in the NPR or the Association's guiding principles with respect to securitizations. More importantly, the SSFA methodology is flawed in various respects as more

²⁸ See letter from the ASF to the Agencies and the Office of Thrift Supervision, dated October 25, 2010, available at http://www.americansecuritization.com/uploadedFiles/ASF_OCC_Legal_Investment_Comment_Letter_10-25-10.pdf.

particularly set forth below. The Associations are therefore proposing modifications to the SSFA and to the SFA that address these flaws and better promote outcomes in line with the NPR's objectives and such guiding principles.

A. General Concerns

- i. The SSFA substantially overstates the amount of capital required for certain securitization exposures, and may have several unintended negative consequences, including, among others, reducing the availability of credit, impeding the recovery of the U.S. economy and encouraging banking organizations to hold riskier securitization exposures.**

For specific reasons demonstrated in *Annex D*, the SSFA will, in its current form, substantially overstate the amount of capital required for certain securitization exposures for all banking organizations subject to the Proposed Rule, including certain investments in securitizations that finance consumer assets such as credit card and auto receivables and student loans and commercial assets including fleet leases and equipment loans and leases. This overstatement will discourage banking organizations from underwriting, making a market in, or engaging in secondary trading in, such securities, which, in turn, will meaningfully reduce the liquidity of ABS generally. If an approach similar to the Proposed Rule's approach is applied to securitization positions held in the banking book, it will also become less likely that banking organizations will invest in these transactions. When they do, the costs of doing so will increase dramatically. Because banking organizations subject to the Proposed Rule are vital intermediaries and financing sources for these assets, the resulting negative effect on the availability and cost of financing for American consumers and businesses and the market liquidity for securitization exposures will be substantial. This negative effect on the availability and liquidity of credit to American consumers and businesses will have significant adverse effects on the recovery of the U.S. economy.

In addition, if the SSFA is adopted in its current form, (i) as a result of the significant changes in required capital levels that occur when losses are close to the threshold for the steep, next highest risk-weighting factor in the supervisory floor, the incentives banking organizations have to sell securitization positions under such circumstances will be greatly increased, thereby significantly reducing the market liquidity for the affected securities and promoting pro-cyclicality, (ii) banking organizations will be discouraged from underwriting, purchasing, making a market in, or engaging in secondary trading in, even high quality, low-risk securitization positions and (iii) banking organizations will be encouraged to hold riskier securitization positions with greater returns. In our view, none of these outcomes is consistent with what should be the goals of appropriate revisions to the risk-based capital rules.

The Associations note that our comments on the SSFA and our proposed alternative methodology are premised on our understanding, that cumulative losses applied in determining the proposed risk weight floors are in reference to the loss of principal on issued securities²⁹ in the relevant

²⁹ As used in this letter, the term "issued securities" refers to issued debt securities in a securitization transaction based on our understanding that equity securities were not intended to be included in the use of this term in the Proposed Rule.

transaction as stated in Table 7 of the NPR rather than as a percentage of the securitized asset pool amount. If our understanding is incorrect, there are substantial additional issues with the Proposed Rule that will need to be addressed and will take additional time to analyze. We reserve the right to provide additional comments with respect to issues related to calculating cumulative losses against the securitized asset pool should our understanding prove incorrect.

B. Specific Concerns³⁰

i. K_G is a highly risk insensitive measure for calculating the required capital for exposures underlying a securitization position.

By reverting to a Basel I methodology for calculating K_G , the Proposed Rule completely ignores differences in the credit quality of exposures of the same broad category underlying a securitization position. For example, prime auto loans and sub-prime auto loans are assigned the same risk weight under the general risk-based capital rules. As demonstrated by the examples set forth in *Annex D*, this methodology for calculating K_G penalizes banking organizations for investing in higher credit quality transactions with low loss levels and therefore low attachment points. K_G as proposed is also not adjusted upward if the credit performance of a securitized asset pool is materially worse than anticipated, which could understate required capital as compared to a more risk sensitive approach to determining K_G . In our view, therefore, the proposed K_G will not achieve the Agencies' stated objective of adequately capturing the risk of particular exposures.

ii. Determining the risk weight floor based on the ratio of cumulative losses to K_G in the manner contemplated by the Proposed Rule is not an appropriate benchmark of credit quality.

As demonstrated by the examples set forth in *Annex D*, establishing a risk weight floor for securitization positions using this ratio in the form proposed does not give appropriate benefit to transaction structure (*e.g.*, tranching of risk that can change during the life of a transaction based upon trigger mechanisms set forth in the transaction documents). As a result, SSFA as proposed will in certain instances require the same amount of capital to be held against riskier junior securitization positions as against less risky senior securitization positions in the same transaction. If cumulative losses are determined as a percentage of the securitized asset pool rather than the principal of issued securities, this effect would be further exaggerated. This is inconsistent with the stated design of the SSFA. The Agencies state in the NPR that "[t]he SSFA is designed to apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses and relatively lower requirements to the most senior positions."³¹ A lack of granularity in the size of the risk weight floors as losses increase also results in inappropriately large increases in capital requirements for securitization positions that are not justified by the level of performance deterioration exhibited by the underlying securitized exposures.

³⁰ *Annex D* to this letter sets forth example calculations of capital using the SSFA that illustrate the points in Parts III.F.ii.1 and III.F.ii.2 set forth below.

³¹ 76 Fed. Reg. 79394.

iii. Setting the minimum risk weight floor at 20% currently creates competitive issues for U.S. banking organizations that seek to purchase high credit quality securitization positions.

Foreign banking organizations that are active investors and market makers in the U.S. securitization market use the Basel II-advanced approaches and therefore their investments in very high credit quality securitization positions would attract substantially less capital than the capital that would be required to support the same position if held by a U.S. banking organization. In addition, the establishment of such a high floor eliminates any risk sensitivity in the assessment of capital at the higher end of the credit spectrum. This lack of sensitivity will discourage investment in the highest quality assets in favor of lower-quality, higher yielding assets and, over time, increase pricing on the highest quality assets as the market seeks to compensate for the higher capital requirements.

iv. The carrying value of a securitization position is not taken into account in determining its attachment point for purposes of the SSFA calculation.

Where the carrying value of a securitization position is less than its par value, the credit risk of that position is reduced and the differential between par value and carrying value represents credit enhancement that is available to that position. Unless that credit enhancement is reflected in the attachment point for such position, the capital requirements for such positions will be overstated using the SSFA methodology.

v. Reserve accounts funded from any source should be taken into account in determining the attachment point of a securitization position.

Section 10(b)(2)(vii)(B)(2) of the Proposed Rule permits “reserve accounts funded by the cash flows from the underlying exposures” to be included in determining the attachment point for a securitization position. However, funded reserve accounts from any source provide the same level and quality of credit enhancement to a securitization position and should therefore be included in any such determination.

vi. Use of the SSFA requires substantially more capital on a transaction-wide basis for certain securitization exposures than would be required if the pool assets were not securitized.

The Associations agree with the Agencies that banking organizations should not be permitted to use securitization to engage in capital arbitrage. Banking organizations should also not be substantially penalized from a regulatory capital perspective, however, for the appropriate use of securitization. Doing so would be inconsistent with the premise long held by the Agencies that capital requirements should neither encourage nor discourage securitization. The Associations are therefore of the view that any methodology used for calculating the regulatory capital requirements for securitization exposures of banking organizations should result in total capital requirements for all securitization exposures in the transaction that do not substantially exceed the capital that would apply to the pool assets if they were not securitized. Otherwise, the Proposed Rule will unnecessarily create impediments to prudent securitizations and the funding provided through such securitizations to consumers and businesses.

- vii. The 1.5 supervisory calibration parameter for re-securitizations in the Proposed Rule will overstate capital requirements for certain positions that meet the current definition of re-securitization under the Agencies' "advanced approaches" rules.**

A re-securitization as currently defined in the Agencies' internal-ratings-based and advanced measurement approaches capital rules³² includes any securitization position with respect to which any of the underlying exposures is a securitization position. Existing corporate loan securitizations frequently include a relatively small percentage of assets in the form of other corporate loan-backed asset-backed securities in order to help ensure appropriate risk diversification for investors. Such securitization exposures should not be treated as re-securitization exposures for purposes of the SSFA calculation.

- viii. The Proposed Rule is not clear as to how capital requirements should be calculated under the SSFA for re-securitization exposures generally.**

The Proposed Rule should be modified to provide clear guidance as to how these calculations should be made.

- ix. The Proposed MRC Rules do not clearly allow for look-through treatment for mortgage and other asset-backed indices, such as the CMBX and ABX, such that an index can be broken down into its constituent parts for risk-weighting and offsetting purposes.**

A failure to permit this look-through treatment would result in an undeservedly punitive capital treatment that does not reflect the nature of the instruments and would be detrimental to market participants' ability to hedge, ultimately raising the cost of credit availability to end users.³³

- C. Given the issues with the SSFA discussed above, the Associations urge the Agencies to make certain modifications to the SSFA to address its deficiencies.**

Because of the foregoing deficiencies in the SSFA, we believe it would be generally preferable to use the SFA (with the modifications we propose herein) in place of the SSFA. Given the SFA's superior risk sensitivity, we believe that a banking organization (whether or not approved to use the Basel II advanced approaches) should be able to use a modified version of the SFA that would permit it to be applied to securitization exposures, provided that the banking organization can demonstrate that it has the necessary sophistication and resources to apply the SFA (as modified) and has an appropriate governance structure in place to prevent arbitrage opportunities, as discussed in further detail in Part III.D below.

³² See 12 C.F.R., part 3, Appendix C (OCC); 12 C.F.R., part 208, Appendix F and 12 C.F.R. part 225, Appendix G (Federal Reserve); 12 C.F.R., part 325, Appendix D (FDIC).

³³ As discussed in Part IV.D, we also believe that this look-through treatment should apply when determining the 8% floor and the standard charge for positions that are part of the correlation trading portfolio but excluded from the CRM.

We recognize, however, that it may not be practical for all banking organizations to utilize the SFA, even with our proposed modifications. We therefore believe there is a place for an alternative methodology, such as the SSFA. Nevertheless, we believe that the SSFA as set forth in the Proposed Rule should be modified to address some of its more important deficiencies so it can serve as a more acceptable alternative where use of the SFA (with our proposed modifications) is not readily achievable.

As such, the Associations propose the following changes to the SSFA.³⁴

- i. **The approach to calculating K_G would consist of (i) specific initial percentages for securitization positions based upon the asset class and in some cases credit quality or underwriting standards applied to the underlying securitized exposures, and (ii) upward adjustments based on the expected losses on seriously delinquent underlying exposures.**

The Associations would propose amending the SSFA to align it (and by extension the treatment of securitization exposures) more closely with the current risk-based capital rules with respect to loans. We believe that this alignment can, importantly, be achieved through modification of the currently proposed SSFA formula, rather than the creation of a new formula.

The calculation of risk-based capital for loans is fairly straight-forward and standardized. The capital requirement for loans is used in the proposed SSFA formula in K_G , defined as “the weighted-average capital requirement of the underlying exposures calculated using the agencies’ general risk-based capital rules.” What we believe K_G is missing or, more specifically, understating, is the fact that banking organizations should be required to reserve for losses against non-performing assets which would make this approach more consistent with overall risk-based capital requirements. A simple correction to the proposed SSFA formula would be to modify K_G to reflect these loan loss provisions in a formulaic fashion.

As an example, prudently underwritten mortgages³⁵ carry a risk-weight of 50%, or 4% risk-based capital, against those loans. If, however, 10% of the loans in a pool of first lien mortgages are seriously delinquent, a banking organization would be required to hold increased reserves against those seriously delinquent loans in the amount of expected losses against those loans.

In lieu of defining K_G as set forth in the Proposed Rule, the Associations would suggest defining K_G as “(a) the weighted-average capital requirement of the *performing* underlying exposures calculated using Table 1 below, plus (b) the expected losses on seriously delinquent underlying exposures (defined as loans 90 days or greater past due) calculated using historical three-month loss

³⁴ *Annex E* sets forth illustrations of the application of the SSFA with our proposed modifications and *Annex F* sets forth comparative calculations for capital for securitization positions using SSFA as set forth in the Proposed Rule and SSFA within our proposed modifications.

³⁵ As used in this letter, “prudently underwritten mortgages” refers to mortgages entitled to receive a 50% risk weighting under Agencies’ general risk-based capital rules.

severities on the underlying exposures if publicly available, or 50%³⁶ (the “Loss Severity”).”
 Formulaically, this would be defined as:

((100% minus the Percent of Seriously Delinquent Loans) * Table 1 Capital Requirement)

plus

(Percent of Seriously Delinquent Loans * the Loss Severity)

Table 1

Asset Type	Loan Capital Requirement
Prudently Underwritten Mortgages	4.0%
Prime Bank Credit Cards	4.0%
Prime Auto Loans	4.0%
Other Low Loss Assets	4.0%
All other	Consistent with General Risk Based Capital Rules

For example, where 10% of the loans in a pool of underlying exposures of prudently underwritten mortgages are seriously delinquent and the Loss Severity is 50%:

$$K_G = (90\% * 4\%) + (10\% * 50\%) = 8.6\%$$

K_G levels for the specific asset classes described above have been derived by members of the Associations from their analysis of the historical performance of these asset classes. This analysis was conducted based on substantial performance data available with respect to these asset classes over extensive time periods and widely varying economic conditions. Members of the Associations would be pleased to provide the Agencies with further detail as to how initial K_G levels were derived for each of these asset classes. The Associations request the ability to provide initial K_G values for additional specific asset classes not currently listed in Table 1 above based on historical loss levels and other data presented to the Agencies justifying such results. Given the time frame to comment on the Proposed Rule, the Associations were unable to analyze the relevant data for other asset classes including, without limitation, equipment loans and leases, fleet leases and SBA loans that may deserve a lower K_G value based upon their historical low loss experience.

³⁶ For the government guaranteed portion of underlying exposures, the loss severity should be assumed to be zero percent.

- ii. We believe that two changes should be made to the attachment point in order to recognize positive difference (if any) between the par value and carrying value of a securitization position and cash reserve funds funded from any source.**

In order for the SSFA's attachment point to better reflect the underlying characteristics (and thus the credit risk) of a securitization position, two changes should be made.

First, the attachment point should recognize the discount from par at which a securitization position is held. Carrying value is an exceedingly important factor in the amount of risk-based capital a bank must hold against a security. Specifically, a notable discount to par for a particular position is typically indicative of a security that has either been previously written-down (*e.g.*, through Other Than Temporary Impairment) or a security that has been purchased in the secondary market, where the markets are highly proficient at pricing for risk. The discount to par for a particular position provides additional protection to the holding value of the position to any potential exposure to writedowns on the pool of underlying assets. Therefore, it is clear that a security held at par carries more risk to the banking organization holding the position than the same security being held at a discount to par. As such, carrying value must be included in the calculation of risk-based capital in the proposed SSFA formula. Reflecting carrying value in the proposed SSFA formula can be done by modifying the calculation of Parameter A, or the attachment point of the position, to reflect an increase in the attachment point by the absolute percentage of the discount from par on the thickness of the security (thickness being defined as the detachment point of the position less the attachment point of the position).

Second, cash reserve funds funded from any source should be taken into account in determining the attachment point for a securitization position. It is our understanding that, under the Proposed Rule, cash funded reserve funds subordinated to a banking organization's securitization position funded from any source should be reflected in available credit enhancement for purposes of determining the attachment point of a securitization position. Section 10(b)(2)(vii)(B)(2) of the Proposed Rule, however, limits the inclusion of cash funded reserve funds for these purposes to those that are funded from accumulated cash flows from the underlying exposures. The Associations are proposing modifications of Section 10(b)(2)(vii)(B)(2) that provide that cash funded reserve funds funded from any source may be included in calculating the attachment point of a securitization position.

More particularly, in order to address the foregoing proposed changes, Parameter A should be defined as (i) the attachment point of the position, defined as a percentage equal to (a) the dollar amount of the securitization positions that are subordinated to the position (including all forms of hard enhancement, such as overcollateralization, cash reserve accounts, letters of credit, etc.), divided by (b) the dollar amount of the entire pool of underlying assets, plus (ii) (a) the discount from par at which the position is held, expressed as a percentage, multiplied by (b) the detachment point of the position less the attachment point of the position. The detachment point of a position should be defined as a percentage equal to (a) the attachment point of the position plus (b) (i) the dollar amount of the positions and all *pari passu* positions with respect to loss allocation, divided by (ii) the dollar amount of the entire pool of underlying assets.

- iii. A risk weight floor would be (i) equal to the single minimum risk weight floor applicable to securitization positions under the Basel II advanced approaches**

as in effect from time to time, or (ii) if the Agencies determine to retain the concept of a dynamic risk weight floor, calculated using a more granular risk weight floor table that takes into account the capital and credit enhancement at the tranche level of a securitization position that is available to absorb cumulative losses.

In the NPR, Table 7 sets forth the “Supervisory Minimum Specific Risk-weighting Factor Floors for Securitization Exposures”, as follows:

Cumulative Losses of Principal on Originally Issued Securities as a Percent of K_G at Origination		Specific Risk-weighting Factor (in percent)
Greater than:	Less than or equal to:	
0	50	1.6
50	100	8.0
100	150	52.0
150	n/a	100.0

Because deterioration of the credit quality of a securitized asset pool would under our modifications be reflected in a higher K_G and thus a higher capital level under the SSFA calculation, the Associations suggest that the only appropriate capital floor is the minimum risk weight factor for securitization positions set forth in the Basel II advanced approaches as the same may be modified from time to time (currently 0.56%). As discussed above, the Associations view the SSFA with our modifications as more than sufficient to reflect the increased risks with respect to securitizations that suffer losses in addition to losses the transactions would have been expected to suffer (and therefore would be reflected in the initial K_G calculation for the securitization position). The Agencies only goal in establishing a floor, therefore, should be to assure a level of competitive equality with international banking organizations, which calibrating a risk weight floor to the Basel II minimum risk weight floor achieves.

If the Agencies nevertheless view a dynamic capital floor as necessary, the Associations believe that Table 7 should be revised as set forth below. As discussed above, the lack of granularity in the size of the risk weight floors in the proposed SSFA Table 7 as losses increase results in inappropriately large increases in capital requirements for securitization positions that are not justified by the level of performance deterioration exhibited by such securitization positions. Our proposed changes to Table 7 would make any applicable risk weight floor more granular. Our proposed methodology for calculating a dynamic risk weight floor would also address the significant issue that the SSFA as proposed will in certain instances require the same amount of capital to be held against riskier junior securitization positions as against less risky senior securitization positions in the same transaction.

The risk weight floor would adjust under our proposal based upon the cumulative losses on the originally issued securities (consistent with Table 7 in the NPR) and changes in the credit enhancement of the relevant securitization position over time.³⁷ The changes in credit enhancement

³⁷ We note that the issued securities with respect to certain securitization positions would not be subject to cumulative losses (*i.e.*, non-write down structures) as that term is defined in the Proposed Regulations. We would suggest that the definition of cumulative losses in the final rule be modified to include implied write downs on issued securities to ensure a more conservative and accurate measure.

would be incorporated by comparing the losses on the originally issued securities to the sum of (i) K_G at origination and (ii) Parameter A (with our suggested changes) at the time of calculation. This inclusion of credit enhancement allows the comparison of experienced losses on the securities not only to the original capital charge of the underlying exposures, but also to the structural protection of the securitization position, which would make Table 7 more risk-sensitive by differentiating between different tranches of a securitization trust. The floor will increase as the credit quality of the credit pool decreases, and will correspondingly decrease as the issued securities have less exposure to losses.

CLP as a percent of (K_{GI} plus A)		Specific Risk-weighting Factor (in percent)
Greater than or equal to:	Less than:	
0	25	0.56
25	30	0.64
30	40	0.80
40	50	1.60
50	60	2.80
60	70	4.00
70	85	6.00
85	100	8.00
100	115	20.00
115	130	34.00
130	150	52.00
150	n/a	100.00

Where:

- CLP = cumulative losses of principal on originally issued securities as a percentage of the original principal amount of such securities
- K_{GI} = K_G at origination of the relevant securitization exposure (expressed as a percentage)
- A = Parameter A (expressed as a percentage) of the securitization position at the time of calculation

iv. A risk weight ceiling for senior securitization positions equal to the K_G (with our proposed modifications) of such positions would be applied.

The Associations believe that the specific risk-weighting factor (both floor and formula) of the most senior tranche of a securitization should be capped at the adjusted K_G (as outlined in Part III.C.i). With respect to a re-securitization position, we would ask that the cap apply for purposes of determining the risk weight floor of such positions. For these purposes, a senior tranche should be defined as one that has a detachment point of 100% at the time of calculation. This treatment will ensure that the most senior tranche of a securitization, which by definition has a less risky profile than the underlying pool in the aggregate, is not subject to a higher risk weight than would be assigned to the underlying loans if they were held on the balance sheet of the banking organization.

- v. **The Proposed Rule would be clarified to provide a subordinate securitization position for purposes of calculating the attachment point for a more senior securitization position is a securitization position that absorbs losses prior to such senior position.**

The Associations believe it would be useful to clarify what constitutes a subordinated position for purposes of the Proposed Rule. The Associations recommend that a position be defined as a “subordinate position” to some other securitization position to the extent that position absorbs losses prior to the other securitization position.

- vi. **Re-securitization positions for purposes of applying the supervisory calibration parameter (“P”) would be redefined as securitization positions where more than 10% of the underlying positions are securitization positions, and certain aspects of the treatment of re-securitization positions should be clarified in the final rule.**

As discussed above, a re-securitization position as currently defined in the Agencies’ capital rules includes any securitization position with respect to which any of the underlying exposures is a securitization position. Existing corporate loan securitizations frequently include a relatively small percentage of assets in the form of other corporate loan-backed asset-backed securities. Such securitization exposures should not be treated as re-securitization exposures for purposes of the SSFA calculation. The Associations therefore propose that a re-securitization position be redefined as securitization positions where more than 10% of the underlying positions are securitization positions.

It is also unclear how the SSFA should be applied to re-securitization positions. We understand that required capital should be calculated for each underlying securitization position by running the SSFA calculation for such position and applying the risk weight floor to such position. K_G for the re-securitization position would be a weighted average of the underlying securitization position required capital based on the principal balances of those positions. Cumulative losses for the re-securitization position would be losses on the issued securities in the re-securitization transaction itself. Cumulative losses on the underlying securities are taken into account in calculating the capital for such underlying position, which is in turn used to calculate the K_G for such position as described above. The Associations would suggest that the final rule contain specific guidance to this effect.

- vii. **Tranche-specific interest only positions would incur capital charges on the same basis as principal positions within the same tranche.**

It is our understanding that interest only positions that receive payments based on a pro rata portion of a securitized asset pool would not be securitization positions under the Proposed Rule. In contrast, interest only positions tied to a specific tranche within a securitization trust would be considered a securitization position. The final rule should clarify that these tranche-specific interest only positions incur capital charges on the same basis as principal positions within the same tranche.

- D. **Any banking organization that demonstrates to the appropriate Agency that it has the necessary resources and sophistication to calculate the SFA should be permitted to use a modified version of the SFA to calculate capital for a securitization position in**

the trading book or banking book, provided that the banking organization has the appropriate monitoring and governance to prevent potential arbitrage opportunities.

Because the SFA relies on inputs for calculating capital for securitization positions that are based upon the performance of the securitized assets underlying the relevant securitization position, it provides a far more accurate capital calculation than the SSFA, even with our proposed modifications. The use of the SFA to calculate capital for securitization positions in the trading book would promote consistent capital calculations as between a banking organization's trading and banking books. It would also be the approach that is most similar to the modified Basel II guidelines and therefore would best promote international alignment of capital standards.

Thus, we believe that banking organizations, whether or not they qualify to use the Basel II advanced approaches, should be permitted to use the SFA to calculate the capital requirements for securitization positions for purposes of both the trading book and the banking book if they demonstrate to the appropriate Agency that they have the necessary resources and sophistication to calculate the SFA, as well as a governance structure to prevent arbitrage opportunities.³⁸ Use of the SFA should be subject to appropriate supervisory review and approval.

As the Agencies point out in the NPR, however, the SFA was designed for use by banking organizations that originated the exposures being securitized. The SFA therefore needs to be modified if it is to be available for use by banking organizations investing in securitization exposures with respect to securitized assets that they did not originate. The Associations therefore propose the following changes to the SFA.³⁹

i. Banking organizations would be permitted to use pool-wide determinations of PD and LGD for all securitized wholesale and retail exposures.

As the Agencies acknowledge, banking organizations investing in such securitization exposures do not in many circumstances have the information available to calculate the PDs and LGDs of individual wholesale exposures and segments of retail exposures as required by the current Basel II advanced approaches for purposes of calculating K_{IRB} . The Associations therefore propose that investing banking organizations be permitted to use information available at the asset pool level in order to determine PD and LGD for purposes of calculating the required capital on a securitization exposure in circumstances where the more specific inputs required by the current version of SFA are not available. As the ASF Alternative Ratings Taskforce has previously proposed, these pool-wide inputs could be updated quarterly in order to increase the risk sensitivity of the approach, as suggested by the Agencies in the NPR.

³⁸ As discussed in Part IV.A, we believe that banking organizations should be able to apply the SFA when computing the 8% floor and 15% surcharge on correlation trading positions under the CRM as well as when calculating the risk weighting of other positions that are part of the correlation trading portfolio but are excluded from the CRM.

³⁹ Attached as *Annex G* to this letter are the specific changes the Associations would recommend to the existing SFA and accompanying regulatory guidance in order to implement the changes the Associations are proposing below.

ii. The modified SFA would require the quarterly re-calculation of SFA inputs if a pool-wide approach is used.

In order to permit the pool-wide calculation of PD and LGD for securitized wholesale and retail exposures, the Associations are proposing a new definition of “eligible securitized exposure” that is based on the definition of “eligible wholesale exposure” in the Basel II advanced approaches without the one year limit on tenor imposed by such definition. It would limit the ability to assign pool-wide PD and LGD inputs to exposures (i) that the banking organization did not directly or indirectly originate or (ii) if originated by the banking organization or related securitization special purpose entity (“SPE”), are (x) not serviced by either such person, or (y) are securitization exposures for which the banking organization is prohibited by law or regulation from accessing the information necessary to determine the risk parameters required to calculate $K_{i,RB}$ for the underlying individual securitized wholesale exposures or segments of securitized retail exposures. Consistent with the definition of eligible wholesale exposure, our proposed definition would also require that the exposure be generated on an arm’s-length basis, provide the banking organization or securitization SPE with a pro rata claim on proceeds and not constitute a concentrated exposure in order to qualify for the pool-wide calculations the Associations are proposing.

iii. Banking organizations could use a conservative proxy for an LGD of less than 100% where LGD cannot otherwise be determined for a securitized asset pool if the appropriate Agency had pre-approved lower LGD assumptions for the asset class and obligor category for the banking organization’s general use.

The current SFA would require an LGD of 100% for assets for which an expected credit loss (but not a PD) can be estimated. This is an overly conservative assumption for assets that have proven over time to result in significant recoveries following default. The Associations would therefore propose that the SFA be modified to permit banking organizations to use LGD assumptions of less than 100% if the appropriate Agency has approved such an LGD assumption for the particular asset class and obligor type for use generally by the banking organization in calculating capital under the Basel II advanced approaches.

iv. The use of conservative market proxies for PD and LGD for asset pools that have experienced low defaults and/or low loss experiences would be specifically permitted.

The current SFA contains no guidance as to how to assign PD and LGD to assets with low historical defaults or losses. The Associations are proposing that guidance be added that indicates that banking organizations should assign conservative market proxies approved by the appropriate Agency for PD and LGD for such asset pools.

v. Positive difference (if any) between the par value and carrying value of a securitization position would be taken into account with respect to the SFA calculation for the securitization position.

The SFA should also take into account any positive difference between the par value and carrying value of a securitization exposure as additional credit enhancement (“L”) for purposes of the SFA calculation. Such carrying value differential provides additional protection to the holder of a

securitization position. Because losses on the underlying assets would be absorbed by this difference before the banking organization would take further write downs (losses) on its position, it needs to be included in L for that term to reflect all credit enhancement. The Associations note in this regard that the Agencies include in L the discount in the purchase price for the underlying securitized receivables. Since the two discounts have the same economic effect, the Associations see no basis for distinguishing between the two discounts in computing L. A corresponding adjustment should also be made to the thickness of the relevant position ("T").

vi. Banking organizations could include as additional credit enhancement additional amounts not represented by subordinate securitization positions determined using cash flow methodology approved by the appropriate Agency.

Finally, as the Agencies also point out in the NPR, the SFA in its current form does not recognize additional credit enhancement available to a securitization position from cash flows on securitized assets. The inability to recognize such cash flows can substantially understate credit enhancement for securitizations such as credit card and auto loan securitizations. As the Agencies acknowledge, this will create competitive issues for U.S. banking organizations in comparison to foreign banking organizations that use the Basel II.5 ratings-based approach, because both of these approaches would allow the recognition of the impact of excess cash flows on the creditworthiness of a securitization position.

In order to assure the integrity of such cash flow calculations, the Associations propose that excess cash flows only be permitted to be taken into account as additional credit enhancement in the SFA calculation in determining the values of L and the amount of the underlying exposures ("UE") to the extent that:

- the banking organization has received prior approval from the relevant banking agency to do so. Such approval would be conditioned on the banking organization's demonstrating that it has a comprehensive understanding of risk characteristics of its individual securitization exposures and the risk characteristics of the pools underlying its securitization exposures;
- the banking organization can access all relevant performance information on the underlying pools on an on-going basis in a timely manner. For resecuritizations, the banking organization must have information not only on the underlying securitization tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitization tranches;
- the banking organization has a thorough understanding of all structural features of the relevant securitization transaction that would materially impact the performance of the bank's securitization exposure;
- the cash flow methodology used by the banking organization is (i) commercially available, (ii) transparent and verifiable and (iii) used by the banking organization for purposes other than the calculation of risk-based capital requirements, such as risk management or impairment analysis; and

- the additional cash flow credit enhancement for a securitization exposure is based on a projection of the available cash flows for the benefit of such securitization exposure determined by undertaking specific steps that are consistent with industry best practices.

E. The Association's proposed modifications to the Proposed Rule's treatment of securitization positions are consistent with the Association's guiding principles.

We believe that our proposed modifications to the Proposed Rule's treatment of securitization positions are consistent with our guiding principles set forth in Part III.

- Both our proposed Revised SSFA and our proposed modified SFA promote understanding by banking organizations of the risks associated with their securitization exposures. Under the Revised SSFA banking organizations will need to constantly monitor the credit enhancement levels of their securitization positions and the delinquency experience of the exposures underlying their securitization positions. The modified SFA requires banking organizations to keep apprised of the risk metrics that affect their securitization positions and encourages them to constantly monitor the effects that changing cash flow characteristics of the asset pools underlying these positions have on the credit quality of these positions.
- Both our proposed Revised SSFA and our proposed modified SFA focus on (i) actual performance of assets, which is the primary driver of the performance of an ABS, and (ii) the credit support available to a given risk position within an ABS structure after factoring in the assets' performance. Under the Revised SSFA, initial capital levels are set based on the historical loss experience of the securitization exposure and the credit quality and/or level of underwriting of the relevant asset class of the underlying exposures and required capital changes is a function of the performance of the underlying asset pool and changes in credit enhancement levels. Specifically, K_G takes into account non-performing assets in our proposal, which makes the SSFA formula more risk sensitive because it now will take into account asset deterioration or improvement. In addition, we have added Parameter A into the floor calculation to give credit to the available credit support for a given risk position to make the floor calculation more relevant to the structure of the ABS. Our proposed modified SFA similarly takes into account these factors in the computation of required capital.
- As a consequence of these features, both of our proposed methods for calculating capital on trading book positions function to facilitate dynamic and timely adjustment of capital in a manner that is consistent with and proportionate to changes in asset performance and the resulting risk profile of a given exposure.
- Finally, both of our proposed approaches are premised on data that are available to all market participants and otherwise comport with standard market practices so that all participants have the option of performing the necessary calculations. With our proposed changes, the information necessary to calculate capital requirements under both the Revised SSFA and the modified SFA is readily available from or can

be derived from servicer reports for securitization transactions or publicly available sources.

We believe that it is important for the Agencies to provide banking organizations with the ability both to use the Revised SSFA and, if they meet the requisite qualifications to do so, the SFA with our proposed modifications. Although we believe the Revised SSFA addresses many of the concerns with the SSFA as set forth in the Proposed Rule, the SFA with our modifications in our view is a better approach for calculating capital given its increased risk sensitivity and that its calculation is based on the specific characteristics of the exposures underlying the securitization position for which capital is being calculated. The Revised SSFA provides a reasonable alternative that produces reasonable capital outcomes for banking organizations that do not qualify to use the modified SFA.

F. Look-through treatment for mortgage and other asset-backed indices should be permitted, such that an index can be broken down into its constituent parts for risk-weighting and offsetting purposes.

The Associations believe it is critical that the final rule allow for look-through treatment for mortgage and other asset-backed indices, such as the CMBX and ABX, such that an index can be broken down into its constituent parts for risk-weighting and offsetting purposes.⁴⁰ We believe this is the appropriate approach to the treatment of indices because the aggregate cash flows of the individual constituents of the index are exactly the same as those of the index itself. A number of market participants use these indices to hedge their residential and commercial mortgage exposures. An undeservedly punitive capital treatment that does not reflect the nature of the instruments would be detrimental to market participants' ability to hedge, ultimately raising the cost of credit availability to end users.

Under a look-through approach, the risk-weights would be based on the individual constituents of the index instead of the index itself. In addition, the individual constituents would be allowed to offset against single name positions to the extent there was a match on the underlying names and other criteria are met. For securitization positions that do not correspond to constituents of an index, the Agencies should further provide for offsetting credit for any hedge obtained for such positions based on the relevant index. Banking organizations should not be punished for taking reasonable steps to hedge their securitization positions where perfect hedges are not available. The Associations believe that this approach better reflects the economic risk of the positions and aligns the regulatory capital calculation to the actual creditworthiness of the index, which is based on its individual constituents, while also providing the regulatory incentive to hedge and prudently risk-manage a banking organization's securitization portfolio.

In addition to the issues above on index look-through, further clarity is required as to how this framework is intended to apply to derivatives, and how the Proposed Rule interacts with the Proposed MRC Rules and the other aspects of the Agencies' capital rules. In particular, how should the

⁴⁰ As discussed in Part IV.D we also believe that look-through should be permitted when determining the 8% floor and the standard charge for positions that are part of the correlation trading portfolio but excluded from the CRM. In addition, see Part IV.D for a discussion of the differences between a "look-through" approach and decomposition.

market value of effective notional be defined in the market risk capital calculations for derivative positions? Also, as discussed in Part IV.C, we believe that the capital requirement be capped at the maximum loss that the banking organization can suffer on long and short positions, notwithstanding the floor, and we would request that the Agencies confirm this treatment.

G. Alternatives to the SSFA

The Associations have also considered the alternatives to the SSFA discussed by the Agencies in the NPR. For the reasons set forth below the Associations do not view any of these alternatives, other than the use of the SFA as discussed above, as viable replacements for the Revised SSFA.

i. A concentration ratio is an overly simplistic and risk insensitive measure.

The concentration ratio poses many of the same issues as do the SSFA and the accompanying risk weight floor without our proposed modifications. A concentration ratio does not capture the positive effects of asset overcollateralization that is not in the form of an issued security, but on the risk inherent on the positions that benefit from the same. It is insensitive to the risk of the securitized exposures, and therefore does not meet the Agencies' policy objectives of distinguishing credit risk exposures within asset classes, providing for timely and accurate measurements of credit quality, and fostering prudent risk management.

ii. A credit spread based measure is not preferable to an analytical assessment of creditworthiness.

For securitization positions, the Associations support the proposal to use an analytical assessment of creditworthiness, such as our proposed Revised SSFA and modified SFA, rather than credit spread based measures. Unlike wholesale markets where issuer default risk is the primary driver of credit spreads, a securitization position's underlying asset type and structural features are the primary drivers of each issued security's risk profile. Different tranches of securities issued by a single issuer will likely have different levels of liquidity (*e.g.*, thick, senior tranches are generally more liquid than thin, non-senior tranches), making it difficult to isolate credit risk for each tranche using a credit spread based approach. In addition, for a given seniority level, credit spreads may also vary significantly by asset type across securitizations. Furthermore, applying an analytical assessment for securitization positions is consistent with the approaches used in the banking book, a stated goal of the

iii. The drawbacks of a third-party vendor approach generally outweigh the benefits.

capital for a securitization position should also result in position-specific, risk sensitive capital calculations. It would also seem that supervisory oversight and calibration of capital outcomes across banking organizations would be manageable. Finally, it is a method that can be used by both large and small banking organizations.

The Associations, however, view the Revised SSFA and SFA with our proposed modifications as better approaches to calculating capital than the NAIC Approach. There are issues with using the NAIC Approach in our view that need to be considered and addressed if it were to be used as an alternative or additional method of calculating capital. As pointed out by the Agencies in the NPR, the NAIC Approach presents many of the same drawbacks as relying on credit rating agencies. The NAIC Approach continues reliance on a third party source for calculating capital. Potential conflicts of interest exist where the vendor engaged by the Agency continues to evaluate securitization positions for other clients. In addition, the “post facto” nature of the calculation of capital using this approach would make it difficult for banking organizations to properly price securitization positions in order to achieve appropriate returns on capital.

IV. Concerns with respect to the Treatment of Correlation Trading Positions

The Associations have serious concerns regarding the appropriateness of using the SSFA in determining the capital requirements for correlation trading positions under the CRM in view of the general risk insensitivity of the SSFA and the fundamental differences between correlation trading and securitization positions.⁴¹ Further, the Associations continue to have a number of concerns with certain aspects of the Proposed MRC Rule’s treatment of correlation trading positions.⁴²

A. Banking organizations, whether or not required to use the Basel II advanced approaches, should be permitted to use the SFA when computing the 8% floor or 15% surcharge on correlation trading positions required under the CRM, as well as when computing the standard charges for other positions that are included in the correlation trading portfolio but are excluded from the CRM.

Banking organizations should be allowed to use the SFA, instead of the SSFA, when calculating the 8% floor or 15% surcharge under the CRM, for several reasons.

First, there are fundamental differences between correlation trading activity and other securitization activity. These differences were recognized through the carve-out for correlation trading to utilize the CRM, which generally permits banking organizations to measure material price risks using a comprehensive risk model. Underlying exposures in correlation trading portfolios generally consist of publicly traded credit default swap (“CDS”) exposures that reference corporate credit risk and are priced by both dealer and pricing services. Unlike traditional asset-backed securitization exposures (*e.g.*, a mortgage backed security), these exposures are valued on a daily basis by the counterparties and

⁴¹ The 8% floor and 15% surcharge required under Sections 9(a)(2)(i)(A) and 9(a)(2)(ii)(B) of the Proposed MRC Rules, respectively, are determined using the standardized measurement method for specific risk. Accordingly, for correlation trading positions that are securitizations, the SSFA must be used in determining the applicable floor or surcharge under the CRM.

⁴² We plan to address these concerns in additional detail in a subsequent letter to the Agencies.

market participants, and market participants are generally aware of any changes to the underlying portfolio (such as a merger or acquisition or realized losses based on credit events) as they occur. Current attachment and detachment points of correlation trading positions are also generally known by counterparties and market participants at all times, which is not the case with most securitization positions. In view of the differences between correlation and other securitization positions, it would not be appropriate to assign capital charges to positions that bear little resemblance to the traditional securitization positions whose capital the SSFA was designed to determine.

Second, as discussed in Part III, the SSFA has several serious flaws, including substantially overstating the amount of capital required for certain securitization exposures because of a lack of risk sensitivity. The SFA would address these flaws by permitting for a significantly more risk sensitive capital calculation than would be possible under the SSFA.

Third, the rationale for the SSFA approach is strongest for securitization exposures in which the underlying data for the SFA is difficult to source. However, as discussed above, for correlation trading, application of the SFA is feasible because the information regarding the underlying pool is available, tranche attachment and detachment are known at all times and actual tranche specifics are known and can be modeled. Additionally, all the underlying pool information is available on a regular and current basis to both market participants and their counterparties.⁴³

Further, banking organizations, for similar reasons, should be able to use the SFA to determine the standard charge for leveraged super-senior positions, LCDX tranche positions and any other securitization positions that are part of the correlation trading portfolio but excluded from the CRM.

Under the U.S. risk-based capital rules, the SFA is only available to banking organizations that have been approved to use the advanced approaches. The Associations urge the Agencies to permit any banking organization, which chooses to do so and is approved by the regulators, to use the SFA with respect to correlation trading positions in light of the significant defects in the SSFA methodology and the superior risk sensitivity of the SFA. The Agencies are not required to tie the use of the SFA for purposes of calculating the CRM supervisory floor to being approved to use the advanced approaches. Any banking organization that has received the approval to determine the CRM should be permitted to utilize SFA when calculating the 8% floor or 15% surcharge, provided that it has demonstrated to the appropriate Agency that it has the necessary resources and sophistication to do so and appropriate monitoring and governance procedures in place to prevent potential arbitrage opportunities.

In the event that a banking organization opted and was approved to use the SFA to calculate the CRM supervisory floor, in order to prevent regulatory arbitrage between the SFA and the SSFA, banking organizations using the SFA should be required to apply the SFA to all correlation trading positions, other than those correlation trading positions for which the information necessary to apply the SFA was unavailable.

⁴³ For obligors that are not covered by an internal rating, the bond credit spread methodology for assigning specific risk-weighting factors to corporate debt positions considered in the NPR could be used to derive LGD and PD for the SFA formula.

B. The Proposed MRC Rule’s 15% surcharge is inconsistent with Basel II.5 and unnecessary, even on a temporary basis, in light of the double and triple counting of price risk.

As discussed in the April 11th Letter, the comprehensive risk measure for correlation trading positions – specified to measure “all price risk” – is duplicative of the VaR-based measure and stress VaR-measure and the modeled specific risk calculations (the latter as part of the VaR and stressed VaR calculations). Those measures encompass price risk of correlation trading positions, covering losses on a position that could result “from movements in market prices.” As a result, price risk is triple-counted, reducing, if not eliminating altogether, the need to impose a 15% surcharge on a banking organization’s modeled measure of price risk, even for a temporary period, as contemplated in Section 9(a)(2)(i) of the Proposed MRC Rules. Moreover, the rationale for the 15% surcharge was partly that Basel I risk-weights were previously used in the standard calculation (and were not sufficiently conservative). The Proposed Rule, however, moves away from Basel I risk-weights, further reducing the need for a surcharge of this magnitude. The proposed 15% surcharge is also not consistent with Basel II.5, which does not impose such a surcharge. Finally, firms requesting model approval under the Proposed MRC Rules have to submit rigorous and comprehensive documentation, and months of test portfolio results. Banking organizations that obtain approval for their CRM model, after this robust evaluation process, should be allowed to move directly to a specific risk calculation for correlation trading positions that is the greater of the CRM or the 8% supervisory floor, and thus should not first have to be subjected to the 15% surcharge for at least one year as required under Section 9(a)(2)(ii) of the Proposed MRC Rules.⁴⁴ For all of the foregoing reasons the Associations urge the Agencies to eliminate the 15% surcharge.

C. The specific risk add-on (“SRAO”) of correlation trading positions for purposes of the 8% supervisory floor should be capped at the maximum potential loss of those positions.⁴⁵

As stated in the April 11th Letter,⁴⁶ banking organizations should not be required to maintain capital against covered positions in an amount that exceeds the maximum loss that the banking organization could suffer under that position. This treatment should extend to the SRAO of correlation trading positions for purposes of calculating the 8% supervisory floor. Capping the SRAO of a correlation trading position at the maximum potential loss of that position is consistent both with the economics of the position and with Basel II.5.

D. Banking organizations should be permitted, but not required, to look through indices for purposes of determining the 8% supervisory floor for the CRM,⁴⁷ as well as

⁴⁴ The Associations believe that a floor of 8%, consistent with international implementation of Basel II.5, is more appropriate than the proposed 15% surcharge.

⁴⁵ The application of maximum loss would also be applicable to the determination of the 15% surcharge should the Agencies decide to retain a surcharge.

⁴⁶ See Part III.A.8 of the April 11th Letter.

⁴⁷ The index look-through treatment would also be applicable to the determination of the 15% surcharge should the Agencies decide to retain a surcharge.

standard charges for positions that are part of the correlation trading portfolio but excluded from the CRM.

Both for purposes of determining the 8% supervisory floor for the CRM and for determining standard charges for positions that are part of the correlation trading portfolio but excluded from the CRM,⁴⁸ banking organizations should be permitted to look-through to the underlying names of an index.

We distinguish “decomposition” from “look-through” as follows. Decomposition into net exposure is how banking organizations view and hedge their economic exposure for correlation trading and other trading desks. It involves calculating sensitivities for the portfolio, such as delta and gamma. This method is an industry standard and well understood, but it utilizes a model to determine the net delta and other sensitivities across the correlation portfolio.

In contrast to decomposition, a “look-through” approach has no model reliance. Look-through refers to an index being broken down into its constituent parts and apportioned to its constituents. The constituents can then be netted/offset against other exposures in the same reference name. Look-through has no model dependency and therefore is only applicable to vanilla indices to be netted/offset with single name exposures. It is not applicable to tranching exposures, which do have a model dependency when decomposed into their underlying positions.

The Associations believe it is critical that the Agencies’ final market risk capital rules permit banking organizations to look-through indices⁴⁹ to the underlying portfolio, and to net/offset those underlying constituents against cash equity or single name credit positions for purposes of determining the 8% supervisory floor for the CRM and more generally, when calculating standard charges for positions that are part of the correlation trading portfolio but excluded from the CRM. Permitting banking organizations to look through indices in this way would appropriately reflect the combined risk of the positions (*e.g.* long equity positions could be offset against a short equity index hedge). Allowing banking organizations to look through to the underlying portfolios would also result in capital requirements that are better aligned with the creditworthiness of the index based on its constituents and would provide the correct incentive to hedge the risks of such positions.⁵⁰

⁴⁸ As discussed in Part III.F, the Associations strongly believe that a “look-through” approach should also be permitted when risk weighting securitization exposures.

⁴⁹ Indices for these purposes include equity, credit and mortgage and other asset-backed indices.

⁵⁰ In a planned subsequent letter, the Associations anticipate providing additional detail on the appropriate offsetting treatment across bespoke and CDS positions and potentially across other positions under Sections 10(a)(4) and 10(a)(5) of the Proposed MRC Rules when determining the 8% floor and 15% surcharge for the CRM.

E. At a minimum, non-securitization index and single name CDS hedges should be removed from the standard charges (i) within the 15% surcharge and the 8% floor and (ii) for positions that are part of the correlation trading portfolio but excluded from the CRM.

The proposed standardized charges under the Proposed MRC Rules for correlation trading positions penalize banking organizations for hedging these positions with vanilla products, because the offsetting benefit of these hedges is not recognized and the hedges themselves attract separate capital charges. A significant portion of the 15% surcharge, the 8% floor and standard charges for positions that are part of the correlation trading portfolio but excluded from the CRM (*e.g.*, LCDX index tranches) would arise from capital attracted by non-securitization index and single name CDS hedges under the Proposed MRC Rules, thereby discouraging banking organizations from buying such hedges. Although our preference would be for the Agencies to permit appropriate hedge recognition (as discussed above in Part III.D), at a minimum, in order to align capital rules with effective risk management practices, we urge the Agencies to remove non-securitization index and single name CDS hedges from such requirements.

We recognize that, if the Agencies allow the offsetting treatment described above, there is a risk that a banking organization may attempt to engage in regulatory arbitrage by claiming that positions outside the correlation trading portfolio are hedges of correlation trading positions in order to receive potentially more favorable capital treatment. We believe, however, that this risk is manageable. As part of the CRM model approval process, we would expect supervisors to insist on appropriate documentation of, and systems and controls for tracking and monitoring, correlation trading positions to prevent opportunistic reclassifications of non-correlation trading positions for regulatory capital purposes, such that any attempts to engage in regulatory arbitrage would be easily identified and prevented or reclassified.

V. Additional Concerns

A. The Proposed Rule could, in practice, impose capital requirements in excess of dollar-for-dollar capital.

Under the Agencies' current market risk capital rules,⁵¹ market risk equivalent assets are added to adjusted risk-weighted assets for purposes of calculating a banking organization's risk-based capital ratio denominator.⁵² Market risk equivalent assets, in turn, are calculated by multiplying the measure for market risk by 12.5, and the measure for market risk is determined by summing up several capital charges, including the specific risk add-on.⁵³ Thus, for example, specific risk-weighting factors of 1.6% and 8% are equivalent to risk weightings of 20% and 100%, respectively.

⁵¹ See 12 C.F.R., part 3, Appendix B (OCC); 12 C.F.R., part 208, Appendix E and 12 C.F.R. part 225, Appendix E (Federal Reserve); 12 C.F.R., part 325, Appendix C (FDIC).

⁵² See, *e.g.*, 12. C.F.R., part 225, Appendix E, § 3(a)(4).

⁵³ See, *e.g.*, *Id.* §§ 3(a)(2), (a)(3).

As a consequence of the way market risk equivalent assets are calculated, a specific risk-weighting factor of 100% is equivalent to a risk weighting of 1250%. Assuming an 8% total risk based capital requirement, a specific risk-weighting factor of 100% is generally equivalent to a dollar-for-dollar capital requirement. However, if the total risk based capital requirement in effect exceeds 8%, then a banking organization will be required to hold more than dollar-for-dollar capital for exposures that have a 100% specific risk-weighting factor. Minimum total capital requirements (including the capital conservation buffer) under Basel III on a fully phased-in basis will be 10.5%, and thus will exceed 8%.⁵⁴ Furthermore, banking organizations will need to hold additional capital buffers as a practical matter given regulatory and market expectations, U.S. requirements concerning capital maintenance levels under stressed scenarios and volatility because Basel III does not filter accumulated other comprehensive income from Tier 1 capital.

If a principal purpose of capital requirements is to protect a banking organization against expected potential losses, it is not sensible to impose capital requirements in excess of an exposure's maximum potential loss. The Associations therefore urge the Agencies to continue to provide banking organization with the options of calculating a dollar-for-dollar capital charge using the "direct reduction method", which is currently permitted in Call Reports. A banking organization that uses this method calculates its capital requirement using the actual amount of the banking organization's total risk-based capital. The direct reduction method replicates a deduction from capital and does not result in banking organization's holding more capital than an asset's carrying value. For a banking organization the capital ratios of which exceed the required minimums, it is normally preferable to use the "direct reduction method."

VI. Responses to Certain Specific Questions

Below are cross-references to parts of the letter that we believe are responsive to part or all of the questions posed by the Agencies in the NPR.

A. Question 2: The agencies solicit comment on the use of the CRC ratings to assign specific risk-weighting factors to sovereign debt positions.

Please see Part II.A.

B. Question 3: How well does the proposed methodology assign specific risk-weighting factors to sovereign debt positions that are commensurate with the relative risk of such exposures? How could it be improved? What are the relative merits of the two market-based alternatives described above (using sovereign CDS spreads and bond spreads) as supplements to the CRC ratings?

Please see Part II.A.

⁵⁴ For "global systemically important banks", minimum total capital requirements could be between 1% and 3.5% higher than 10.5%. The countercyclical capital buffer, if imposed by the Agencies, would also increase total minimum capital requirements above 10.5%.

- C. Question 4: How well does the proposed methodology assign specific risk-weighting factors that are commensurate with the relative risk of positions that are exposures to depository institutions, foreign banks, and credit unions?**

Please see Part II.C.

- D. Question 5: Does the method of assigning specific risk-weighting factors to positions that are exposures to PSEs do so in a manner that is consistent and commensurate with the relative risk of such exposures? How could it be improved?**

Please see Part II.D.

- E. Question 8: How well does the three-indicator methodology capture credit risk for purposes of assigning risk-based capital requirements for covered debt positions of publicly-traded companies that are not financial institutions? How could it be improved?**

Please see Part II.E.

- F. Question 9: How does the bond spreads alternative to credit ratings compare to the proposed approaches regarding operational feasibility and reliability in assessing risk and an appropriate amount of capital?**

Please see Part II.E.ii.

- G. Question 10: For what types of positions would the bond-spread approach be most appropriate, and for what types of positions would it not be appropriate? Are there measures of market liquidity or other factors that the agencies should consider in evaluating the applicability of a credit spread approach?**

Please see Part II.E.ii.

- H. Question 11: What are the pros and cons of a more simple approach, which distinguishes only among investment grade and non-investment grade corporate debt positions (the "investment grade methodology") relative to the more granular three-indicator methodology? What are the pros and cons of offering the investment grade/non-investment grade (under the OCC's proposed revisions to 12 CFR part 1) approach as an alternative for banks that do not use the three-indicator approach?**

Please see Part II.F.

- I. Question 12: Is the SSFA function appropriately calibrated and would it be a feasible and appropriate methodology for assigning specific risk add-ons for securitization positions? Why or why not? Are the minimum risk-weighting factors appropriate and appropriately calibrated? Why or why not? Please provide detailed responses and supporting data wherever possible.**

Please see the discussion in Part III.A.

- J. Question 13: What are the benefits and drawbacks to using a scaling factor to better align the minimum capital requirements under the SSFA with those generated by the ratings-based approach? What other adjustments could the agencies consider to better recognize credit enhancements and align the minimum capital requirements? Please provide specific details on the mechanics of, and rationale for, any suggested methodology and the position types to which it should apply. How should an adjustment, such as a scaling factor, be implemented? For example, should it take into account the type of credit enhancement, asset class, loss experience, prudential requirements, or other criteria, and if so how and why?**

Please see Parts III.B through III.E.

- K. Question 14: What are the pros and cons of incorporating the concentration ratio into the market risk capital rules as a replacement or alternative to the SSFA?**

Please see Part III.G.i.

- L. Question 15: In what instances and for what types of securitization positions should the concentration ratio be used? For what types of securitization positions does the concentration ratio produce a specific risk-weighting factor that is better aligned with the risk inherent in the position than the SSFA?**

Please see Part III.G.i.

- M. Question 16: Is the spread-based methodology feasible for assigning securitization positions to specific risk-weighting factors? What are the particular types of securitization positions for which it is more or less feasible, and why?**

Please see Part III.G.ii.

- N. Question 17: Would the spread-based methodology be more or less effective as a methodology for assigning specific risk-weighting factors for securitization positions than the proposed methodology using the SSFA? What difficulties or challenges would a bank have in assigning specific risk-weighting factors for securitization positions under this approach?**

Please see Part III.G.ii.

- O. Question 18: What limitations currently exist with respect to banks' ability to obtain reliable spread data for securitization positions, including illiquid positions? If the third-party vendor approach is implemented, how could banks demonstrate to supervisors sufficient access to such information to use the methodology?**

Please see Part III.G.iii.

- P. Question 19: Given concerns noted above, what would be the advantages and disadvantages of a third-party vendor approach, particularly relative to the proposed SSFA approach?**

Please see Part II.G.iii.

- Q. Question 20: Should banks that are approved to use the advanced approaches be allowed to use the advanced approaches SFA to calculate specific risk-weighting factors for their securitization positions under the market risk capital rules? If the advanced approaches banks are permitted to use SFA, what safeguards should be put in place to mitigate arbitrage concern?**

Please see Part III.D.

- R. Question 21: How could the SFA be modified to permit the use of pool-level inputs to increase the applicability of the SFA for banks as investors? What effect would the use of pool-level inputs and the recognition of cash flow hedges have on the risk sensitivity of the SFA? To what extent does use of pool-level inputs camouflage the risk inherent in an asset pool? Are there other issues that should be considered if pool-level inputs are used?**

Please see Part III.D.

VII. Conclusion

In view of the significant shortcomings in the Proposed Rule's methodologies and the potentially significant impact that the Proposed Rule could have on capital requirements, we respectfully urge the Agencies not to implement any alternative methodologies before the Associations, their members and other interested parties have had an opportunity to more thoroughly review the proposed methodologies and more fully develop potential alternatives in conjunction with the Agencies, and the Agencies undertake a quantitative impact study (a "QIS") to determine the comparability of the Proposed Rule's alternative methodologies to Basel II.5's ratings-based approach as well as to assess the impact of the Proposed Rule on banking organizations, the availability and cost of credit and the U.S. economy. Once these potential alternatives have been more fully developed and a QIS has been completed, we urge the Agencies to re-publish the Proposed Rule for further comment given the potentially significant impact that the Proposed Rule's methodologies will have not only on capital requirements under the Agencies' market risk capital rules, but also on the capital requirements under the general risk-based rules to the extent similar methodologies are incorporated in those rules. We strongly believe that a re-publication of the Proposed Rule following the completion of a QIS and additional work on proposed alternative methodologies would lead to better calibrated, more risk sensitive approaches that are more closely aligned with international standards and better promote the Agencies' objectives set forth in the NPR.

We fully recognize and appreciate that the various issues raised in this letter concerning the NPR and the Proposed Rule, including with respect to sovereign debt and corporate debt, securitization and correlation trading, are quite challenging and complex. We look forward to meeting and working together with the Agencies in the coming weeks to more fully develop sensible and practical solutions with respect to these matters.

* * *

The Associations appreciate your consideration of the views expressed in this letter. If you have any questions, or need further information, please contact Eli Peterson, Senior Regulatory Counsel and Associate General Counsel of The Clearing House (202-649-4602) or one of the other signatories below. If you need any further information regarding the matters discussed in Part III of this letter, please contact Tom Deutsch, Executive Director of the ASF (212-412-7107).

Respectfully Submitted,



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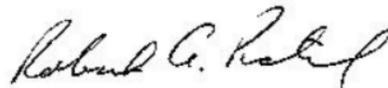
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The Clearing House

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The Financial Services Roundtable

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for \$92.7 trillion in managed assets, \$1.2 trillion in revenue, and 2.3 million jobs.

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The International Swaps and Derivatives Associations (“**ISDA**”), which represents participants in the privately negotiated derivatives industry, is among the world’s largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: www.isda.org.

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SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

Annex B

Standard Specific Risk: Sovereigns

Comparison: *BIS 2.5 MR to US NPR Risk Weights on Sovereign Debt*

CRC	Change	RW Change	# of Countries
0-1	Lower Same	150% → 0%	1
		100% → 0%	6
		20% → 0%	10
		0%	19
2-3	Lower Same Higher	100% → 20%	8
		20%	16
		0% → 20%	3
4-6	Same Higher	100%	49
		20% → 100%	6
7	Same Higher	150%	1
		100% → 150%	47
No CRC	Same Higher	100% → 100%	40
		20% → 100%	2
		0% → 100%	2
Total			210

Impact: *Significantly lower capital charges for OECD sovereigns, compared to BIS 2.5 MR.*

Standard Specific Risk: IG Corporates

Comparison: BIS 2.5 MR to US NPR Risk Weights for IG 15

S&P Equivalent	Change	RW Change	# of Issuers
AAA	Higher	20% → 100%	1
AA	Higher	20% → 100%	3
A	Higher	20% → 100%	31
BBB	Higher	20% → 100%	78
BB	Same	100%	7
NR	Same	100%	5
Total			125

Change	# of Issuers
Lower	0
No Change	12
Higher	113
Total	125

Comparison: Basel 1 to US NPR Risk Weights for IG 15

S&P Equivalent	Change	RW Change	# of Issuers
AAA	Higher	20% → 100%	1
AA	Higher	20% → 100%	3
A	Higher	20% → 100%	31
BBB	Higher	20% → 100%	78
BB	Same	100%	7
NR	Same	100%	5
Total			125

Change	# of Issuers
Lower	0
No Change	12
Higher	113
Total	125

Impact: 90% of IG names migrate from 20% to 100% compared to both BIS 2.5 MR and Basel 1.

Annex C

Figure 1 (% IG not classified as low risk among DTCC's 1000 most actively traded names as of 1/13/12)

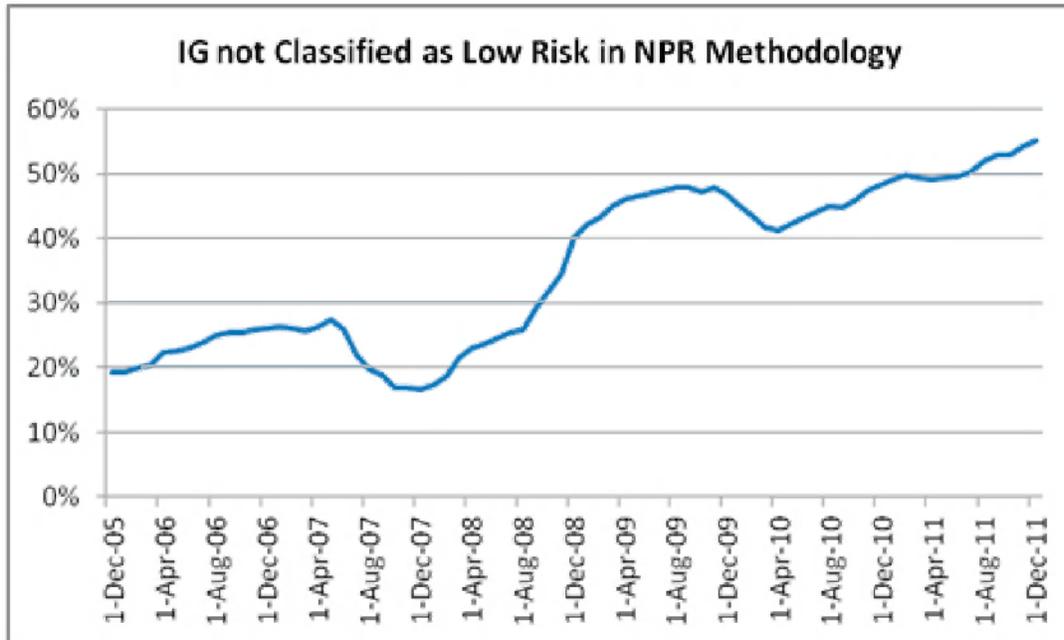


Figure 2 (% of misclassified DTCC's 1000 most actively traded names as of 1/13/12)

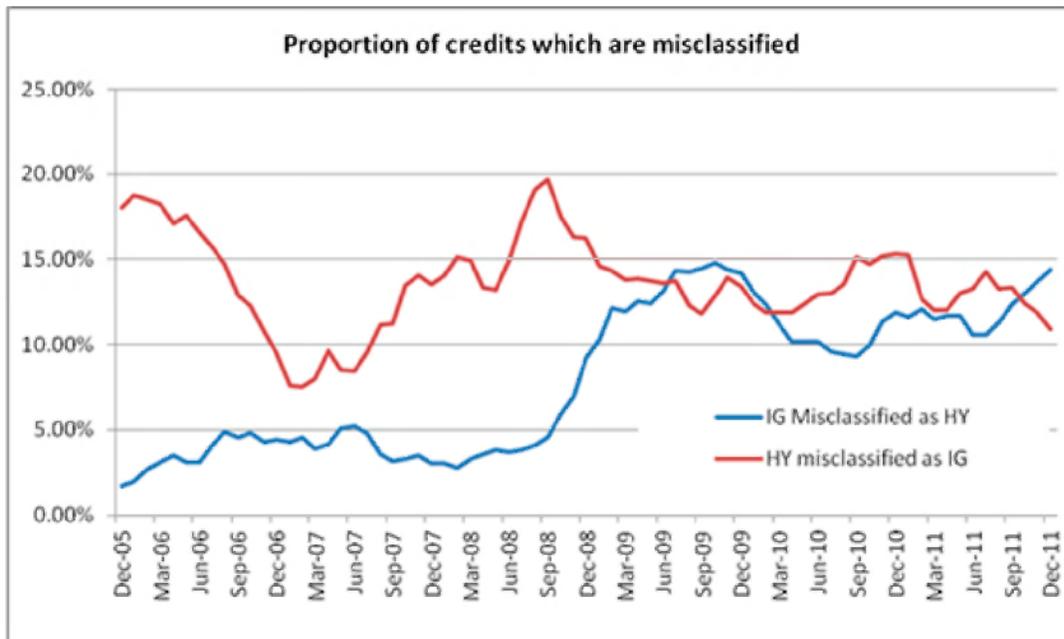
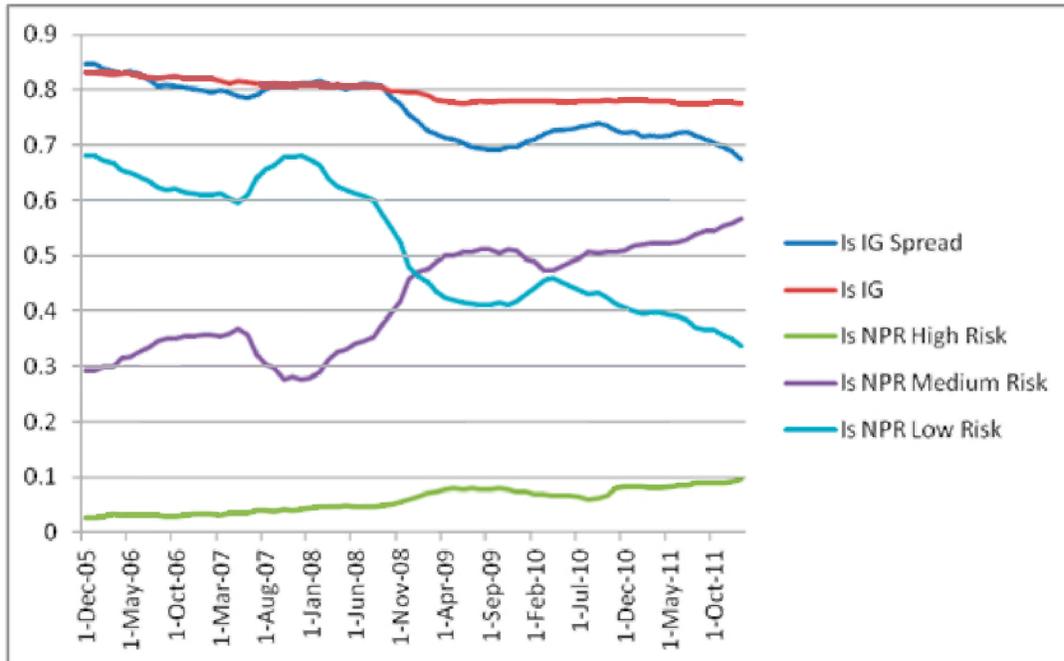


Figure 3 (% of DTCC's 1000 most actively traded names as of 1/13/12 in different categories)



Annex D

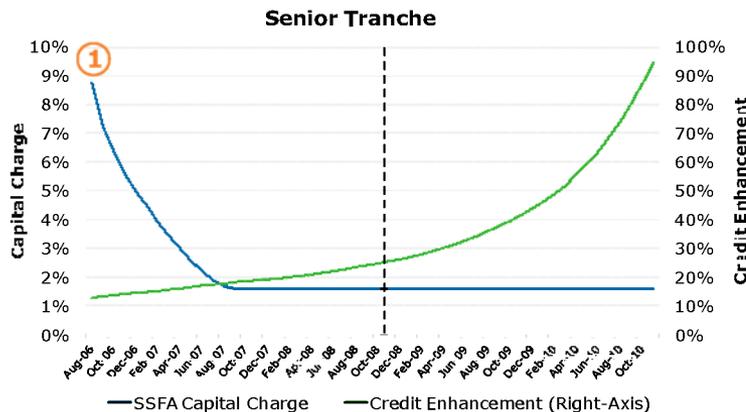
Specific Concern with the NPR SSFA, Section (III)(B)(i)

K_G is a highly risk insensitive measure for calculating the required capital for exposures underlying a securitization exposure

Higher capital charge for a prime auto senior bond, compared to a subprime auto senior bond

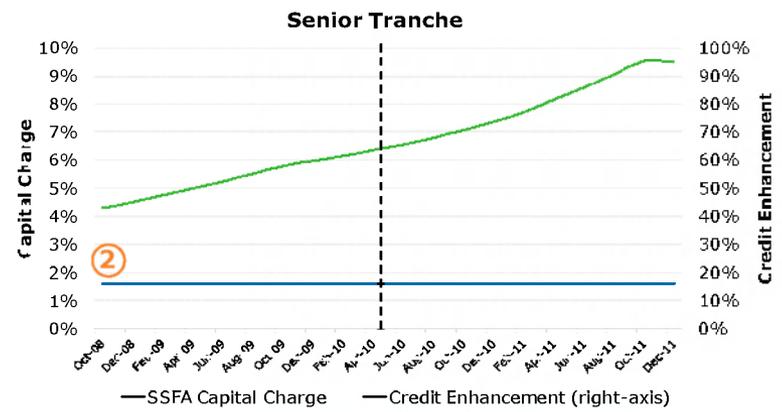
- K_G , in its proposed form, does not distinguish the credit risk associated with a particular exposure within an asset class
- The example below illustrates how the SSFA, as proposed, results in a higher capital charge for the senior bond in a prime auto securitization (FORDO 2006-B) compared to the senior bond in a subprime auto securitization (AmeriCredit 2008-1)
 - ① FORDO 2006-B capital charge at issuance: 8.77%
 - ② AmeriCredit 2008-1 capital charge at issuance: 1.60%
- Risk insensitivity and resulting inappropriate capital charges are due to an arbitrary K_G value of 8% for both trusts

FORDO 2006-B Capital Charges Over Time



Date	08/15/2006	11/15/2008	11/15/2010
Tranche	A-4	A-4	A-4
Capital Charge	8.77%	1.60%	1.60%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	12.64%	25.56%	94.64%
D	26.49%	63.78%	100.00%
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	1.31%	2.10%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

AmeriCredit 2008-1 Capital Charges Over Time



Date	10/06/2008	05/06/2010	01/06/2012
Tranche	A-3	A-3	A-3
Capital Charge	1.60%	1.60%	1.60%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	42.75%	64.62%	94.98%
D	54.02%	83.52%	100.00%
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	9.29%	14.81%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

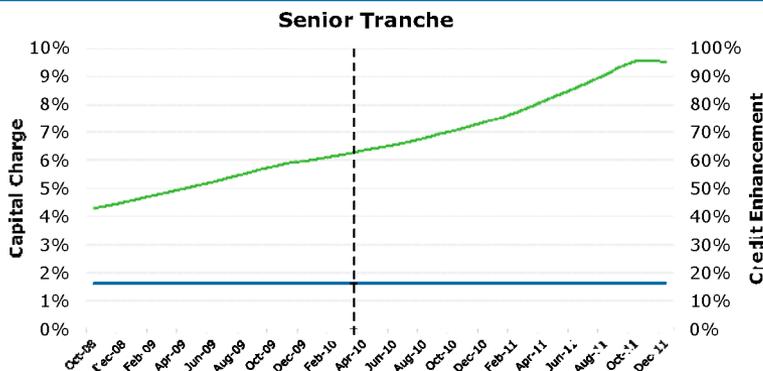
Specific Concern with the NPR SSFA, Section (III)(B)(i)

K_G is a highly risk insensitive measure for calculating the required capital for exposures underlying a securitization exposure

Same capital charge for a trust's senior bond as its riskier junior bond

- K_G , in its proposed form, does not increase beyond 8%, even for asset classes with expected and unexpected losses in excess of 8%
- The example below illustrates how the SSFA, as proposed, results in an identical capital charge for both the senior bond and the junior bond in a subprime auto securitization (AmeriCredit 2008-1)
 - The senior bond has initial credit enhancement of 42.75%, compared to the junior bond's initial credit enhancement of 23.87%
 - Such risk insensitivity may not foster prudent risk management as banks would be incentivized to hold riskier bonds

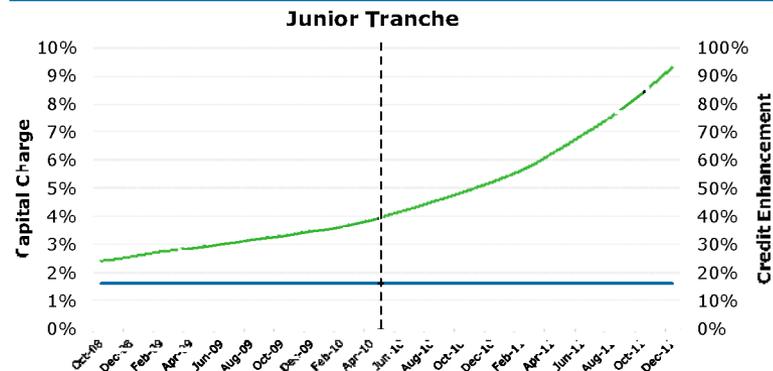
AmeriCredit 2008-1 Capital Charges Over Time



— SSFA Capital Charge — Credit Enhancement (right-axis)

Date	10/06/2008	05/06/2010	01/06/2012
Tranche	A-3	A-3	A-3
Capital Charge	1.60%	1.60%	1.60%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	42.75%	64.62%	94.98%
D	54.02%	83.52%	100.00%
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	9.29%	14.81%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

AmeriCredit 2008-1 Capital Charges Over Time



— SSFA Capital Charge — Credit Enhancement (right-axis)

Date	10/06/2008	05/06/2010	01/06/2012
Tranche	C	C	C
Capital Charge	1.60%	1.60%	Paid Down
Moody's/S&P	A3/A	A3/A	Paid Down
Inputs			
A	23.87%	40.13%	Paid Down
D	34.90%	51.47%	Paid Down
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	9.29%	14.81%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

Specific Concern with the NPR SSFA, Section (III)(B)(ii)

Determining the supervisory risk-weight floor based on the ratio of cumulative losses to K_G in the manner contemplated by the Proposed Regulations is not an appropriate benchmark of credit quality

The supervisory floor can require a 100% capital charge for a senior bond with 92% credit enhancement; which is the same capital charge for a junior bond with only 7% credit enhancement

- The supervisory floor, as proposed, can result in situations in which more risky junior tranches of a securitization have higher capital requirements, but the most senior positions **do not** have relatively lower capital requirements

Trust	HEAT 2006-5
Collateral Type	Home Equity
Tranche	2A2
Moody's/S&P	Aa3/AAA
Date	03/25/2011
A	91.59%
D	100.00%
p	0.5
K_G	8.00%
Cumulative Net Losses on Issued Securities	17.24%
Cumulative Net Losses on Underlying Exposures	24.19%
K_{SSFA} Core Formula Capital Charge	0.00%
Supervisory Floor Capital Charge	100.00%
Overall Capital Charge	100.00%

Trust	HEAT 2006-5
Collateral Type	Home Equity
Tranche	2A4
Moody's/S&P	C/CCC
Date	03/25/2011
A	6.79%
D	34.76%
p	0.5
K_G	8.00%
Cumulative Net Losses on Issued Securities	17.24%
Cumulative Net Losses on Underlying Exposures	24.19%
K_{SSFA} Core Formula Capital Charge	0.00%
Supervisory Floor Capital Charge	100.00%
Overall Capital Charge	100.00%

Identical Capital Charges

Annex E

Proposed Modifications, Section (III)(C)(i)(i)

The following modifications to the currently proposed NPR SSFA can help produce more risk-sensitive capital charges for securitization exposures

- To increase the risk-sensitivity of the SSFA, K_G , the weighted-average capital requirement, should be based on non-arbitrary values, by asset class, that represent unexpected losses of the underlying exposures

Expanded Table of Weighted-Average Capital Requirements	
Asset Type	Loan Capital Requirement
Prudently Underwritten Mortgages	4.00%
Prime Bank Credit Cards	4.00%
Prime Auto Loans	4.00%
Other Low Loss Assets	4.00%
All Other	Consistent with General Risk Based Capital

Proposed Modifications, Section (III)(C)(i)(ii)

The following modifications to the currently proposed NPR SSFA can help produce more risk-sensitive capital charges for securitization exposures and is in-line with current risk-based capital rules on loans

- Redefine K_G to include reserves for losses against non-performing loans
 - Redefining K_G to reflect the sum of risk-based capital on loans (based on the table in the previous slide), plus loan loss reserves, would bring required capital on securitizations in sync with how loans would be treated on a bank's balance sheet
 - K_G is redefined as follows:
 - (a) the weighted-average capital requirement of the **performing** underlying exposures calculated using the expanded table of general risk-based capital values (see previous slide), plus (b) the expected losses on seriously delinquent underlying exposures calculated using the 3-month loss severity¹ on the underlying exposures*
 - Formulaically:
$$K_G = ((1 - \% \text{ of Underlying Exposures Greater than 90 Days Past Due}) \times \text{Weighted Average Capital Requirement}) + (\% \text{ of Underlying Exposures Greater than 90 Days Past Due} \times 3 \text{ month severity}^1)$$
 - K_G is updated quarterly

1. If historical severity is not available, a severity of 50% is used as a proxy

Proposed Modifications, Section (III)(C)(ii)

A security held at a discount to par carries less risk than the same security held at par, and as such, should require a lower risk-based capital charge in the SSFA

Carrying value is an important component of credit enhancement and should be included in the attachment point; it is not applied to directly deduct capital

- The example securitization structure shown below includes three tranches (A1, B1, and C1) that are sequential for interest and principal payments. Tranche A1 and B1 were purchased at a 25% discount

Example Securitization Structure		Tranche A1 SSFA Inputs		Tranche B1 SSFA Inputs	
Collateral Pool \$100	Tranche A1 \$85	K_G	8%	K_G	8%
	Tranche B1 \$10	p	0.5	p	0.5
	Tranche C1 \$5	A	15%	A	5%
		D	100%	D	15%
		Carrying Value	75%	Carrying Value	75%

- Carrying value can be incorporated into the SSFA methodology by modifying the calculation of the attachment point variable, A , to reflect an increase in the credit enhancement by an absolute percent of the discount factor from par on the thickness of the security, as follows:

Modification to the SSFA

$$\text{Parameter } A = A + (D - A) * (1 - C)$$

$$C = \frac{\text{Carrying value of security}}{\text{Par value of security}}$$

Results of modification

Tranche A1	NPR SSFA	Modified SSFA
A	15.00%	15.00%
A_{modified}	-	36.25%
Capital Charge	1.6%¹	1.6%¹

Tranche B1	NPR SSFA	Modified SSFA
A	5.00%	5.00%
A_{modified}	-	7.50%
Capital Charge	63.05%	50.73%

1. Capital charge of 1.60% is representative of the SSFA floor, as proposed in the NPR. The revised version of the SSFA, including all of the proposed changes, would result in a capital charge of 0.56% due to the revised floor

Proposed Modifications, Section (III)(C)(iii)(i)

A K_{SSFA} formula that appropriately accounts for the risk of a security with a proper K_G value, attachment point, detachment point, and calibration parameter will produce suitable capital charges

- A single risk-weight floor that is equal to the minimum risk-weight floor applicable to securitization positions under the Basel II advanced approaches as in effect from time to time
- A ceiling (maximum) is introduced on the capital charge of the most senior tranche in a securitization that is equal to K_G , where the most senior tranche is defined as the tranche with a detachment point of 100% (as proposed in 1(d) of the 'Summary of Proposed Changes' section)
 - Securitizations are subject to this ceiling, however, re-securitizations are *not* subject to this ceiling

Proposed Modifications, Section (III)(C)(iii)(ii)

A supervisory floor that contemplates the structural features of a trust will result in non-arbitrary and more appropriate capital charges

Any supervisory floor table should be:

- a) more granular to reduce the cliff impact and make increases in capital more gradual as performance warrants such increases, and**
- b) incorporate attachment point to differentiate between less risky senior tranches and riskier junior tranches**

- The supervisory floor (NPR Table 15) calculation is adjusted to better reflect the risk of a security
 - The supervisory floor metric is adjusted to account for the seniority of a security by including Parameter A:

$$\text{Supervisory Floor Metric} = \frac{\text{Cumulative Losses of Principal on Originally Issued Securities (as a \%)} + \text{Current Period Parameter A (as a \%)}}{K_G \text{ at Origination (as a \%)} + \text{Current Period Parameter A (as a \%)}} \text{ (Note: The original image has a typo in the denominator, it should be } K_G \text{ at Origination (as a \%))}$$

- The supervisory floor table is adjusted to become more granular and better reflect the risk-level of a securitization exposure, as shown below:

CLP / (K _{GI} + Parameter A)		Specific Risk-weighting Factor (in percent)
Greater than:	Less than or equal to:	
0%	25%	0.56
25%	30%	0.64
30%	40%	0.80
40%	50%	1.60
50%	60%	2.80
60%	70%	4.00
70%	85%	6.00
85%	100%	8.00
100%	115%	20.00
115%	130%	34.00
130%	150%	52.00
150%	n/a	100.00

Where,

CLP = cumulative losses of principal on originally issued securities as a percentage of the original principal amount of such securities

K_{GI} = the initial K_G of the relevant securitization exposures (expressed as a percentage)

Parameter A = the attachment point, modified to reflect carrying value, of the securitization position at the time of calculations (expressed as a percentage)

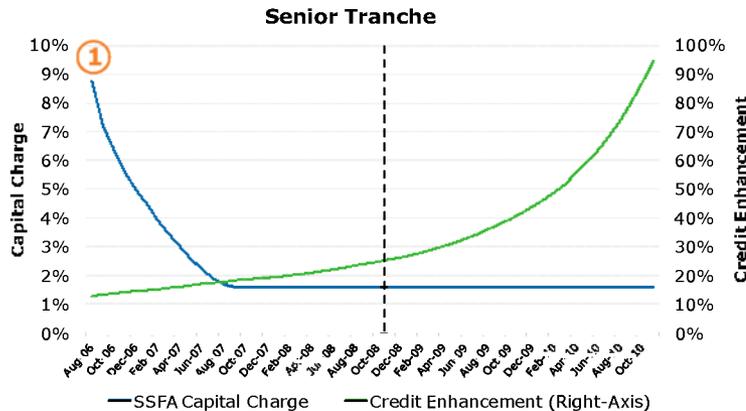
- A ceiling (maximum) is introduced in the supervisory floor capital charge calculation for the most senior tranche in **both** securitizations and re-securitizations that is equal to K_G, where the most senior tranche is defined as the tranche with a detachment point of 100% (as proposed in 1(d) of the 'Summary of Proposed Changes' section)

Results of Revised SSFA

K_G , as proposed in the NPR, is a risk insensitive measure for calculating the required capital for exposures underlying a securitization exposure

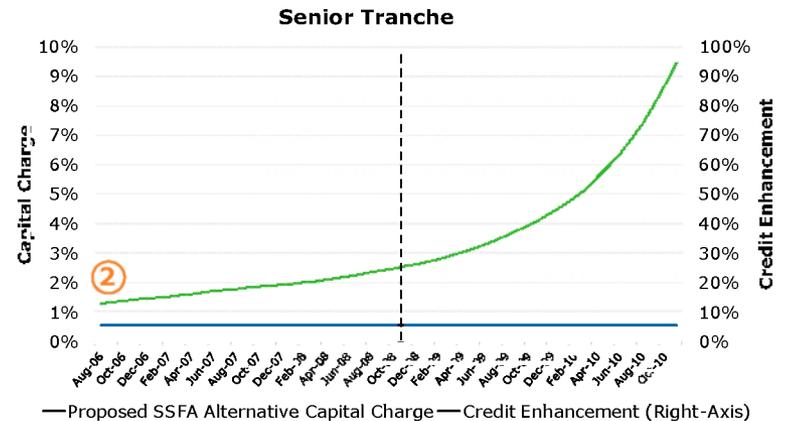
- Incorporating a more risk sensitive measure for K_G results in capital charges that are more appropriate for each type of asset class
- The example below illustrates how the proposed changes to SSFA results in a **more appropriate** capital charge for the senior bond in a **prime** auto securitization (FORDO 2006-B) than would be required from the current SSFA
 - ① FORDO 2006-B capital charge at issuance (current SSFA): 8.77%
 - ② FORDO 2006-B capital charge at issuance (revised SSFA): 0.56%

FORDO 2006-B Capital Charges (current SSFA)



Date	08/15/2006	11/15/2008	11/15/2010
Tranche	A-4	A-4	A-4
Capital Charge	8.77%	1.60%	1.60%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	12.64%	25.56%	94.64%
D	26.49%	63.78%	100.00%
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	1.31%	2.10%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

FORDO 2006-B Capital Charges (revised SSFA)



— Proposed SSFA Alternative Capital Charge — Credit Enhancement (Right-Axis)

Date	08/15/2006	11/15/2008	11/15/2010
Tranche	A-4	A-4	A-4
Capital Charge	0.56%	0.56%	0.56%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	12.64%	25.56%	94.64%
D	26.49%	63.78%	100.00%
KG	4.00%	4.36%	5.47%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative loss (on securities) %	0.00%	0.00%	0.00%
Seriously Delinquent Loans	0.00%	0.40%	2.32%
Historical Severity	0.00%	94.39%	67.22%
Cumulative loss (on collateral) %	0.00%	1.31%	2.10%

Results of Revised SSFA

Determining the risk weight floor based on the ratio of cumulative losses to K_G in the manner contemplated by the Proposed Regulations is not an appropriate benchmark of credit quality

- Including a supervisory floor table that allows the core SSFA equation to appropriately calculate capital charges results in capital charges that are both risk sensitive and will not incentivize banks to hold riskier assets based on capital charges
- The example below illustrates how the proposed changes to SSFA results in a **high** capital charge for a tranche with **little credit enhancement and thickness**, however, a **lower** capital charge for a tranche with exceedingly **higher credit enhancement and thickness**
 - The super senior bond (2A2) has a capital charge of 6.35% with attachment point, A, of 91.59% and detachment point, D, of 100%
 - The senior bond (2A4) has a capital charge of 100% with attachment point, A, of 6.79% and detachment point, D, of 34.76%

Trust	HEAT 2006-5
Collateral Type	Home Equity
Tranche	2A2
Moody's/S&P	Aa3/AAA
Date	03/25/2011
A	91.59%
D	100.00%
p	0.5
Discount/Premium to Par	95.00%
Parameter A	92.01%
K_G at Origination	8.00%
Cumulative Net Losses on Issued Securities	17.24%
Cumulative Net Losses on Underlying Exposures	24.19%
90+ Days Past Due Rate	41.42%
Historical 3-Month Severity Rate	86.00%
K_G	40.31%
K_G at Origination + Parameter A	100.00%
K_{SSFA} Core Formula Capital Charge	6.35%
Supervisory Floor Capital Charge	0.56%
Overall Capital Charge	6.35%

Trust	HEAT 2006-5
Collateral Type	Home Equity
Tranche	2A4
Moody's/S&P	C/CCC
Date	03/25/2011
A	6.79%
D	34.76%
p	0.5
Discount/Premium to Par	85.00%
Parameter A	10.99%
K_G at Origination	8.00%
Cumulative Net Losses on Issued Securities	17.24%
Cumulative Net Losses on Underlying Exposures	24.19%
90+ Days Past Due Rate	41.42%
Historical 3-Month Severity Rate	86.00%
K_G	40.31%
K_G at Origination + Parameter A	18.99%
K_{SSFA} Core Formula Capital Charge	100.00%
Supervisory Floor Capital Charge	8.00%
Overall Capital Charge	100.00%

Capital Charge Reflecting the Risk of Each Tranche

Annex F

Revised SSFA Example Calculations

The examples below illustrate the SSFA calculation under Revised SSFA, compared to the SSFA calculation based on the NPR

- Examples include scenarios at various points in time and different collateral deterioration assumptions for six different securities within the same trust

Collateral Full Performance						
Time: Securitization Settlement						
Total Principal Received:	0	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	0%					
Loss Severity:	0%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	92,000,000	8.00%	100	0.56%	1.60%	
Mezz	2,500,000	5.50%	8.00%	26.96%	26.96%	
Mezz	2,000,000	3.50%	5.50%	85.87%	85.87%	
Mezz	1,250,000	2.25%	3.50%	100.00%	100.00%	
Mezz	1,250,000	1.00%	2.25%	100.00%	100.00%	
Sub	1,000,000	0.00%	1.00%	100.00%	100.00%	
100,000,000				6.41%	7.36%	
Time: Settlement + 12 months						
Total Principal Received:	5,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	0%					
Loss Severity:	0%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	87,000,000	8.42%	100	0.56%	1.60%	
Mezz	2,500,000	5.79%	8.42%	22.73%	22.73%	
Mezz	2,000,000	3.68%	5.79%	76.56%	76.56%	
Mezz	1,250,000	2.37%	3.68%	100.00%	100.00%	
Mezz	1,250,000	1.05%	2.37%	100.00%	100.00%	
Sub	1,000,000	0.00%	1.05%	100.00%	100.00%	
95,000,000				6.41%	7.36%	
Time: Settlement + 24 months						
Total Principal Received:	10,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	0%					
Loss Severity:	0%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	82,000,000	8.89%	100	0.56%	1.60%	
Mezz	2,500,000	6.11%	8.89%	18.81%	18.81%	
Mezz	2,000,000	3.89%	6.11%	65.63%	65.63%	
Mezz	1,250,000	2.50%	3.89%	100.00%	100.00%	
Mezz	1,250,000	1.11%	2.50%	100.00%	100.00%	
Sub	1,000,000	0.00%	1.11%	100.00%	100.00%	
90,000,000				6.38%	7.33%	
Time: Settlement + 36 months						
Total Principal Received:	15,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	0%					
Loss Severity:	0%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	77,000,000	9.41%	100	0.56%	1.60%	
Mezz	2,500,000	6.47%	9.41%	15.23%	15.23%	
Mezz	2,000,000	4.12%	6.47%	55.43%	55.43%	
Mezz	1,250,000	2.65%	4.12%	100.00%	100.00%	
Mezz	1,250,000	1.18%	2.65%	100.00%	100.00%	
Sub	1,000,000	0.00%	1.18%	100.00%	100.00%	
85,000,000				6.38%	7.32%	

Collateral Slight Deterioration						
Time: Securitization Settlement						
Total Principal Received:	0	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	0%					
Loss Severity:	0%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	92,000,000	8.00%	100	0.56%	1.60%	
Mezz	2,500,000	5.50%	8.00%	26.96%	26.96%	
Mezz	2,000,000	3.50%	5.50%	85.87%	85.87%	
Mezz	1,250,000	2.25%	3.50%	100.00%	100.00%	
Mezz	1,250,000	1.00%	2.25%	100.00%	100.00%	
Sub	1,000,000	0.00%	1.00%	100.00%	100.00%	
100,000,000				6.41%	7.36%	
Time: Settlement + 12 months						
Total Principal Received:	5,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	1%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	87,000,000	8.42%	100	0.56%	1.60%	
Mezz	2,500,000	5.79%	8.42%	32.34%	22.73%	
Mezz	2,000,000	3.68%	5.79%	94.72%	76.56%	
Mezz	1,250,000	2.37%	3.68%	100.00%	100.00%	
Mezz	1,250,000	1.05%	2.37%	100.00%	100.00%	
Sub	1,000,000	0.00%	1.05%	100.00%	100.00%	
95,000,000				7.04%	7.36%	
Time: Settlement + 24 months						
Total Principal Received:	10,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	2%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	82,000,000	8.89%	100	0.56%	1.60%	
Mezz	2,500,000	6.11%	8.89%	36.93%	18.81%	
Mezz	2,000,000	3.89%	6.11%	100.00%	65.63%	
Mezz	1,250,000	2.50%	3.89%	100.00%	100.00%	
Mezz	1,250,000	1.11%	2.50%	100.00%	100.00%	
Sub	1,000,000	0.00%	1.11%	100.00%	100.00%	
90,000,000				7.65%	7.33%	
Time: Settlement + 36 months						
Total Principal Received:	15,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	4%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	77,000,000	9.41%	100	0.95%	1.60%	
Mezz	2,500,000	6.47%	9.41%	50.78%	15.23%	
Mezz	2,000,000	4.12%	6.47%	100.00%	55.43%	
Mezz	1,250,000	2.65%	4.12%	100.00%	100.00%	
Mezz	1,250,000	1.18%	2.65%	100.00%	100.00%	
Sub	1,000,000	0.00%	1.18%	100.00%	100.00%	
85,000,000				8.82%	7.32%	

Revised SSFA Example Calculations

The examples below illustrate the SSFA calculation under Revised SSFA, compared to the SSFA calculation based on the NPR

- Examples include scenarios at various points in time and different collateral deterioration assumptions for six different securities within the same trust

Collateral Degradation						
Time: Securitization Settlement						
Total Principal Received:	0	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	0%					
Loss Severity:	0%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	92,000,000	8.00%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.50%	8.00%	100	26.96%	26.96%
Mezz	2,000,000	3.50%	5.50%	100	85.87%	85.87%
Mezz	1,250,000	2.25%	3.50%	100	100.00%	100.00%
Mezz	1,250,000	1.00%	2.25%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.00%	100	100.00%	100.00%
				100,000,000	6.41%	7.36%
Time: Settlement + 12 months						
Total Principal Received:	5,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	1,000,000	Calibration Parameter:		50.00%		
Seriously Delinquent:	2%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	87,000,000	7.45%	100.00%	100	0.95%	1.60%
Mezz	2,500,000	4.79%	7.45%	100	66.28%	37.31%
Mezz	2,000,000	2.68%	4.79%	100	100.00%	100.00%
Mezz	1,250,000	1.33%	2.66%	100	100.00%	100.00%
Mezz	1,250,000	0.00%	1.33%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
				94,000,000	7.43%	7.26%
Time: Settlement + 24 months						
Total Principal Received:	10,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	2,000,000	Calibration Parameter:		50.00%		
Seriously Delinquent:	4%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	82,000,000	6.82%	100.00%	100	2.24%	8.00%
Mezz	2,500,000	3.98%	6.82%	100	100.00%	54.37%
Mezz	2,000,000	1.70%	3.98%	100	100.00%	100.00%
Mezz	1,250,000	0.28%	1.70%	100	100.00%	100.00%
Mezz	250,000	0.00%	0.28%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
				88,000,000	8.91%	12.98%
Time: Settlement + 36 months						
Total Principal Received:	15,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	3,000,000	Calibration Parameter:		50.00%		
Seriously Delinquent:	8%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	77,000,000	6.10%	100.00%	100	7.68%	8.00%
Mezz	2,500,000	3.05%	6.10%	100	100.00%	88.01%
Mezz	2,000,000	0.61%	3.05%	100	100.00%	100.00%
Mezz	500,000	0.00%	0.61%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
				82,000,000	13.31%	13.24%

Collateral Severe Degradation						
Time: Securitization Settlement						
Total Principal Received:	0	K _C at Origination:		4.00%		
Total Losses Realized:	0	Calibration Parameter:		50.00%		
Seriously Delinquent:	0%					
Loss Severity:	0%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	92,000,000	8.00%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.50%	8.00%	100	26.96%	26.96%
Mezz	2,000,000	3.50%	5.50%	100	85.87%	85.87%
Mezz	1,250,000	2.25%	3.50%	100	100.00%	100.00%
Mezz	1,250,000	1.00%	2.25%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.00%	100	100.00%	100.00%
				100,000,000	6.41%	7.36%
Time: Settlement + 12 months						
Total Principal Received:	5,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	2,500,000	Calibration Parameter:		50.00%		
Seriously Delinquent:	4%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	87,000,000	5.95%	100.00%	100	2.99%	8.00%
Mezz	2,500,000	3.24%	5.95%	100	100.00%	85.65%
Mezz	2,000,000	1.08%	3.24%	100	100.00%	100.00%
Mezz	1,000,000	0.00%	1.08%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
				92,500,000	8.76%	13.08%
Time: Settlement + 24 months						
Total Principal Received:	10,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	5,000,000	Calibration Parameter:		50.00%		
Seriously Delinquent:	8%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	82,000,000	3.53%	100.00%	100	7.68%	82.00%
Mezz	2,500,000	0.59%	3.53%	100	100.00%	100.00%
Mezz	500,000	0.00%	0.59%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
				85,000,000	10.94%	63.69%
Time: Settlement + 36 months						
Total Principal Received:	15,000,000	K _C at Origination:		4.00%		
Total Losses Realized:	7,500,000	Calibration Parameter:		50.00%		
Seriously Delinquent:	16%					
Loss Severity:	50%					
Size	Attach	Detach	Price	Revised SSFA	NPR SSFA	
Senior	77,000,000	0.65%	100.00%	100	11.36%	100.00%
Mezz	500,000	0.00%	0.65%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
				77,500,000	11.93%	100.00%

Revised SSFA Example Calculations

The examples below illustrate the SSFA calculation under Revised SSFA, compared to the SSFA calculation based on the NPR

- Examples include scenarios at various points in time, different collateral deterioration assumptions, and with security markdowns for six different securities within the same trust

Collateral Severe Degradation w/ Price Markdowns						
Time: Securitization Settlement						
Total Principal Received: 0		K_c at Origination: 4.00%				
Total Losses Realized: 0		Calibration Parameter: 50.00%				
Seriously Delinquent: 0%						
Loss Severity: 0%						
	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	92,000,000	8.00%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.50%	8.00%	100	26.96%	26.96%
Mezz	2,000,000	3.50%	5.50%	100	85.87%	85.87%
Mezz	1,250,000	2.25%	3.50%	100	100.00%	100.00%
Mezz	1,250,000	1.00%	2.25%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.00%	100	100.00%	100.00%
	100,000,000				6.41%	7.36%
Time: Settlement + 12 months						
Total Principal Received: 5,000,000		K_c at Origination: 4.00%				
Total Losses Realized: 2,500,000		Calibration Parameter: 50.00%				
Seriously Delinquent: 4%						
Loss Severity: 50%						
	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	87,000,000	5.95%	100.00%	95	0.63%	8.00%
Mezz	2,500,000	3.24%	5.95%	60	100.00%	85.65%
Mezz	2,000,000	1.08%	3.24%	40	100.00%	100.00%
Mezz	1,000,000	0.00%	1.08%	20	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Sub	0	0.00%	0.00%	0	100.00%	100.00%
	92,500,000				6.54%	13.08%
Time: Settlement + 24 months						
Total Principal Received: 10,000,000		K_c at Origination: 4.00%				
Total Losses Realized: 5,000,000		Calibration Parameter: 50.00%				
Seriously Delinquent: 8%						
Loss Severity: 50%						
	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	82,000,000	3.53%	100.00%	90	1.06%	52.00%
Mezz	2,500,000	0.59%	3.53%	40	100.00%	100.00%
Mezz	500,000	0.00%	0.59%	10	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Sub	0	0.00%	0.00%	0	100.00%	100.00%
	85,000,000				4.55%	53.69%
Time: Settlement + 36 months						
Total Principal Received: 15,000,000		K_c at Origination: 4.00%				
Total Losses Realized: 7,500,000		Calibration Parameter: 50.00%				
Seriously Delinquent: 16%						
Loss Severity: 50%						
	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	77,000,000	0.65%	100.00%	80	1.43%	100.00%
Mezz	500,000	0.00%	0.65%	10	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Sub	0	0.00%	0.00%	0	100.00%	100.00%
	77,500,000				2.06%	100.00%

ANNEX G

Proposed Revisions to Section 45 of
U.S. Advanced Capital Adequacy Framework - Basel II

(e) *SFA parameters*

(1) *Amount of the underlying exposures (UE).* UE is the EAD of any underlying exposures that are wholesale and retail exposures (including the amount of any funded spread accounts, cash collateral accounts, and other similar funded credit enhancements and any additional cash flow credit enhancement) plus the amount of any underlying exposures that are securitization exposures (as defined in paragraph (e) of section 42 of this appendix) plus the adjusted carrying value of any underlying exposures that are equity exposures (as defined in paragraph (b) of section 51 of this appendix).

New subsection (e)(3)(iv). In calculating Kirb, in lieu of assigning risk parameters pursuant to Section 31 of this appendix, a [bank] may assign a PD, LGD, EAD, and M to each pool of securitized exposures of a single asset class if the exposures in the pool are eligible securitized exposures. A [bank] may use net loss data with respect to the pool of securitized exposures in assigning risk parameters pursuant to this paragraph. If the [bank] can estimate ECL (but not PD or LGD) for a pool of eligible securitized exposures, the [bank] must assume that (A) the LGD of the pool equals 100 percent or such lesser percentage determined by the [bank] for the relevant asset class using a methodology for exposures of such asset type that has been approved by the [AGENCY] for use by the [bank] generally with respect to exposures of the relevant asset class and obligor type and (B) the PD of the pool equals ECL divided by the product of EAD and LGD. The estimated ECL must be calculated for the exposures without regard to any assumption of recourse or guarantees from the seller. A [bank] assigning risk parameters pursuant to this paragraph must review and update such risk parameters no less frequently than quarterly.

(e)(4) Credit enhancement level (L). (i) L is the ratio of:

(A) The sum of (i) the amount of all securitization exposures subordinated to the tranche that contains the [bank]'s securitization exposure, and (ii) the additional cash flow credit enhancement; to

(B) UE.

(ii) ~~A~~ Except with respect to the carrying value discount of a [bank]'s securitization exposure and additional cash flow credit enhancement, a [bank] must determine L before considering the effects of any tranche-specific credit enhancements.

(iii) Any gain-on-sale or CEIO associated with the securitization may not be included in L.

(iv) Any reserve account funded by accumulated cash flows from the underlying exposures that is subordinated to the tranche that contains the [bank]'s securitization exposure

may be included in the numerator and denominator of L to the extent cash has accumulated in the account. Unfunded reserve accounts (that is, reserve accounts that are to be funded from future cash flows from the underlying exposures) may not be included in the calculation of L except to the extent such amounts qualify as additional cash flow credit enhancement.

(v) In some cases, the purchase price or carrying value of receivables or a securitization exposure will reflect a discount that provides credit enhancement (for example, first loss protection) for all or certain tranches of the securitization. When this arises, L should be calculated inclusive of this discount ~~if the discount provides credit enhancement for the securitization exposure~~.

(e)(5) *Thickness of tranche (T)*. T is the ratio of:

(i) The amount of the tranche that contains the [bank]'s securitization exposure less the amount obtained by multiplying (A) any discount reflected in the carrying value of the [bank]'s securitization exposure that provides credit enhancement for the [bank]'s securitization exposure expressed as a percentage, and (B) the size of the tranche containing the [bank]'s securitization exposure; to

(ii) UE.

New subsection (g). Additional cash flow credit enhancement. Additional cash flow credit enhancement may only be included in the calculation of the SFA risk parameters under paragraph (e) of this section if the following requirements are met:

(1) The [bank] must have received prior approval from the [AGENCY] to include additional cash flow credit enhancement in determining SFA parameters for its securitization exposures generally. To receive such approval, the [bank] must demonstrate to the [AGENCY]'s satisfaction that it has a comprehensive understanding of risk characteristics of its individual securitization exposures, whether on balance sheet or off-balance sheet, as well as the risk characteristics of the pools underlying its securitization exposures;

(2) The [bank] must be able to access performance information on the underlying pools on an on-going basis in a timely manner. Such information may include, as appropriate: exposure type; percentage of loans 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; property type; occupancy; average credit score or other measures of creditworthiness; average loan to value equity; and industry and geographic diversification. For resecuritizations, the [bank] must have information not only on the underlying securitization tranches, such as the Issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitization tranches;

(3) The [bank] must have a thorough understanding of all structural features of the securitization transaction that would materially impact the performance of the [bank]'s securitization exposure, such as the contractual waterfall and waterfall-related

triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default;

(4) The cash flow methodology used by the [bank] in determining additional cash flow credit enhancement for the relevant asset class of eligible securitized receivables must be (A) commercially available, (B) transparent and verifiable, and (C) used by the [bank] for purposes other than the calculation of risk-based capital requirements, such as risk management or impairment analysis; and

(5) The additional cash flow credit enhancement for a securitization exposure must be based on a projection of the available cash flows for the benefit of such securitization exposure determined by undertaking the following steps:

(i) Projecting aggregate exposure principal and interest cash flows using a cash flow methodology for the relevant asset class described in paragraph (g)(4) of this section, using the assumptions used in assigning the PD, LGD, EAD and M to the underlying exposures and other inputs appropriate for the asset class, which may include default timing, recovery timing, prepayment, prepayment timing, and static pool or other historical loss data for the securitized exposures and similar exposures;

(ii) Applying such aggregate projected exposure cash flows to the securitization liability structure as detailed in the contractual waterfall set forth in the legal documents governing the securitization exposure; and

(iii) Stressing the assumptions and inputs in (i) above until the securitization exposure suffers its first one dollar of loss in (ii) above. The corresponding cumulative net losses experienced by the aggregate underlying exposures at this first one dollar of loss equals the total credit enhancement for the securitization exposure.

**PROPOSED REVISIONS TO SECTION 2 OF
U.S. ADVANCED CAPITAL ADEQUACY FRAMEWORK - BASEL II**

Additional cash flow credit enhancement means the amount of credit enhancement not included in the securitization exposures subordinated to the tranche that contains the [bank]'s securitization exposure determined to be available to a [bank]'s securitization exposure based upon the procedures set forth in Section 45(g)(5) of this appendix.

Eligible ~~purchased wholesale~~ securitized exposure means a ~~purchased~~ retail or wholesale exposure underlying a [bank]'s securitization exposure that:

(1) ~~The~~ Either (x) (i) the [bank] or securitization SPE ~~—purchased from an unaffiliated seller and~~ did not directly or indirectly originate or (ii) if originated by the [bank] or securitization SPE, are not serviced by either such person, or (v) the [bank] is prohibited by law or regulation from accessing the information necessary to determine the risk parameters required to calculate Kirb for the individual securitized wholesale exposures or segments of securitized retail exposures underlying the securitization exposure:

(2) Was generated on an arm's-length basis between the seller and the obligor ~~(intercompany accounts receivable and receivables subject to contra-accounts between firms that buy and sell to each other do not satisfy this criterion);~~

(3) Provides the [bank] or securitization SPE with a claim on all proceeds from the exposure or a pro rata interest in the proceeds from the exposure: and

(4) ~~Has an M of less than one year; and~~

~~(5)~~ When consolidated by obligor, does not represent a concentrated exposure relative to the ~~portfolio of purchased wholesale~~ pool of securitized exposures.

**PROPOSED REVISIONS TO LGD DEFINITION IN
U.S. ADVANCED CAPITAL ADEQUACY FRAMEWORK - BASEL II**

Loss given default (LGD) means:

- (1) For a wholesale exposure, the greatest of:
 - (i) Zero;
 - (ii) The [bank]'s empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the [bank] would expect to incur if the obligor (or a typical obligor in the loss severity grade assigned by the [bank] to the exposure) were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions; or
 - (iii) The [bank]'s empirically based best estimate of the economic loss, per dollar of EAD, the [bank] would expect to incur if the obligor (or a typical obligor in the loss severity grade assigned by the [bank] to the exposure) were to default within a one-year horizon during economic downturn conditions.

- (2) For a segment of retail exposures, the greatest of:
 - (i) Zero;
 - (ii) The [bank]'s empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the [bank] would expect to incur if the exposures in the segment were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions; or
 - (iii) The [bank]'s empirically based best estimate of the economic loss, per dollar of EAD, the [bank] would expect to incur if the exposures in the segment were to default within a one-year horizon during economic downturn conditions.

- (3) The economic loss on an exposure in the event of default is all material credit-related losses on the exposure (including accrued but unpaid interest or fees, losses on the sale of collateral, direct workout costs, and an appropriate allocation of indirect workout costs). Where positive or negative cash flows on a wholesale exposure to a defaulted obligor or a defaulted retail exposure (including proceeds from the sale of collateral, workout costs, additional extensions of credit to facilitate repayment of the exposure, and draw-downs of unused credit lines) occur after the date of default, the economic loss must reflect the net present value of cash flows as of the default date using a discount rate appropriate to the risk of the defaulted exposure.

(4) Notwithstanding (1), (2) and (3) above, the LGD of a pool of securitized exposures for purposes of calculating Kirb as described in Section 45(e)(3)(iv) of this appendix shall be determined pursuant to such section, based on:

(i) The [bank]'s empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the [bank] would expect to incur if the exposures in the pool were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions; or

(ii) The [bank]'s empirically based best estimate of the economic loss, per dollar of EAD, the [bank] would expect to incur if the exposures in the pool were to default within a one-year horizon during economic downturn conditions.

**PROPOSED REVISIONS TO PD DEFINITION IN
U.S. ADVANCED CAPITAL ADEQUACY FRAMEWORK - BASEL II**

Probability of default (PD) means:

- (1) For a wholesale exposure to a non-defaulted obligor, the [bank]'s empirically based best estimate of the long-run average one-year default rate for the rating grade assigned by the [bank] to the obligor, capturing the average default experience for obligors in the rating grade over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the rating grade.
- (2) For a segment of non-defaulted retail exposures, the [bank]'s empirically based best estimate of the long-run average one-year default rate for the exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the segment and adjusted upward as appropriate for segments for which seasoning effects are material. For purposes of this definition, a segment for which seasoning effects are material is a segment where there is a material relationship between the time since origination of exposures within the segment and the [bank]'s best estimate of the long-run average one-year default rate for the exposures in the segment.
- (3) For a wholesale exposure to a defaulted obligor or segment of defaulted retail exposures, 100 percent.
- (4) Notwithstanding (1), (2) and (3) above, the PD of a pool of securitized exposures for purposes of calculating Kirb as described in Section 45(e)(3)(iv) of this appendix shall be determined pursuant to such section based on the [bank]'s empirically based best estimate of the long-run average one-year default rate for the exposures in the pool, capturing the average default experience for exposures in the pool over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the pool and adjusted upward as appropriate for pools for which seasoning effects are material.

Portfolios with limited defaults. Commenters indicated that they had experienced very few defaults for some portfolios, most notably margin loans and exposures to some sovereign issuers, which made it difficult to separately estimate PD and LGD. The agencies recognize that some portfolios have experienced very few defaults and have very low loss experiences. The absence of defaults or losses in historical data does not, however, preclude the potential for defaults or large losses to arise in future circumstances. Moreover, as discussed previously, the ability to separate EL into PD and LGD is a key component of the IRB approach.

As with the cases described above in which internal data are limited in all dimensions, external data from some related portfolios or for similar obligors may be used to estimate risk parameters that are then mapped to the low default portfolio or obligor. For example, banks could consider instances of near default or credit deterioration short of default in these low default portfolios to inform estimates of what might happen if a default were to occur. Similarly, scenario analysis that evaluates the hypothetical impact of severe market disruptions may help inform the bank's parameter estimates for margin loans. For very low-risk wholesale obligors that have publicly traded financial instruments, banks may be able to glean information about the relative values of PD and LGD from different changes in credit spreads on instruments of different maturity or from different moves in credit spreads and equity prices. In all cases, risk parameter estimates should incorporate a degree of conservatism that is appropriate for the overall rigor of the quantification process. [These risk parameter estimates should be based upon default and loss proxies derived by the bank consistent with such conservatism in lieu of historical data under such circumstances.](#)

Probability of Default (PD)

As noted above, under the final rule, [except as described further herein](#), a bank must assign each of its wholesale obligors to an internal rating grade and then must associate a PD with each rating grade. PD for a wholesale exposure to a non-defaulted obligor is the bank's empirically based best estimate of the long-run average one-year default rate for the rating grade assigned by the bank to the obligor, capturing the average default experience for obligors in the rating grade over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the rating grade.

In addition, under the final rule, a bank must assign a PD to each segment of retail exposures. Some types of retail exposures typically display a seasoning pattern—that is, the exposures have relatively low default rates in their first year, rising default rates in the next few years, and declining default rates for the remainder of their terms. Because of the one-year IRB horizon, the proposed rule provided two different definitions of PD for a segment of non-defaulted retail exposures based on the materiality of seasoning effects for the segment or for the segment's retail exposure subcategory. Under the proposed rule, PD for a segment of non-defaulted retail exposures for which seasoning effects *were not* material, or for a segment of non-defaulted retail exposures in a retail exposure subcategory for which seasoning effects *were not* material, would be the bank's empirically based best estimate of the long-run average of one-year default rates for the exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the segment. PD for a segment of non-defaulted retail exposures for which seasoning effects *were* material would be the bank's empirically based best estimate of the annualized cumulative default rate over the expected remaining life of exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) to provide a reasonable estimate of the average performance over the economic cycle for the segment.

Commenters objected to this treatment of retail exposures with material seasoning effects. They asserted that requiring banks to use an annualized cumulative default rate to recognize seasoning effects was too prescriptive and would preclude other reasonable approaches. The agencies believe that commenters have presented reasonable alternative approaches to recognizing the effects of seasoning in PD and are, therefore, providing additional flexibility for recognizing those effects in the final rule.

Based on comments and additional consideration, the agencies also are clarifying that a segment of retail exposures has material seasoning effects if there is a material relationship between the time since origination of exposures within the segment and the bank's best estimate of the long-

run average one-year default rate for the exposures in the segment. Moreover, because the agencies believe that the IRB approach must, at a minimum, require banks to hold appropriate amounts of risk-based capital to address credit risks over a one-year horizon, the final rule's incorporation of seasoning effects is explicitly one-directional. Specifically, a bank must increase PDs above the best estimate of the long-run average one-year default rate for segments of unseasoned retail exposures, but may not decrease PD below the best estimate of the long-run average one-year default rate for a segment of retail exposures that the bank estimates will have lower PDs in future years due to seasoning.

The final rule defines PD for a segment of non-defaulted retail exposures as the bank's empirically based best estimate of the long-run average one-year default rate for the exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the segment and adjusted upward as appropriate for segments for which seasoning effects are material. If a bank does not adjust PD to reflect seasoning effects for a segment of exposures, it should be able to demonstrate to its primary Federal supervisor, using empirical analysis, why seasoning effects are not material or why adjustment is not relevant for the segment.

For wholesale exposures to defaulted obligors and for segments of defaulted retail exposures, PD is 100 percent.

Loss Given Default (LGD)

Under the proposed rule, [except as described further herein](#), a bank would directly estimate an ELGD and LGD risk parameter for each wholesale exposure or would assign each wholesale exposure to an expected loss severity grade and a downturn loss severity grade, estimate an ELGD risk parameter for each expected loss severity grade, and estimate an LGD risk parameter for each downturn loss severity grade. In addition, a bank would estimate an ELGD and LGD risk parameter for each segment of retail exposures.

Expected Loss Given Default (ELGD)

The proposed rule defined the ELGD of a wholesale exposure as the bank's empirically based best estimate of the default-weighted average economic loss per dollar of EAD the bank expected to incur in the event that the obligor of the exposure (or a typical obligor in the loss severity grade assigned by the bank to the exposure) defaulted within a one-year horizon.³¹ The proposed rule defined ELGD for a segment of retail exposures as the bank's empirically based best estimate of the default-weighted average economic loss per dollar of EAD the bank expected to incur on exposures in the segment that default within a one-year horizon. ELGD estimates would incorporate a mix of economic conditions (including economic downturn conditions). ELGD had four functions in the proposed rule—as a component of the calculation of ECL in the numerator of the risk based capital ratios; in the EL component of the IRB risk-based capital formulas; as a

³¹ Under the proposal, ELGD was not the statistical expected value of LGD.

floor on the value of the LGD risk parameter; and as an input into the supervisory mapping function.

Many commenters objected to the proposed rule's requirement for banks to estimate ELGD for each wholesale exposure and retail segment, noting that ELGD estimation is not required under the New Accord. Commenters asserted that requiring ELGD estimation would create a competitive disadvantage by creating additional systems, compliance, calculation, and reporting burden for those banks subject to the U.S. rule, many of which have already substantially developed their systems based on the New Accord. They also maintained that it would decrease the comparability of U.S. banks' capital requirements and public disclosures relative to those of foreign banking organizations applying the advanced approaches. Several commenters also contended that defining ECL in terms of ELGD instead of LGD raised tier 1 risk based capital requirements for U.S. banks compared to foreign banks using the New Accord's LGD-based ECL definition.

The agencies have concluded that the regulatory burden and potential competitive inequities identified by commenters outweigh the supervisory benefits of the proposed ELGD risk parameter, and are, therefore, not including it in the final rule. Instead, consistent with the New Accord, a bank must use LGD for the calculation of ECL and the EL component of the IRB risk based capital formulas. Because the proposed ELGD risk parameter was equal to or less than LGD, this change generally will have the effect of decreasing both the numerator and denominator of the risk-based capital ratios.

Consistent with the New Accord, under the final rule, the LGD of a wholesale exposure or retail segment must not be less than the bank's empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the bank would expect to incur if the obligor (or a typical obligor in the loss severity grade assigned by the bank to the exposure or segment) were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions. The final rule also specifies that LGD may not be less than zero. The implications of eliminating the ELGD risk parameter for the supervisory mapping function are discussed below.

PD and LGD of Certain Securitization Exposures Where Supervisory Formula Approach is Used

In calculating Kirb, banks using the supervisory formula approach to calculate capital may assign a PD and LGD to securitized exposures of the same asset class on a pool-wide basis with respect to securitization exposures where the underlying securitized exposures consist of eligible securitized exposures. The agencies recognize that banks ordinarily do not possess the information necessary to assign a PD and LGD to individual wholesale exposures or segments of retail exposures with respect to securitization exposures where the underlying securitized exposures were not originated by the bank or, if originated by the bank, are not serviced by the bank. A bank may assign such risk parameters using net loss data for the pool of securitized exposures. Banks using this method for assigning PD and LGD must review and update such risk parameters no less frequently than quarterly.

4. SUPERVISORY FORMULA APPROACH (SFA)

Inputs to the SFA Formula

Consistent with the proposal, the final rule defines the seven inputs into the SFA formula as follows: (i) *Amount of the underlying exposures (UE)*. This input (measured in dollars) is the EAD of any underlying wholesale and retail exposures plus the amount of any underlying exposures that are securitization exposures (as defined in section 42(e) of the proposed rule) plus the adjusted carrying value of any underlying equity exposures (as defined in section 51(b) of the proposed rule). UE also includes any funded spread accounts, cash collateral accounts, and other similar funded credit enhancements and any additional cash flow credit enhancement.

(ii) *Tranche percentage (TP)*. TP is the ratio of (i) the amount of the bank's securitization exposure to (ii) the amount of the securitization tranche that contains the bank's securitization exposure.

(iii) *KIRB*. KIRB is the ratio of (i) the risk-based capital requirement for the underlying exposures plus the ECL of the underlying exposures (all as determined as if the underlying exposures were directly held by the bank) to (ii) UE. The definition of KIRB includes the ECL of the underlying exposures in the numerator because if the bank held the underlying exposures on its balance sheet, the bank also would hold reserves against the exposures.

The calculation of KIRB must reflect the effects of any credit risk mitigant applied to the underlying exposures (either to an individual underlying exposure, a group of underlying exposures, or to the entire pool of underlying exposures). In addition, all assets related to the securitization must be treated as underlying exposures for purposes of the SFA, including assets in a reserve account (such as a cash collateral account).

In practice, a bank's ability to calculate KIRB will often determine whether it can use the SFA or whether it must instead deduct an unrated securitization exposure from total capital. As noted above, there is a need for flexibility when the estimation of KIRB is constrained by data shortcomings, such as when the bank holding the securitization exposure is not the originator or the servicer of the underlying assets. The final rule clarifies that the simplified approach for eligible purchased wholesale exposures (Section 31) may be used for calculating KIRB.

To reduce the operational burden of estimating KIRB, several commenters urged the agencies to develop a simple look-through approach such that when all of the assets held by the SPE are externally rated, KIRB could be determined directly from the external ratings of these assets. The agencies believe that a look-through approach for estimating KIRB would be inconsistent with the New Accord and would increase the potential for capital arbitrage. The

agencies note that several simplified methods for estimating risk weighted assets for the underlying exposures for the purposes of computing KIRB are provided in other parts of the framework. For example, the simplified approach for eligible purchased wholesale exposures in section 31 may be available when a bank can estimate risk parameters for segments of underlying wholesale exposures but not for each of the individual exposures. ~~If the assets held by the SPE are securitization exposures with external ratings, the RBA would be used to determine risk-weighted assets for the underlying exposures based on these ratings.~~ If the assets held by the SPE represent shares in an investment company (that is, unleveraged, pro rata ownership interests in a pool of financial assets), the bank may be eligible to determine risk-weighted assets for the underlying exposures using the Alternative Modified Look-Through Approach of Section 54 (d) based on investment limits specified in the program's prospectus or similar documentation.

In addition, in calculating Kirb, a bank may elect to use a top down approach for certain securitized exposures. This approach may be used for retail and wholesale exposures underlying securitization exposures that are eligible securitized exposures. Under this approach, a bank may assign a PD, LGD, EAD, and M to each pool of eligible securitized receivables that are of a single asset class. A bank may assign such risk parameters using net loss data for the pool of securitized receivables. A bank assigning risk parameters using this approach must review and update such risk parameters no less frequently than quarterly. To be an eligible securitized exposure, several criteria must be met:

- Either (i) the securitized exposure must not have been originated by the bank or securitization SPE or, if originated by the bank or securitization SPE, are not serviced by such person or (ii) the bank is prohibited by law or regulation from accessing the information necessary to determine the risk parameters required to calculate Kirb for the individual securitized wholesale exposures or segments of securitized retail exposures underlying the securitization exposure;
- The securitized exposure must be generated on an arm's-length basis between the seller and the obligor;
- The bank must have a claim on all proceeds from the exposure or a pro rata interest in the proceeds; and
- The securitized exposure must, when consolidated by obligor, not represent a concentrated exposure relative to the pool of securitized exposures.

(iv) *Credit enhancement level (L)*. L is the ratio of (i) the sum of (A) the amount of all securitization exposures subordinated to the securitization tranche that contains the bank's securitization exposure and (B) additional cash flow credit enhancement (provided that the requirements discussed further below are met with respect to such additional cash flow credit enhancement). to (ii) UE. Banks must determine L before considering the effects of any tranche-specific credit enhancements (such as third-party guarantees that benefit only a single tranche) except with respect to additional cash flow credit and carrying value discount of a securitization

tranche. Any after-tax gain-on- sale or CEIOs associated with the securitization may not be included in L.

Any reserve account funded by accumulated cash flows from the underlying exposures that is subordinated to the tranche that contains the bank's securitization exposure may be included in the numerator and denominator of L to the extent cash has accumulated in the account. Unfunded reserve accounts (reserve accounts that are to be funded from future cash flows from the underlying exposures) may not be included in the calculation of L except to the extent that such amounts qualify as additional cash flow credit enhancement.

In some cases, the purchase price or carrying value of receivables or a securitization exposure will reflect a discount that provides credit enhancement (for example, first loss protection) for all or certain tranches. When this arises, L should be calculated inclusive of this discount ~~if the discount provides credit enhancement for the securitization exposure~~.

(v) *Thickness of tranche (T)*. T is the ratio of (i) the size of the tranche that contains the bank's securitization exposure less the amount obtained by multiplying (x) the discount reflected in the carrying value of the bank's securitization exposure that provides credit enhancement for that securitization exposure expressed as a percentage and (y) the size of the tranche containing the bank's securitization exposure, to (ii) UE.

Inclusion of Additional Cash Flow Credit Enhancement

Additional cash flow credit enhancement is the amount of credit enhancement not included in the securitization exposures subordinated to the tranche that contains the bank's securitization exposure determined to be available to a bank's securitization exposure based upon the procedures described further below.

Additional cash flow credit enhancement may only be included in the calculation of the SFA risk parameters if the following requirements are met:

(1) The bank must have received prior approval from its primary Federal Supervisor to include additional cash flow credit enhancement in determining SFA parameters for its securitization exposures generally. To receive such approval, the bank must demonstrate to the satisfaction of its primary Federal Supervisor that it has a comprehensive understanding of risk characteristics of its individual securitization exposures, whether on balance sheet or off-balance sheet, as well as the risk characteristics of the pools underlying its securitization exposures;

(2) The bank must be able to access performance information on the underlying pools on an on-going basis in a timely manner. For resecuritizations, the bank must have information not only on the underlying securitization tranches, such as the Issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitization tranches;

(3) The bank must have a thorough understanding of all structural features of the securitization transaction that would materially impact the performance of the bank's securitization exposure, such as the contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default;

(4) The cash flow methodology used by the bank in determining additional cash flow credit enhancement for the relevant asset class of eligible securitized exposures must be (A) commercially available, (B) transparent and verifiable, and (C) used by the bank for purposes other than the calculation of risk-based capital requirements, such as risk management or impairment analysis; and

(5) The additional cash flow credit enhancement for a securitization exposure must be based on a projection of the available cash flows for the benefit of such securitization exposure determined by undertaking the following steps:

(i) Projecting aggregate exposure principal and interest cash flows using a cash flow methodology for the relevant asset class, using the assumptions used in assigning the PD, LGD, EAD and M to the underlying exposures and other inputs appropriate for the asset class, which may include default timing, recovery timing, prepayment, prepayment timing, and static pool or other historical loss data for the securitized exposures and similar exposures;

(ii) Using such aggregate projected exposure cash flows to the securitization liability structure as detailed in the contractual waterfall set forth in the legal documents governing the securitization exposure; and

(iii) Stressing the assumptions and inputs in (i) above until the securitization exposure suffers its first one dollar of loss in (ii) above. The corresponding cumulative net losses experienced by the aggregate underlying exposures at this first one dollar of loss equals the total credit enhancement for the securitization exposure.

Studies – Tab 1



“How much capital is enough?”

**Capital Levels and
G-SIB Capital Surcharges**

September 26, 2011

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Executive Summary

The Clearing House (TCH) commissioned this study to answer four questions:

1. How much additional capital would be required by U.S. banks to meet the proposed Basel III minimum-capital ratios and the proposed G-SIB capital surcharge?
2. What does the crisis experience indicate is 'enough' capital for banks to hold?
3. Using forward-looking stress tests, how much stronger are the new definitions of capital and how much stronger are banks' balance sheets?
4. What would be the impacts of the Basel III capital proposals?

We conducted this analysis using proprietary data, current as of 4Q 2010, collected from 10 U.S. institutions representing \$8.3 trillion in assets, or 54% of the U.S. banking system, and supplemented it with publicly available information.

Summary of Results:

1. We believe that Basel III's capital requirements, without a G-SIB surcharge, would promote a safe and prudent banking system.
2. If the Basel Committee's G-SIB capital surcharge is implemented in the U.S., these banks would have to either increase the borrowing costs to their customers by 60 basis points (a 15% increase in their net interest margin) or reduce their non-interest expense ratios by almost 11 percentage points (a 19% reduction in expenses).

Key Findings:

1. Relative to pre-crisis levels, banks would have to raise an additional 100% more capital, or \$525 billion in common equity, to meet Basel III's 7% common equity capital requirement (from \$525 to \$1050 billion).¹

If the G-SIB surcharge is imposed, banks will need to raise an additional 66% more capital, or \$500 billion, over year-end 2010 levels (from \$750 to \$1250 billion). This shortfall is approximately as large as all of the capital held by U.S. banks pre-crisis.

2. The capital levels of 123 large global banks were analyzed over the financial crisis period. No bank that met Basel III's 7% common equity requirement (1) went bankrupt, (2) was taken over by the government, (3) was forced into a distressed takeover by another bank, or (4) received government assistance greater than 30% of its Tier 1 capital.²

We believe that Basel III's capital requirements, without a G-SIB surcharge, would promote a safe and prudent banking system.

¹ See presentation slide 13.

² See presentation slide 18. We believe this is a fair definition of "distress" as some firms were forced to accept limited government support during the crisis.

Executive Summary

3. Using the Federal Reserve's adverse stress scenario (March 2011), we collected internal stress tests from seven large U.S. banks to study the impact of Basel III's improvements on the quality of capital and to analyze how much more resilient bank balance sheets have become.³ We found that, if banks began at Basel III minimum common equity ratios of 7%, the banks on average would see only a 0.6 percentage point reduction in their Basel III common equity ratios (from 7% to 6.4%).

The worst bank in the sample would only see a 1.4 percentage point reduction in its common equity ratio (from 7% to 5.6%). These seven banks represent 51% of U.S. banking assets.

4. We estimate that the cumulative impact of the Basel III minimum capital requirement and G-SIB surcharges would decrease bank return on equity (ROEs) by up to 4.9 percentage points.⁴ Based on empirically estimated relationships from the academic literature,⁵ required returns on equity could fall by as little as 0.7 %.⁶

To make up for the greater reduction in return on equity relative to the reduction in returns required by investors, **U.S. banks would have to either increase the borrowing costs to their customers by 60 basis points (a 15% increase in their net interest margin) or decrease their non-interest expense ratio by almost 11 percentage points (a 19% reduction in non-interest expenses).**

³ See presentation slide 20.

⁴ See presentation slide 24.

⁵ David Miles, Jing Yang and Gilberto Marcheggiano, *Optimal Bank Capital*, (April 2011) available at <http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031.pdf>.

⁶ See presentation slide 25.

The Basel III Capital Requirements: Frequently Asked Questions

What is bank capital?

Capital represents the portion of a bank's liabilities that does not have to be repaid (like common equity) and therefore is available as a buffer in case the value of the bank's assets becomes lower than the value of the bank's other liabilities. As banking is a regulated industry, bank supervisors in every country specify the type of financial instruments that can be used to calculate capital for purposes of bank safety and soundness. This is known as "regulatory capital." There are many kinds of regulatory capital that are used to measure different levels of capital strength, including "Total Risk-Based Capital," "Tier 1 Capital," and "Common Equity Tier 1 Capital."

How is bank capital measured?

Capital requirements are often expressed as a ratio of capital to assets held by a bank. Capital is the numerator and the assets are the denominator. To better account for the risks associated with individual asset types, regulators rely on a concept called "risk-weighted assets" (RWA). There are several ways that banks can calculate Risk Weighted Assets, and the method used often depends on the national regulator. In the simplest method, assets are multiplied by an associated "risk weight." The riskier the asset, the greater the risk weight assigned to that asset class. For example, in the U.S., residential mortgages are usually assigned a 50% risk weight and U.S. Treasury bonds are assigned a 0% risk weight. To be considered "well capitalized" in the U.S., a bank must have a Total Risk-Based Capital Ratio of at least 10% and a Tier 1 Risk-Based Capital Ratio of 6%.

What is the Basel Committee?

The Basel Committee on Banking Supervision is based at the Bank for International Settlements in Basel, Switzerland, and is made up of bank supervisors from 27 countries. The Basel Committee is best known for its work drafting international agreements on bank capital standards, known as the Basel Accord or Basel I (1988), Basel II (2004), and Basel III (2010).

Are the recommendations of the Basel Committee binding on the U.S. or U.S. banks?

No. The Basel Committee has no founding treaty and does not issue binding regulations. Instead, it formulates broad supervisory standards, guidelines, and recommended best practices. National implementation must occur according to each national system, whether by law or regulation.

How does Basel III change the *quality* of capital that banks will be required to hold?

Under Basel II, the primary capital measurement for a bank was its Tier 1 capital ratio which had to be at least 4%. Tier 1 capital could be comprised of half common equity (2%) and half noncumulative preferred stock (2%). Basel III relies less on Tier 1 capital, focusing instead on only common equity capital ratios, as common equity is the most robust form of capital during a stress event. Basel III also disallows certain instruments from capital treatment, including deferred tax assets, mortgage servicing rights, and investments in common shares of unconsolidated financial institutions. All of these changes will increase the cost of capital for banks, as common equity shares are the most expensive form of attracting investment.

The Basel III Capital Requirements: Frequently Asked Questions

How does Basel III change the *amount* of capital that banks are required to hold?

Basel III requires that banks maintain a common equity ratio of 7%, three and a half times the 2% common equity capital ratio required before the crisis. The Basel Committee has also proposed that Global Systemically Important Banks (G-SIBs, sometimes also called G-SIFIs) be required to hold additional common equity capital between 1% and 2.5% depending on the size, global footprint, and activities of each bank.

How do Basel III's changes compare to the amount of Tier 1 capital banks held before the crisis?

Basel III changes both the denominator and the numerator of the capital ratio for banks. Because of changes in the risk weightings of assets in the denominator (which increase it approximately 66% over Basel I), and changes in allowed capital in the numerator, the 7% requirement under Basel III is equivalent to a 14% Tier 1-capital ratio for the U.S. banking system under the pre-crisis Basel I rules. If the G-SIB capital surcharge is imposed in the U.S., it would result in the U.S. banking system holding the equivalent of 16% capital in Basel I terms, or 400% the Tier 1 capital required before the crisis (4%).

How are banks trying to meet the Basel III capital increases?

Banks are relying on two methods to meet Basel III capital requirements. First, they are working to increase their capital levels. Because it would be too costly to issue new shares, banks are paying little to no dividends to shareholders as they build capital internally. Second, banks are managing the denominators of their capital ratios to meet Basel III's high standards. Banks have increased their holdings of low risk weighted assets and decreasing their holdings of loans.

In light of the recent crisis, how much capital should banks hold?

If banks had met Basel III's 7% common equity capital requirement, we believe that vast majority of these institutions would have weathered the crisis without requiring extraordinary government assistance.

We conducted a retrospective analysis using the actual stresses experienced by banks during the recent financial crisis, which has been described by Fed Chairman Bernanke as more stressful than the Great Depression. We analyzed the capital levels of 123 large global banks from before the crisis (December 2007) and determined that no bank that met the Basel III 7% common equity to risk-weighted asset ratio (1) went bankrupt, (2) was taken over by the government, (3) was forced into a distressed takeover by another bank or (4) received government assistance greater than 30% of its Tier 1 capital. We believe that this is a fair definition of "distress," as some firms were forced to accept limited government support during the crisis and a minimal capital investment would not have been determinative of a bank's survival. Our analysis showed that 35 of the analyzed banks met our definition of distress, representing 28% of the sample and 30% of the sample's assets and none of these would have met the Basel III minimum capital standards prior to the onset of the crisis.

We believe that Basel III's capital requirements, without a G-SIB surcharge, would promote a safe and prudent banking system.

The Basel III Capital Requirements: Frequently Asked Questions

According to the Federal Reserve's stress tests, how much capital should banks hold?

As a result of the crisis, banks have become much more conservative in their activities and in choosing what assets to hold. We conducted an analysis, based on the Federal Reserve's adverse stress scenario (March 2011), to see how resilient bank balance sheets would be after Basel III's 7% common equity requirement is implemented. Tested against the Fed's adverse stress scenarios, seven large U.S. banks on average would see only a 0.6% reduction in their Basel III common equity ratios. The worst bank in the sample would see only a 1.4% reduction in its common equity ratio. These seven banks represent 51% of U.S. banking assets.

How much capital is enough? Capital Levels and G-SIB Capital Surcharges



September 2011

Executive summary (1/2)

Scope of our work

This report addresses two questions: first, what are the impacts of Basel III capital requirements based on what is known about the G-SIB surcharge? Second, what do historical crisis experience and forward-looking analyses indicate is 'enough' capital?

We conducted this analysis using proprietary data, current as of 4Q 2010, collected from 10 U.S. institutions representing \$8.3 trillion in assets (or 54% of the U.S. banking system) and supplemented it with publicly available information

Additional Capital Required

- Between 4Q 2007 and Q4 2010, US Banks increased Basel III Tier 1 Common capital by ~\$200-250Bn
- From 4Q 2010 levels, Basel III minimums still require an additional ~ \$300 billion of common equity, or an approximately 40% increase in aggregate for the US industry
- Relative to pre-crisis levels, this is an increase of more than 100% or ~\$525 billion in common equity and is equivalent to banks holding a Tier 1 Common to RWA ratio under Basel I definitions of 12-14%
- Further, the estimated G-SIB surcharges of 100-250 bps would require the industry to hold an additional ~\$200 billion in common equity or an additional ~25% over 4Q2010 levels

Impact of higher capital ratios

- Over the 2007-2010 period, banks have improved capital ratios by growing equity and by reducing the riskiness of their assets; bank holdings of Treasuries and cash have increased, whereas consumer, C&I, and other loans have been flat or down
- Unmitigated, the impact of Basel III minimum capital requirements and a G-SIB surcharge of 150-250 bps would reduce bank ROEs by ~430-490 bps
- In order to offset this impact on returns, banks would have to increase NIMs by 40-100 bps or decrease the non-interest expense ratio by 8-19 percentage points

Executive summary (2/2)

Assessing capital needs from crisis experience

We conducted two analyses to quantify how much capital is 'enough' and identify the level of capital at which there are diminishing benefits to bank solvency:

▪ **Historical likelihood of financial distress compared to initial capital levels:**

- Based on an analysis of 123 global banks' experience between Q4 2007 and Q4 2009, we found that no institutions that began the crisis with greater than 7% Tier 1 Common (Basel III definition) suffered financial distress
 - Distress was defined as going bankrupt, being acquired by another institution, being taken over by the government, or receiving >30% government capital infusion relative to Tier 1 capital on Dec. 31, 2007; based on this definition, 35 banks are considered distressed
- The probability of distress also decreased significantly for banks with >4.5% CET1, and even for those banks that began the crisis with 5.5-7.0% Tier 1 Common under Basel III

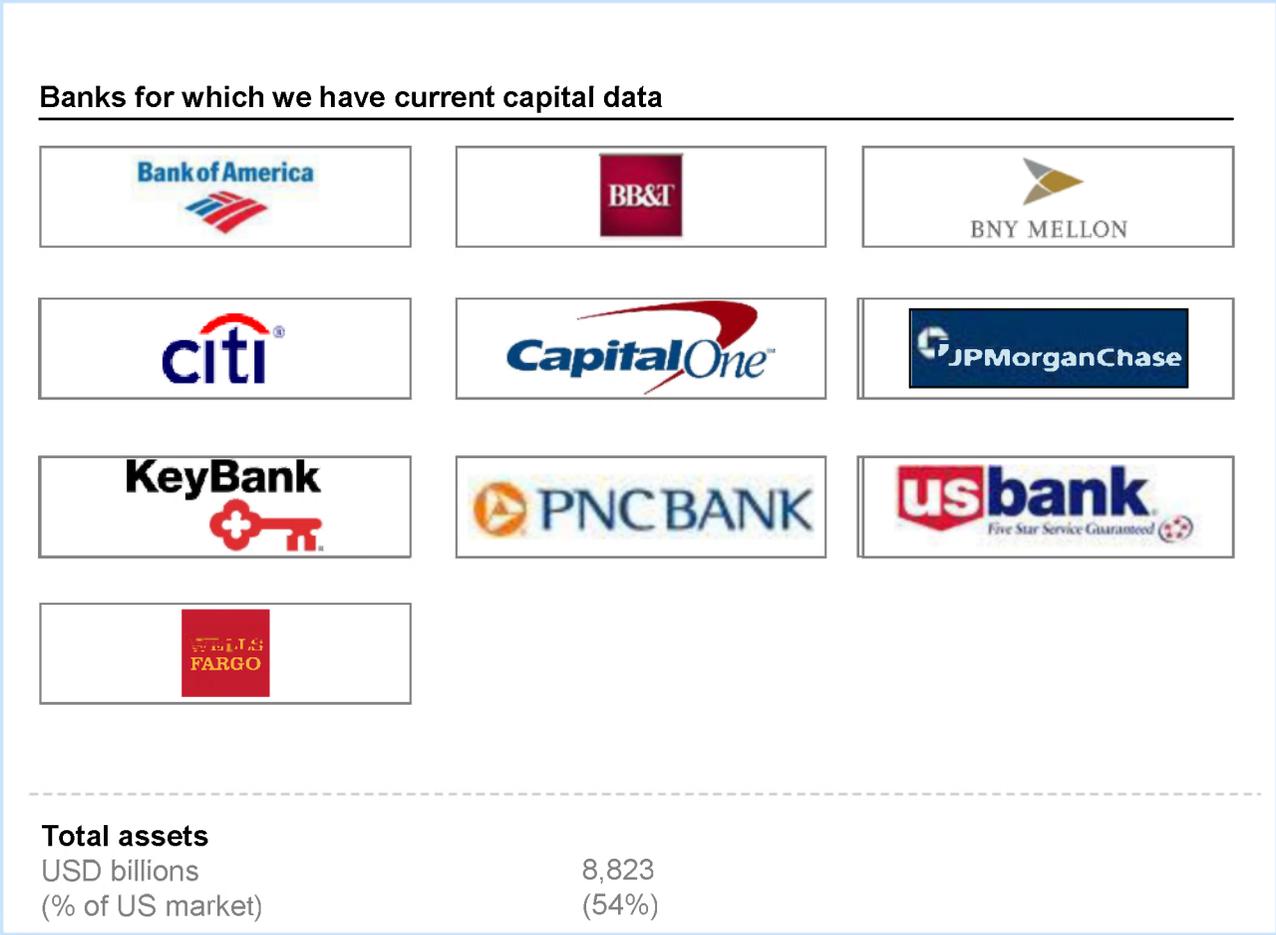
▪ **Forward-looking stress test:**

- Bank by bank stress test analysis of an adverse economic environment, similar to the scenario released by the Federal Reserve in March 2011, shows an average reduction of 60 bps in Basel III CET1/RWA with a maximum reduction of 140 bps.

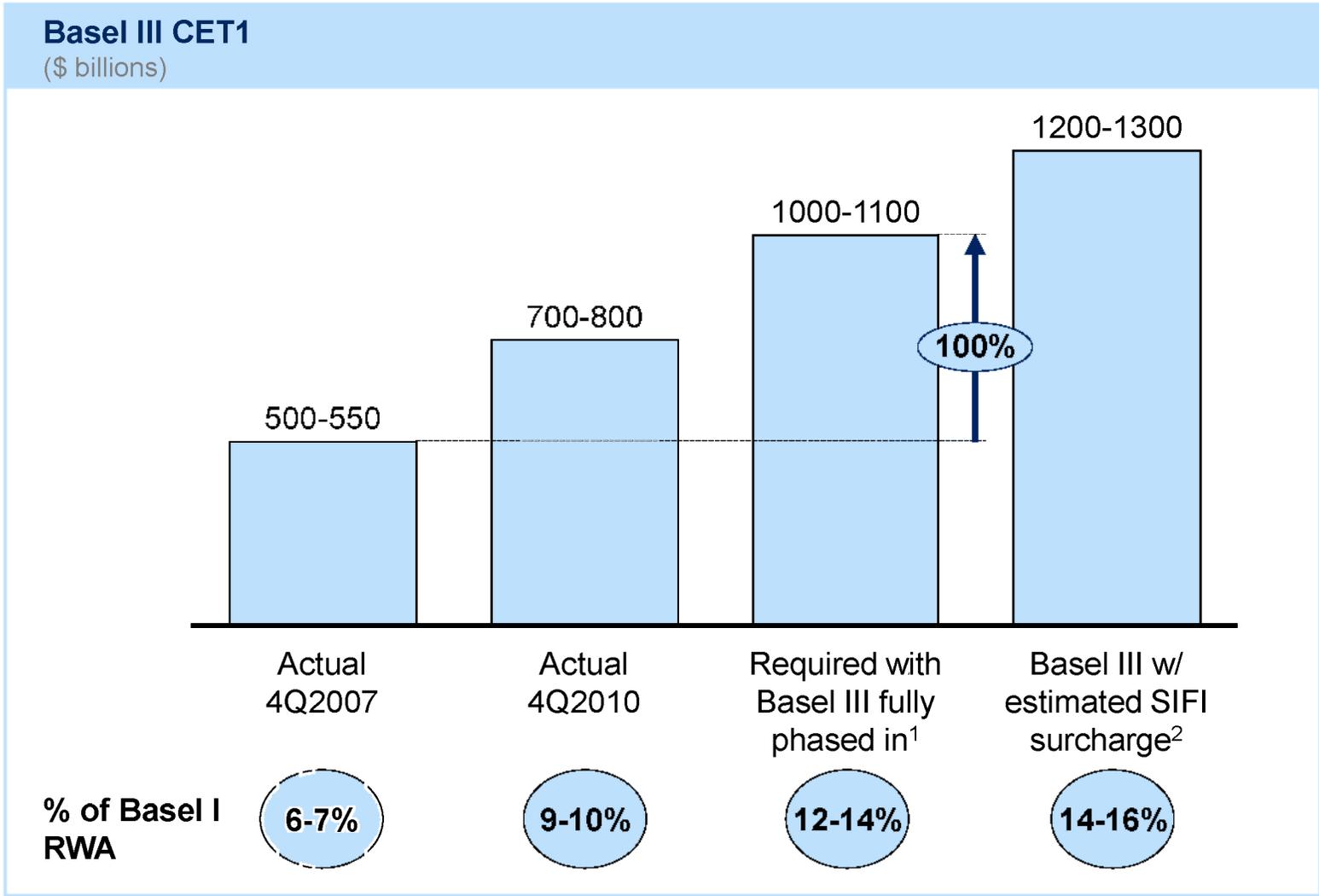
Contents

- **Additional capital required**
 - Assessing capital needs from crisis experience
 - Impact of higher capital ratios

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



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



1 Fully phased in at CET1 as 7% of RWA

2 Estimated G-SIB surcharge of 100-250bps for the industry

Contents

- Additional capital required
- **Assessing capital needs from crisis experience**
- Impact of higher capital ratios

We have used 2 approaches to assess the necessity of G-SIB surcharges based on crisis experience and forward-looking stress tests

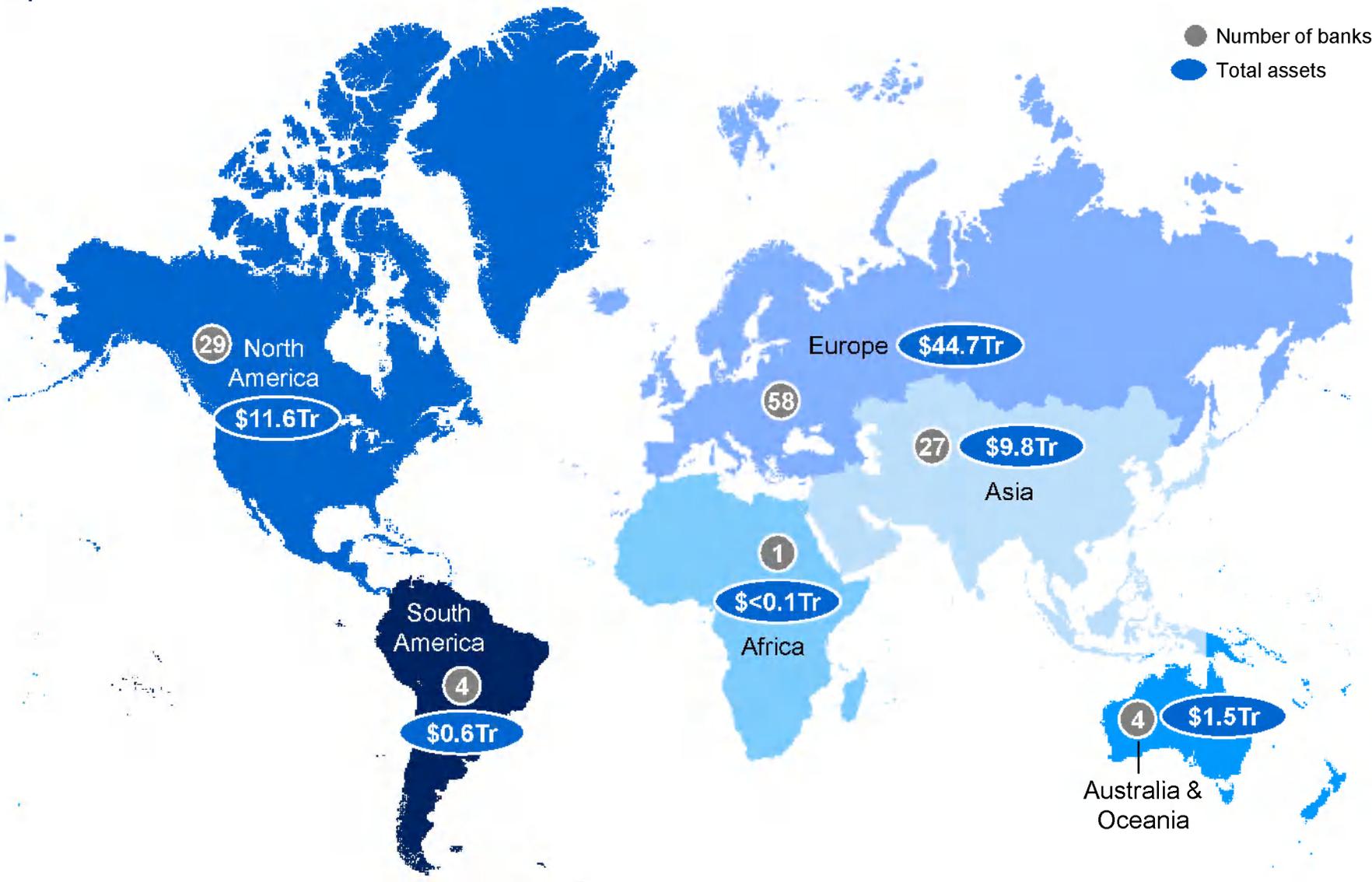
1 Distressed bank analysis

Analyzed the relationship between Basel III capital ratios of large global banks at the onset of the financial crisis (defined as December 2007), and subsequent Bank distress during the crisis

2 Stress test analysis

Measured peak-to-trough drop in Tier 1 common ratios for US banks on forward looking basis under stress conditions (based on Federal reserve adverse scenario published on March 18, 2011) assuming banks hold capital at fully-phased-in Basel III minimum levels (7% of Basel III RWA)

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



1 Methodology for analyzing the relationship between pre-crisis bank capital ratios and the likelihood of a bank going into distress

Approach

- Analyzed the relationship between capital ratios of large global banks, at the onset of the financial crisis (defined as December 2007), and subsequent Bank distress during the crisis
 - Initial capital ratios as defined in both Basel III and Basel I terms used to study relationship to Bank distress

Banks in sample

- 123 large global banks with minimum asset size of \$30 billion
 - Represent \$68.2 trillion in total assets
 - About 85% of developed-market banking and 65% of total banking assets worldwide
 - Broker-dealers excluded as risk-weighted assets data unavailable in December 2007.

Definition of distress

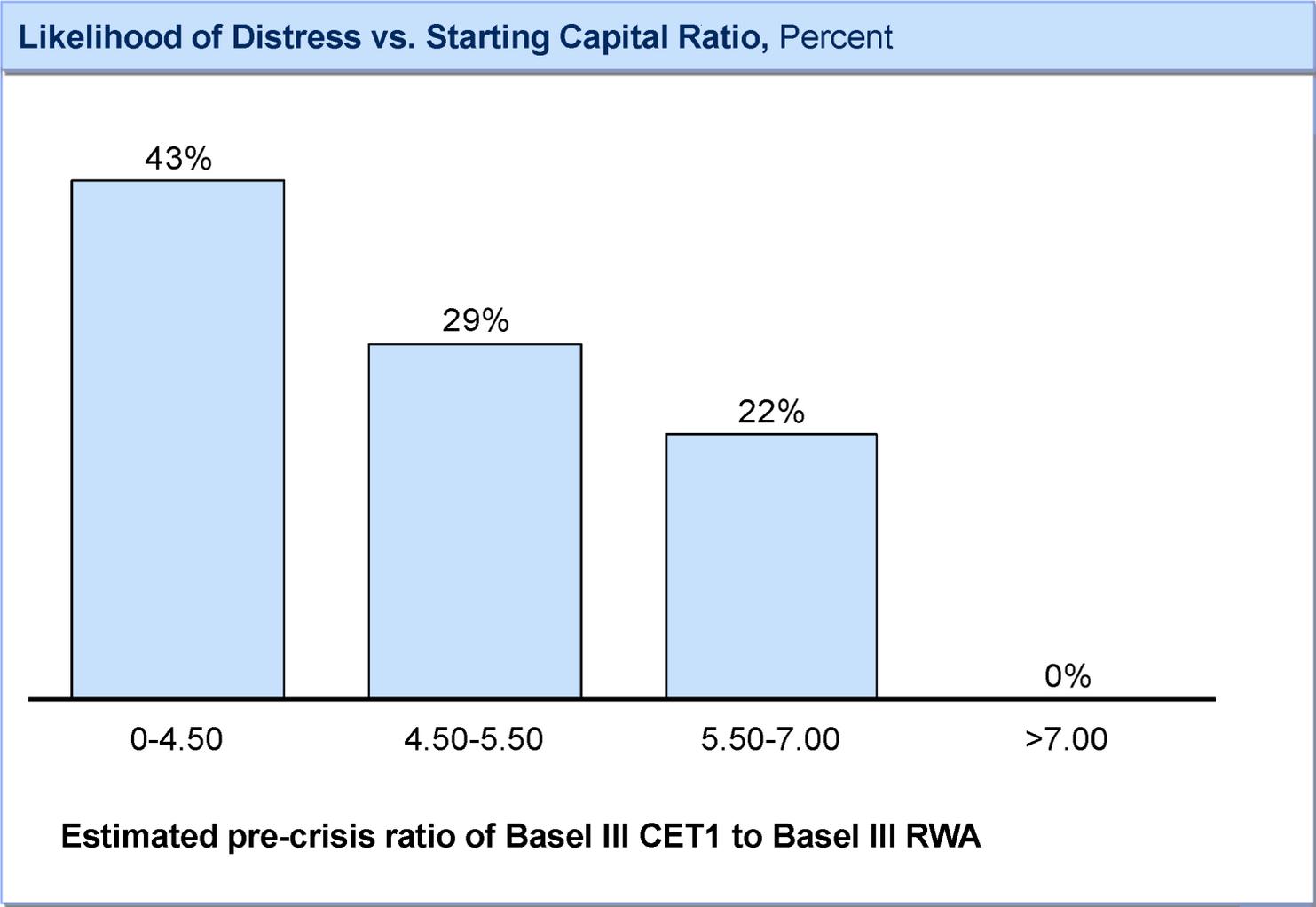
- An institution is defined as distressed if any of the following conditions was met 2007-09:
 1. Bankruptcy
 2. Government takeover or placement into government conservatorship
 3. Merger under duress with another bank
 4. Receipt of a substantial direct government capital investment or bailout¹
- Using the above definition, a total of 35 banks were deemed distressed (28% of banks in the sample, covering 30% of the assets)

Adjustments for Basel III

- Adjustments developed to convert December 2007 capital and RWA for each bank into estimates of what Basel III capital ratios would have been, had Basel III rules existed at the time
 - Adjustment factors estimated for different type of banks (e.g., by country, by mix of business such as wholesale vs. retail, trading assets)

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

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



2 Methodology for stress test analysis

Approach

- Analyzed how much banks capital levels would drop under stress conditions if they started with 7% Basel III Tier 1 Common Equity (B3 CET1)
 - Starting with 7% B3 CET1 in the initial quarter, analyzed forward over eight quarters

Banks in sample

- 7 large US banks with minimum asset size > \$150 billion
 - Represent \$8.2 trillion in total assets
 - About 51% of US banking assets

Definition of stress conditions

Conditions over the 9 quarters are consistent with stress scenario released by the Federal Reserve in March 2011:

- | | |
|---|--|
| ▪ Real GDP decline of 0.9% in first 5 quarters | ▪ 3-Month T-Bill rate decline of 18.8% |
| ▪ CPI increase of 4.5% | ▪ 10-Year Treasury Bond rate increase of 31.4% |
| ▪ Real Disposable Personal Income decline of 0.7% | ▪ BBB Corporate Bond rate increase of 22.7% |
| ▪ Unemployment rate starting at 9.6% and peaking at 11.0% | ▪ Dow Jones decline of 23.7% in first 3 quarters |
| | ▪ National House Price Index decline of 8.5% |

Methodology

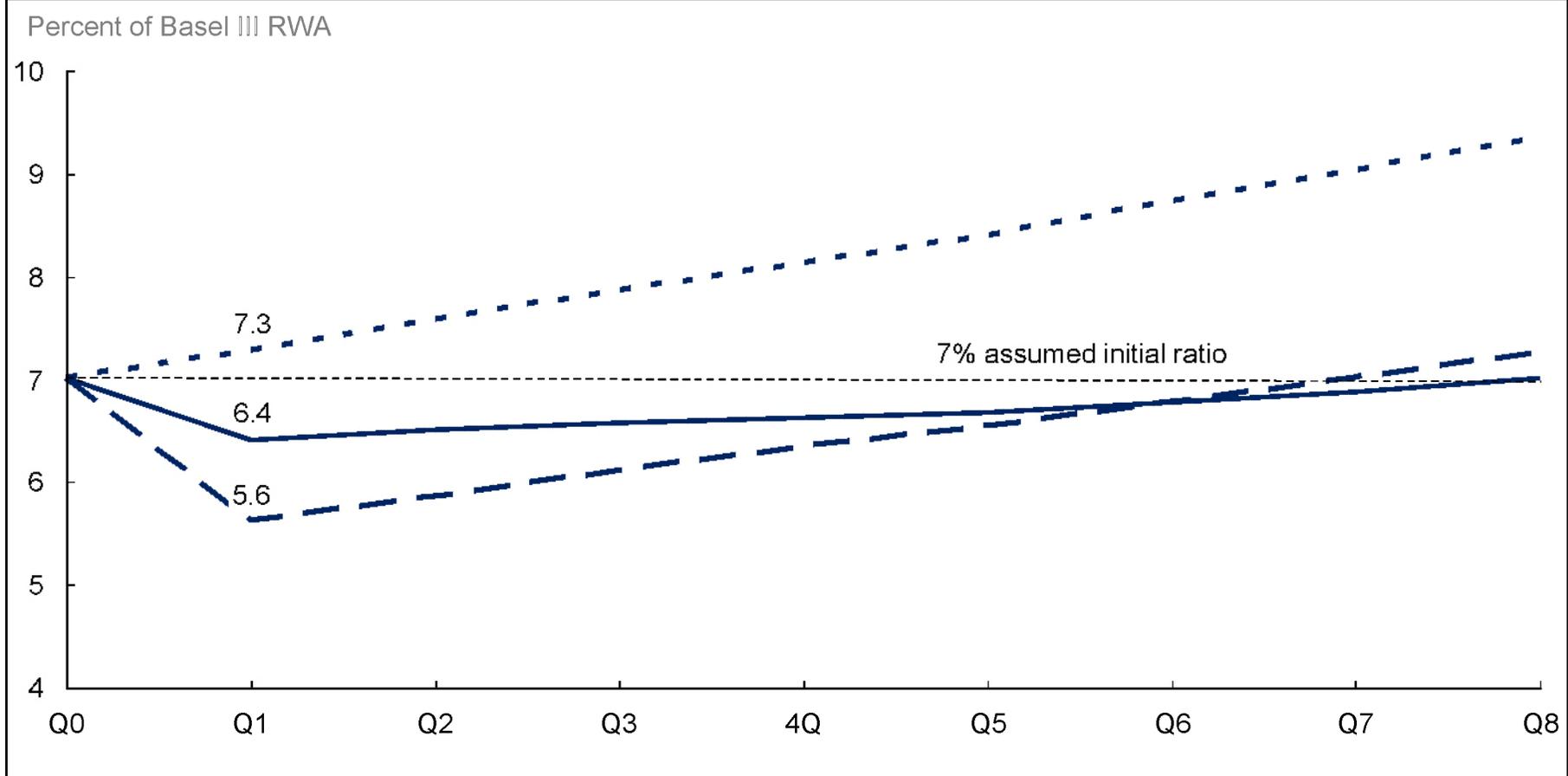
- Started with 4Q 2010 Basel III Risk-weighted Assets (B3 RWA) in the initial quarter
- Set B3 CET1 to 7% of B3 RWA in the initial quarter
- Calculate the Basel III CET1 Ratio for subsequent quarters based on projections of PPNR, loss provisions, realized gains (losses) on held-to-maturity securities, realized gains (losses) on available-for-sale securities, other gains (losses), income tax expense, income attributable to non-controlling interest, and other comprehensive income.

1 Defined as the drop from the initial 7% (rather than from the absolute peak).

② Stress test results have an average 60 bps reduction in CET1 to RWA under stress, and a maximum reduction of 140 bps

- Average
- - Bank with Largest Decline
- · - Bank with Smallest Decline

Tier 1 Common/RWA Ratios for US Banks under stress test scenario



Additional capital required

- Assessing capital needs from crisis experience
- **Impact of higher capital ratios**



Overall balance sheet structures have changed significantly since Q4 2007

U.S. \$ Trillions, Q1 2011

**4Q 2007
balances**

1Q 2011 balances of aggregate US Commercial Banks

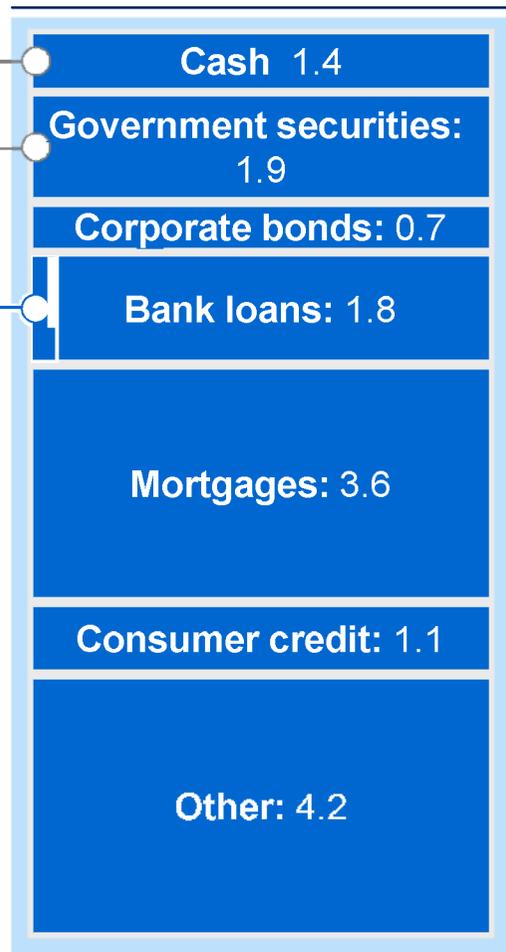
**4Q 2007
balances**

**0.1
(+1300%)**

**1.3
(+45%)**

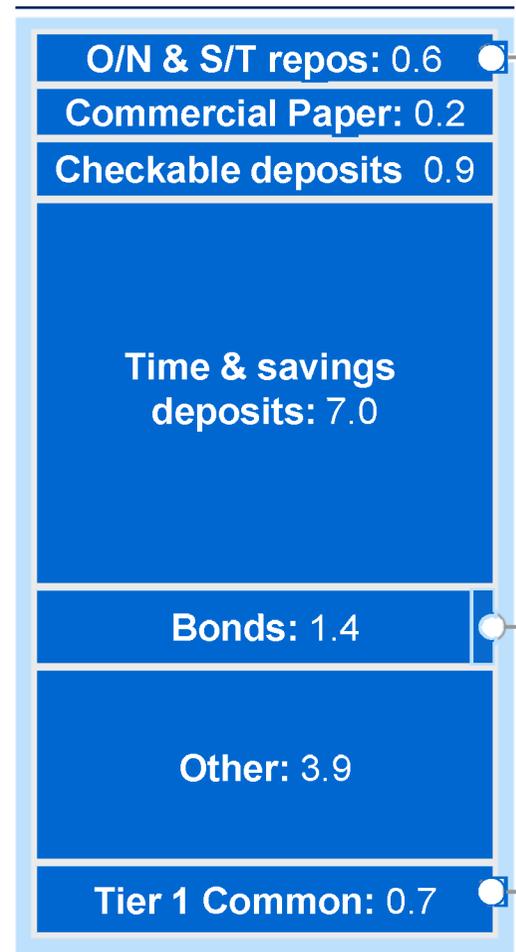
**2.0
(-10%)**

Assets



14.7

Liabilities



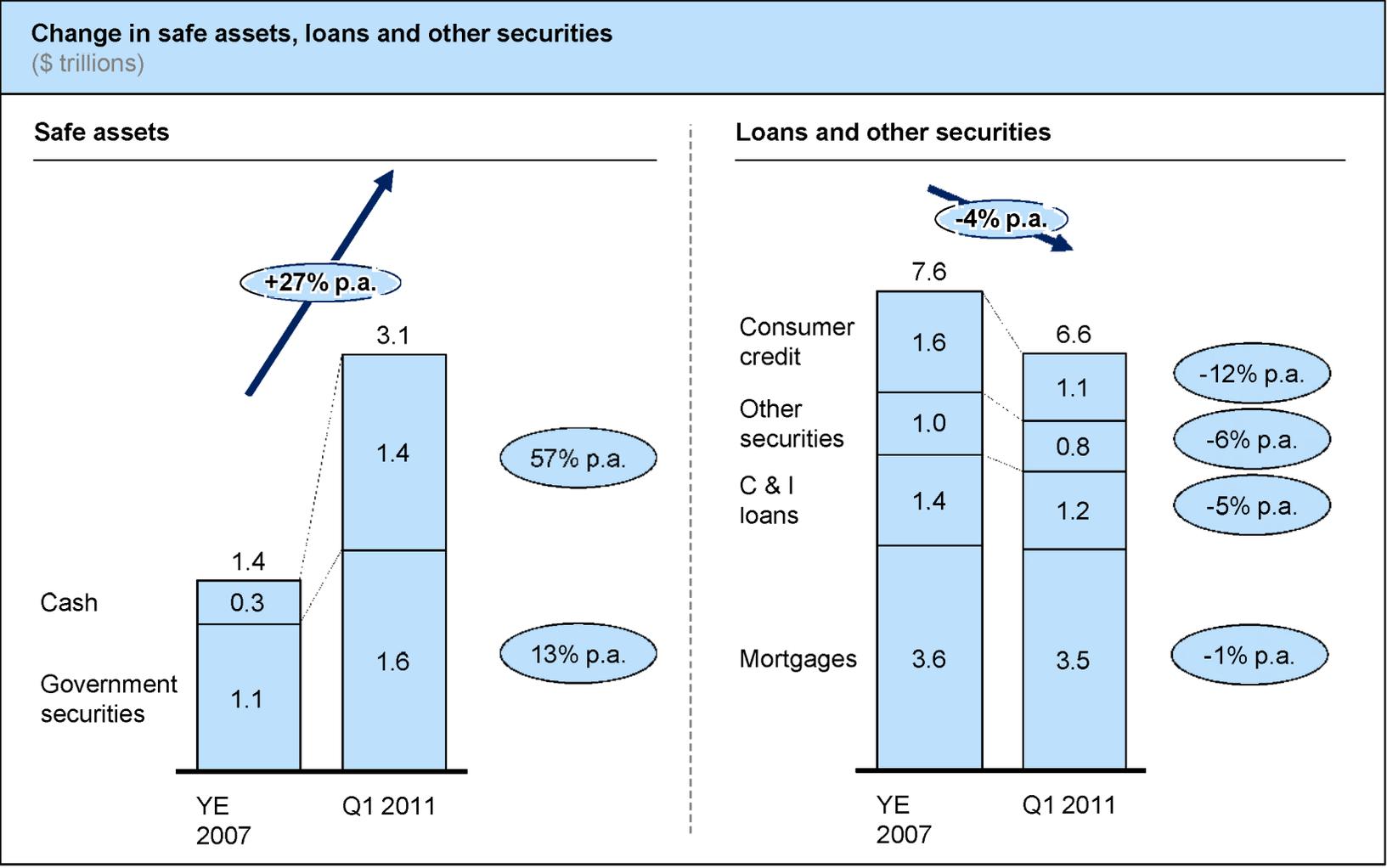
14.7

**0.8
(-25%)**

**0.7
(+100%)**

**0.5
(+40%)**

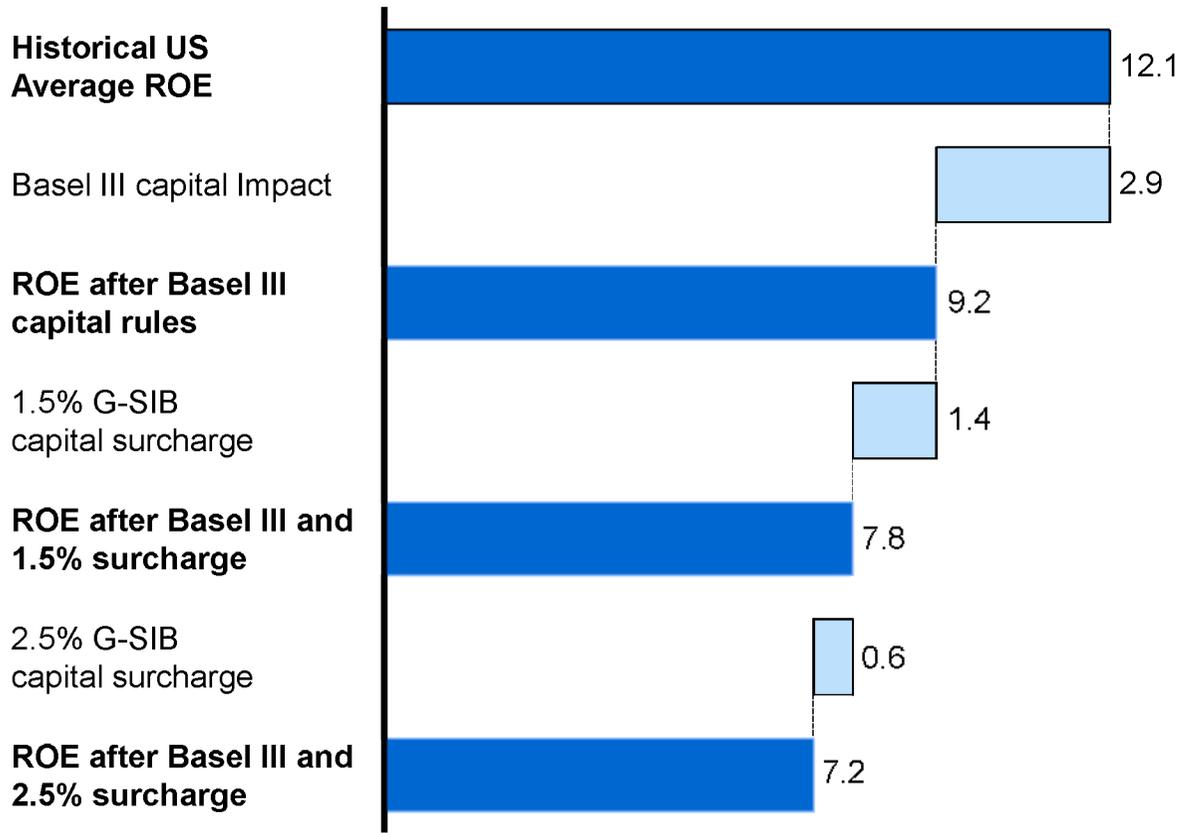
Coming out of the crisis, banks are holding more safe assets and there has been a decline in loans and “other securities”



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

Unmitigated ROE impact of Basel III capital proposals, as of Q4 2010¹

Percentage points



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

¹ Not including ROE impacts of the LCR and NSFR

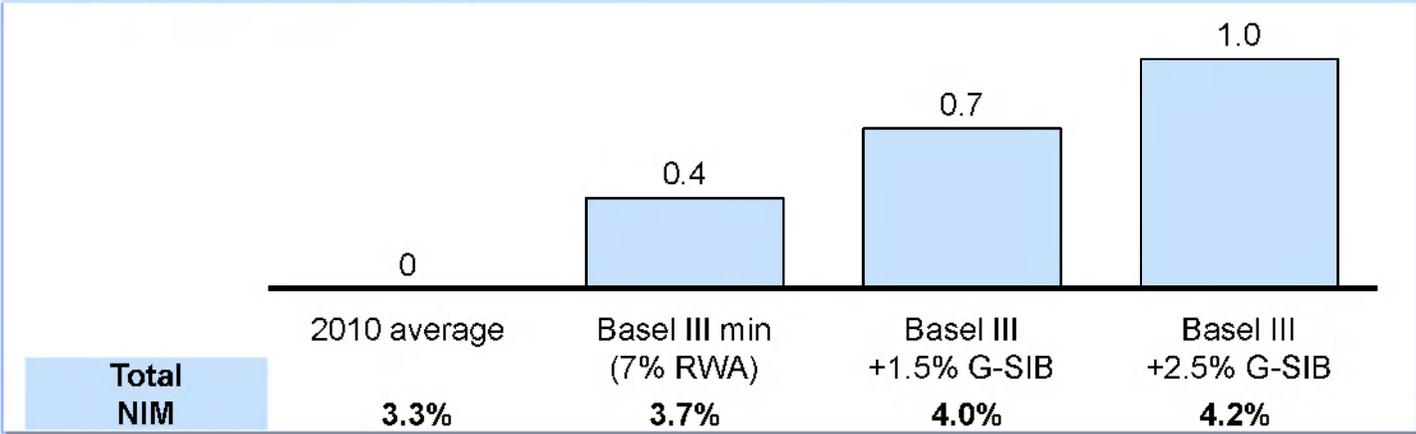
Banks would have to increase NIM or decrease NIX ratio to meet new capital requirements and maintain shareholder returns

Impact on required return on equity

- 8 banks provided us with of their internal costs of equity (including risk free rate, beta, and equity premium). The change in cost of equity is found by applying estimates from the academic literature¹ to compute change in levered beta
- Basel III requirements (including 2.5% G-SIB buffer) could reduce cost of equity by as little as ~70 bps (compared to an ROE reduction of 490 bps)
- We estimate how much margins and costs need to change to equalize reduction in ROE with reduction in COE

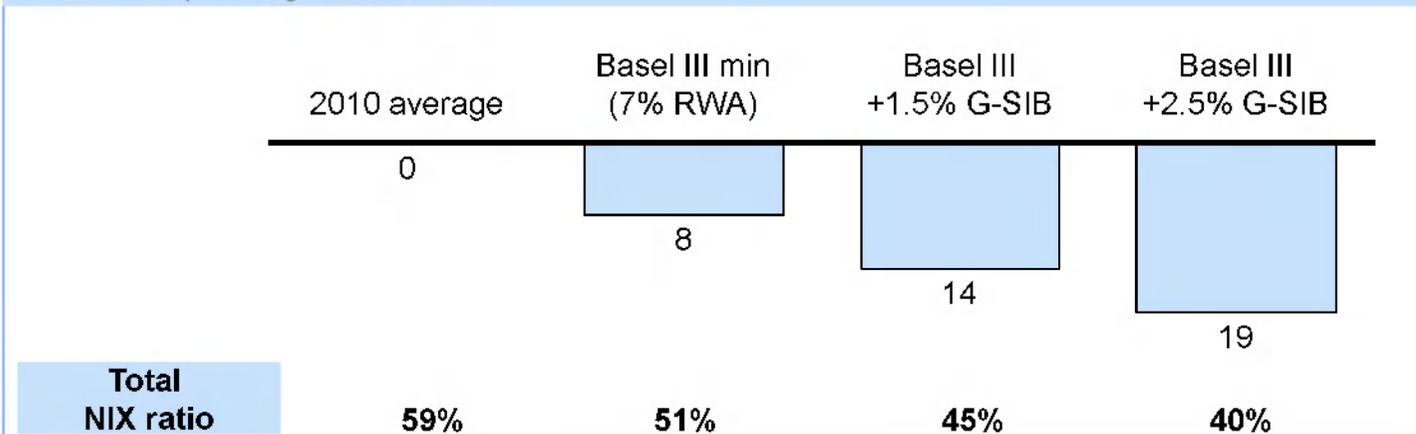
Net interest margin (NIM) increase accounting for reduced cost of equity

Percent of average assets, 2010



Non-interest expense (NIX) decrease accounting for reduced cost of equity

Percent of operating income, 2010



¹ Miles et al, 2011 estimates empirically the change in levered betas from changing capital ratios. Specifically: Change in Levered Beta = 0.031 * Change in Assets/Equity. Required rate of return = Risk-free Rate + Levered Beta * Market Risk Premium.

Financial Services

July 13, 2011

SIFI Capital Policy

Review of related research

Executive summary

- Given international efforts to impose additional capital requirements on banks considered Systemically Important Financial Institutions (SIFIs), Oliver Wyman has reviewed relevant academic literature on the impact of additional capital requirements
- Proponents of a SIFI capital surcharge beyond Basel 3 standards argue that a surcharge policy:
 - Will force SIFIs to internalize the large negative externalities associated with their disorderly failure
 - Will offset any funding advantages SIFIs derive by virtue of being perceived as too big to fail
 - Will not disrupt economic activity, as financial intermediation provided by SIFIs can transition to other institutions
- We found no independent academic research into the potential effects of differentially raising capital requirements for the largest banks
 - The assertion that activities that become uneconomic for SIFIs with higher capital requirements will be assumed by smaller institutions is untested
- A number of recent studies have attempted to estimate the costs and benefits of higher across-the-board bank capital
 - Broadly speaking, the dominant macroeconomic models in use today do not adequately incorporate financial markets or the dynamics of financial intermediation
 - Unsurprisingly, significant assumptions are needed to quantify the economic costs and benefits of higher bank capital, and different assumptions lead to very different results
 - Overall, the academic literature is inconsistent in its results, reflecting the difficulty of robustly estimating the magnitude of offsetting costs and benefits of requiring higher overall bank capital

Executive summary

- Claims by some academics that sharply higher bank capital can produce social benefits with minimal or no costs are unconvincing
 - These “equity is cheap” arguments are based on the Modigliani-Miller theorem – but the idea that the Modigliani-Miller theorem applies in any substantive way to banks is incorrect
 - Modigliani-Miller is an idealized theory of firm financing that requires the absence of taxes, bankruptcy costs, agency costs, and asymmetric information
 - Modigliani-Miller does not explain bank financing costs, because it ignores the presence of socially desirable bank funding arrangements (such as deposit insurance) and assumes that external investors have access to the same information on bank assets that banks themselves do
 - The prevailing view reflected in most research is that higher bank capital would result in a higher cost of credit, with ultimately a cost in terms of economic output
- Capital requirements are a very blunt policy tool with which to address systemic risk
 - A systemic capital surcharge co-opts the Basel framework for microprudential risk measurement for a completely new purpose
 - Given that every capital framework is the imperfect result of tradeoffs, this co-opting exposes the regulatory capital regime to additional strain
- Working to directly address “too big to fail” via the policies and processes to enable the orderly resolution of any institution is likely to be the most effective SIFI policy response
 - Externalities associated with disorderly failure and potential SIFI funding advantages can be directly remedied if any firm can “fail cleanly”

Research landscape: Publications most relevant to current policy debates on bank capital levels

Quantitative analysis of costs and benefits of higher bank capital

- **Basel LEI working group (BIS, 2010)** assesses long-term economic impact of Basel 3 capital and liquidity requirements
- **Macroeconomic Assessment Group (BIS, 2010)** assesses economic costs of the transition to higher Basel 3 capital standards
- **IIF (2010)** estimates the costs of new bank regulations and reviews approaches to estimating associated benefits
- **Slovik and Cournède (OECD, 2011)** also assess economic costs of transition to higher capital under Basel 3
- **Cosimano and Hakura (IMF, 2011)** estimate the increase in lending rates due to Basel 3 increases in bank capital
- **Miles et al (BoE, 2011)** estimate costs and benefits of different levels of bank capital
- **Hanson et al (2011)** argue for a suite of policy tools including higher capital to address macroprudential concerns

Evaluation of SIFI capital surcharge

- We found no independent research into the potential effects of requiring differentially higher capital for the largest and most complex banks
- **Suttle et al (IIF, 2011)** estimate the impact of SIFI capital surcharges on GDP growth
- Remarks by Fed Governor **Tarullo (2011)** discuss desirable elements of a SIFI capital surcharge

“Equity is cheap” arguments based on Modigliani-Miller theorem

- **Admati et al (2011)** review arguments for the prevailing view that equity is an expensive form of financing for banks and conclude they are “fallacious, irrelevant, or very weak”
- **Miles et al (BoE, 2011)** empirically estimate the extent to which Modigliani-Miller holds for banks

Research landscape:

Selected additional publications with relevance to bank capital regulation

- **Acharya, Mehran, and Thakor (2011)** develop a theoretical model to examine the privately optimal level of bank capital given the tension between two agency problems: the role of leverage in disciplining bank managers and the role of bank capital in diminishing the risk-shifting incentives of bank shareholders. **Acharya, Mehran, Schuermann, and Thakor (2011)** use this model to further discuss a novel approach to bank capital regulation that emphasizes the disciplining role of bank debt.
- **Diamond and Rajan (2000)** develop a model to examine the tradeoffs among three effects of higher bank capital: increased banker rents, increased buffer against shocks, and changes to the amounts extracted from borrowers.
- **Berlin (2011)** reviews theoretical explanations of why banks held capital above regulatory minimums during the last 20 years
- **Rubin (2010)** assesses reasons bank capital proved inadequate during the crisis, including lack of discipline from bank funding markets
- **Benes and Kumhof (IMF, 2011)** develop a theoretical model that demonstrates large welfare gains from adjusting capital requirements when there is a contractionary shock to borrower riskiness

Section 1

Cost/benefit analyses of higher bank capital

Recent research on costs and benefits of higher bank capital have broadly used a similar framework for analysis

Costs of higher capital

- Increased cost of funding for banks
- Higher lending rates / decrease in lending activity
- Long term output loss / decline in growth
- Moral hazard associated with ‘too-big-to-fail’
- Growth of shadow banking sector

Focus of quantification

Benefits of higher capital

- Less frequent financial crises
- Less severe crises with less lost economic output/growth
- More effective monetary policy (less constrained by zero bound)
- Buffer against all bank activities instead of specific risks
- Discourages systemically significant growth

Focus of quantification

Costs: Wide range of estimates regarding long term output loss; some consensus around increasing lending rates and cost of funds

Comparison of key findings	
Increased cost of funding for banks	<ul style="list-style-type: none"> ▪ General consensus that some increase in cost of funds will occur ▪ Cosimano argues that increased cost of funding will remain in the long run
Higher lending rates / decreased lending	<ul style="list-style-type: none"> ▪ General consensus that increase in lending rates will occur and estimates are roughly similar ▪ Consensus around need for phasing
Long term output loss / decline in growth	<ul style="list-style-type: none"> ▪ Very wide range of estimates, e.g., BIS estimates a 0.38% cumulative GDP decline by 2015, while Slovik et al. estimate the annual impact to be three times larger and the IIF takes the most pessimistic view estimating a 3.1% decline by 2015 ▪ IIF claims BIS study includes jurisdictions where “effects are most likely smaller to non-existent” driving average results down ▪ BIS claims several IIF assumptions are very aggressive, notably: ROE will return to pre-crisis level and link between aggregate credit growth and real GDP will be similar to pre-crisis levels ▪ Slovik et al. claim BIS assumption of no discretionary capital buffers is unrealistic and assume that banks will retain their current additional buffers
Increased moral hazard associated with too big to fail	<ul style="list-style-type: none"> ▪ Industry views designation of SIFIs as a potential moral hazard ▪ Tarullo counters saying “moral hazard is already undermining market discipline on firms that are perceived to be too-big-to-fail”
Growth of ‘shadow banking’ sector	<ul style="list-style-type: none"> ▪ Consensus regarding increase in risk from growth in shadow banking sector, however no attempts to quantify this risk ▪ Notably, Tarullo’s speech does not address this point

Benefits: Consensus regarding benefits of financial stability but significant variance in the estimated magnitude of any net benefits

Comparison of key findings

Less frequent financial crises

- BIS and Tarullo agree that there are clear benefits to enhanced capital requirements (in terms of less frequent financial crises and enhanced stability)
- IIF on the other hand claims that benefits are overstated

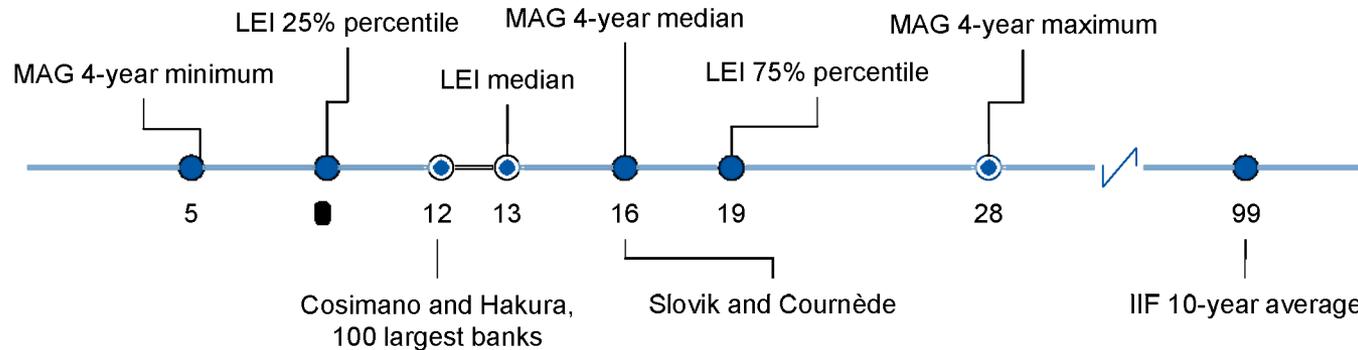
Less severe crises, with less lost economic output / growth

- Range of views regarding impact of capital requirements on severity of crises
 - For example, BIS finds a weak statistical relationship between severity of crises and higher capital, and contends that balance sheets will be less risky. While the IIF contends that the overall cost of crises might not be reduced by any significant amount
-

Key studies agree that higher bank capital will come with economic costs, but the range of estimates indicate a significant degree of uncertainty

Selected estimates of increase in bank lending rates (in bps)

Assuming 1% increase in bank capital across major global economies



- Official BIS studies (LEI and MAG) readily acknowledge the significant uncertainty involved in estimating costs and benefits of higher bank capital
- This reflects the inherent difficulty of modeling macroeconomic effects of different financial intermediation structures using existing techniques

Section 2

Critique of “equity is cheap” arguments

“Equity is cheap” arguments are erroneously based on the assumption that Modigliani and Miller at least partially holds for banks

- Two prominent “equity is cheap” articles (Admati et al. and Miles et al.) are based to a large extent on Modigliani-Miller (MM), which proposes that the value of a firm is independent of how it is financed. The theorem requires the absence of agency costs, bankruptcy costs, taxes and asymmetric information. It also requires that the costs of investor financing and firm financing are the same. There are a number of problems with applying MM to levered financial institutions:
 1. **Costs of investor financing and firm financing are markedly different** e.g., FDIC deposits, liquidity, array of financing structures only available to financial institutions, stringent regulation etc. significantly lower the cost of firm financing. There is no way for investors to reconstruct the levered returns from an unlevered firm. Additionally, deposits (debt) are a factor of production for banks (i.e. debt is both a means of financing assets and debt is itself an input to the production of assets), removing tax subsidies would in effect be taxing banks on their revenues instead of profits
 2. **There is substantial asymmetric information** for banks. First, bank assets and risk are highly firm specific, highly dependent on firm underwriting standards, require substantial specialized expertise to risk manage etc. Secondly, banks can quickly change their asset mix (unlike GM or Ford, for example). Given this asymmetry of information, there is no way an investor could prudently re-lever an unlevered financial institution to achieve the same return
 3. **There are constraints on investors that prevent replication of the unlevered firm.** Vast majority of equity investors invest unlevered capital (this is probably also true for fixed income investors but to a much lesser extent). There is simply not enough equity capital with a mandate to invest in a levered fashion that they could operationalize a MM replicating strategy. It is more likely that fixed income investors would end up owning a substantial fraction of bank assets
 4. **Shadow banking system would substantially increase and it would have more leverage** as a result of #3. Obviously, a larger and more leveraged shadow banking system opposes the outcomes that regulators are seeking. Also, recourse to the banking system is not needed to grow the shadow banking system meaning a large part of the shadow banking system will be difficult to regulate

Additionally, some proposals in the Admati et al. and Miles et al. articles are challenging to implement or are simply not accurate

- **Changes to tax subsidies are difficult to implement**
 - Admati suggests that subsidies for debt financing should be removed because they are ‘paradoxical’ and create systemic risk. Miles suggests that the increased tax revenue from using stricter equity financing requirements could be used to neutralize any impact on the wider economy
 - Reform of tax subsidies would be very challenging to implement and it is unclear what framework could be used to ‘neutralize’ effects on the wider economy
- **Mandatory equity issuance and limits on payouts would be challenging to implement and oversee**
 - Admati suggests applying restrictions on equity payouts and mandate equity issuance on a pre-specified schedule, for a period of time for all banks
 - Firstly, this is a significant and unnecessary intrusion into the private sector
 - Secondly, implementation of this proposal would require a very complex and robust legal framework. Applying a uniform rule across banks would not be practical and a mechanism to tailor the rule to specific banks and update the rule periodically would need to be in place

Section 3

**Forms of systemic risk and effective
policy tools to address them**

Systemic risk arises from root causes in the financial system, that ultimately affect the broader economy by one or more transmission mechanisms

- Root causes are vulnerabilities that when manifested, can cause distress to the financial system and the broader economy
- Historically, root causes of financial crises have included one or more of the following:
 - Large-scale uncertainty around asset values
 - Large-scale asset-liability mismatches
 - Problems in design or operations of financial ‘plumbing’ (such as payments, clearing, settlement)
- These root causes often interact once they manifest – for example, uncertainty around asset values and asset/liability mismatches can spark a vicious cycle of fire sales
- Once manifested, these vulnerabilities transmit distress throughout the financial system by interruptions to the core functions of the financial system, including:
 - Enabling flow of liquidity among financial institutions and their customers
 - Facilitating orderly capital markets, including price discovery, two-way markets, and extensions of counterparty credit and funding to market participants
 - Providing credit to the real economy, including households and companies
 - Engendering a broad sense of trust among the processes and institutions that make financial and economic transactions possible

Capital has limited ability to address systemic risk, compared to other policy tools now being considered and implemented

- To be effective, policy should be developed to address both the causes and mechanisms of systemic risk
- Capital fundamentally serves to absorb unexpected losses from asset uncertainty
 - Capital requirements do not address asset/liability mismatches or financial plumbing problems, and can only partially mitigate the transmission mechanisms of systemic distress
- Other policy tools more directly and effectively address other aspects of systemic risk
 - Resolution and recovery plans
 - Provision for orderly liquidation of a failed firm
 - OTC derivatives reform
 - Liquidity requirements (e.g. Basel 3)
 - Restrictions on concentrated exposures
 - Targeted asset policies (e.g. exposure concentration restrictions, underwriting restrictions)

Examples of systemic risk root causes and transmission mechanisms

Root causes

Large-scale uncertainty around asset values

- US mortgage lending circa 2005-2007, and related RMBS and CDO securitizations
- Unsound real estate lending leading to S&L crisis
- Japanese property bubble of the 1980s

Large-scale asset/liability mismatches

- Mismatch between short-term funding and fixed-rate mortgages leading to S&L crisis
- Reliance on repos and other short-term funding at large securities firms prior to 2008 crisis
- Asset-back commercial paper (ABCP) and structured investment vehicles (SIVs)

Financial plumbing problems

- Plumbing design problems occur when arrangements for vital services (such as payments, clearing, and settlement) create vulnerabilities (e.g. 1974 Herstatt Bank failure)
- Plumbing operational problems include operational breakdowns due to natural and man-made disaster (e.g. 9/11)



Transmission mechanisms

Interruptions to flow of wholesale liquidity

- Cascading failures in wholesale payment flows (e.g. Barings failure near-breakdown of trade settlement)
- Breakdowns in routine extensions of liquidity and intraday and short-term credit (e.g. interbank lending stresses in 2008)

Breakdown in orderly markets

- Evaporation of trading liquidity and absence of price discovery for mortgage-related securitizations in 2008
- May 2010 Flash Crash

Lack of access to credit

- Concerns about ability of corporates to roll over commercial paper given stresses in money market funds in 2008

Broad-based loss of confidence

- Bankruptcy of Lehman Brothers and fear of cascading collapses as market participants lost confidence in wholesale financial institutions in 2008

Capital addresses just one source of systemic risk

Root causes

Large-scale uncertainty around asset values



- Capital requirements
- Restrictions on concentrated exposures
- Underwriting restrictions (e.g. caps on LTV ratios)

Large-scale asset/liability mismatches



- Liquidity and funding requirements
- Traditional bank safety net (including deposit insurance and access to lender of last resort)
- Resolution planning
- Provision for orderly liquidation of failed firms

Financial plumbing problems



- Redesign of institutional arrangements
- Regulation of financial utilities
- Resolution planning
- Provision for orderly liquidation of failed firms

Among policy tools to address systemic transmission mechanisms, capital plays at best a supporting role

Effective policy tools

- Redesign of institutional arrangements
 - OTC derivatives reform
 - Changes to tri-party repo market
- Liquidity requirements
- Resolution planning
- Provision for orderly liquidation of failed firms
 - Ability to transfer vital functions to new institutions without disruption
- Capital requirements

Transmission mechanisms

Interruptions to flow of wholesale liquidity

Breakdown in orderly markets

Lack of access to credit

Broad-based loss of confidence

Studies – Tab 2

Assessing the Liquidity Coverage Ratio



November 2, 2011

Executive summary (1/4)

In order to analyze crisis experience and compare it to the calibration of the LCR, we collected data from 10 U.S.-headquartered banks, with ~\$8.8 trillion of assets (~54% total U.S. banking system) during the period of time including July 2008 through January 2009. In addition, our analyses included data from 4 acquired and distressed institutions, whose total assets prior to acquisition totaled over ~\$1 trillion¹, in order to include the liquidity experience of institutions under severe idiosyncratic and systemic stress. Not all institutions provided data for each product/segment we analyzed; thus, analyses of some products/segments do not include all banks. LCR sensitivity analyses are calculated using banks' positions as of 12/31/2010.

The crisis experience for the sample of banks we examined appears to differ significantly from the calibration of the LCR in some respects.

Deposits: crisis experience differed from the LCR calibration in the following ways:

- Aggregate worst run-offs were below LCR factors (lower run-off for wholesale, but higher run-off for retail)
 - Worst 30-day wholesale run-offs of 33% vs. LCR 72% for the worst-case bank.
 - Financial institutions: largely aligned with LCR for operational (23% observed vs. 25% LCR) but ~62% percentage points lower than LCR for non-operational (38% observed vs. 100% LCR)
 - Non-financial corporates: 10-35 percentage points lower than LCR (16% observed vs. 25% LCR for operational; 41% observed vs. 75% LCR for non-operational)
 - Governments: 10-15 percentage points lower than LCR (15% observed vs. 25% LCR for operational; 60% observed vs. 75% LCR for non-operational)
 - Retail run-offs were 12% vs. LCR 7% factor for the worst-case bank

¹ Acquired firm assets are included in the ~\$8.7 trillion figure above

Executive summary (2/4)

Credit and liquidity (C&L) line crisis experience we collected compared to LCR factors:

- Worst drawdowns of liquidity lines to non-financials and all lines to financials observed in our sample were well below LCR factors
 - Committed credit and liquidity lines to financials: ~90 percentage points lower than LCR (9% observed vs. 100% LCR)
 - Liquidity lines to non-financials: ~90 percentage points lower than LCR (10% observed vs. 100% LCR)
- Worst non-financial and retail credit line drawdowns observed in our sample were largely aligned with LCR factors
 - Retail: largely aligned (4% observed vs. 5% LCR)
 - Non-financial credit lines: largely aligned (10% observed vs. 10% corporate LCR/5% SME LCR)

Diversification: The LCR assumes worst-case run-off across all LCR categories occurs simultaneously, which differed from the data we collected, in which worst-case run-offs did not occur at the same bank nor in the same month.

Additional potential sources of liquidity:

FHLBs: The FHLBs provided increased liquidity to the U.S. banking system and increased funding to banks (including acquired firms) during the crisis. Including the excess FHLB capacity in the liquid asset buffer would reduce the shortfall by \$250-400 billion

Level 2 assets: The L2 cap increases the industry-wide liquid asset buffer shortfall by more than \$450 billion

Sensitivity analysis

- Setting deposit run-off and C&L lines drawdowns to crisis experience increases LCR by 21% and decreases shortfall by \$800 billion
- Additional potential liquidity sources: including FHLB capacity and removing L2 cap increases LCR by 24% and decreases shortfall by \$720-870 billion
- Combining deposits, C&L and prepayments with additional potential sources increases industry LCR from 60% to 104% and reduces U.S. industry shortfall from ~\$1,450 billion to a surplus of \$0-100 billion
- Removing simultaneous worst-case event assumption increases LCR by ~6% and decreases shortfall by ~\$240 billion
- Combining all 3 impacts increases LCR from 60% to 110% and reduces shortfall from ~\$1,400 billion to a surplus of ~\$300-400 billion

Executive summary (3/4)

Implications: product and market level impacts of the LCR

- Leading banks currently hold liquidity against products based on internal liquidity stress assumptions, which they develop based on historical experience. Accordingly, there is a significant difference between banks' internal liquidity held and the 2008 crisis experience versus the LCR requirement, across the same product areas identified in the historical analysis
 - Liquidity lines to non-financials and all lines to financials (19% average historical liquidity held and 10% maximum drawdown during 2008 crisis vs. 100% assumed in LCR)
 - Non-operational deposits (40% average historical liquidity held and 41% maximum drawdown during 2008 crisis vs. 75% and 100% assumed in LCR for corporate and financial institution deposits, respectively)
- Consistent with the calibration analyses, we have found a significant cost impact to 5 products and markets, which may lead to changes in either price, structure, or availability for customers:
 - Credit and liquidity lines
 - Commercial paper backstops
 - Variable rate demand note backstops
 - Financial institution credit and liquidity lines (e.g., to money market funds)
 - Non-operational deposits
 - Corporate non-operational deposits (e.g., money market demand accounts, term deposits)
 - Financial institution non-operational deposits
- This fact-based view on the impact of the LCR on banks, products, and markets was developed with a 4-step approach:
 - Collected internal data on current economics and cost impact of LCR across 15 products and 13 banks (representing ~\$9.2 Tr in assets, or 57% of U.S. bank assets)
 - Interviewed product managers to understand implications for product pricing, structure, and availability in response to increased costs (26 interviews across 13 banks)
 - Interviewed customers and investors to understand implications of product impact for their cash management, financing, and investing (18 customers, including municipal treasurers, corporate CFOs, and money market investors)
 - Interviewed bank treasurers to understand implications for overall balance sheet management (e.g., overall lending availability) (12 treasurers across 13 banks)

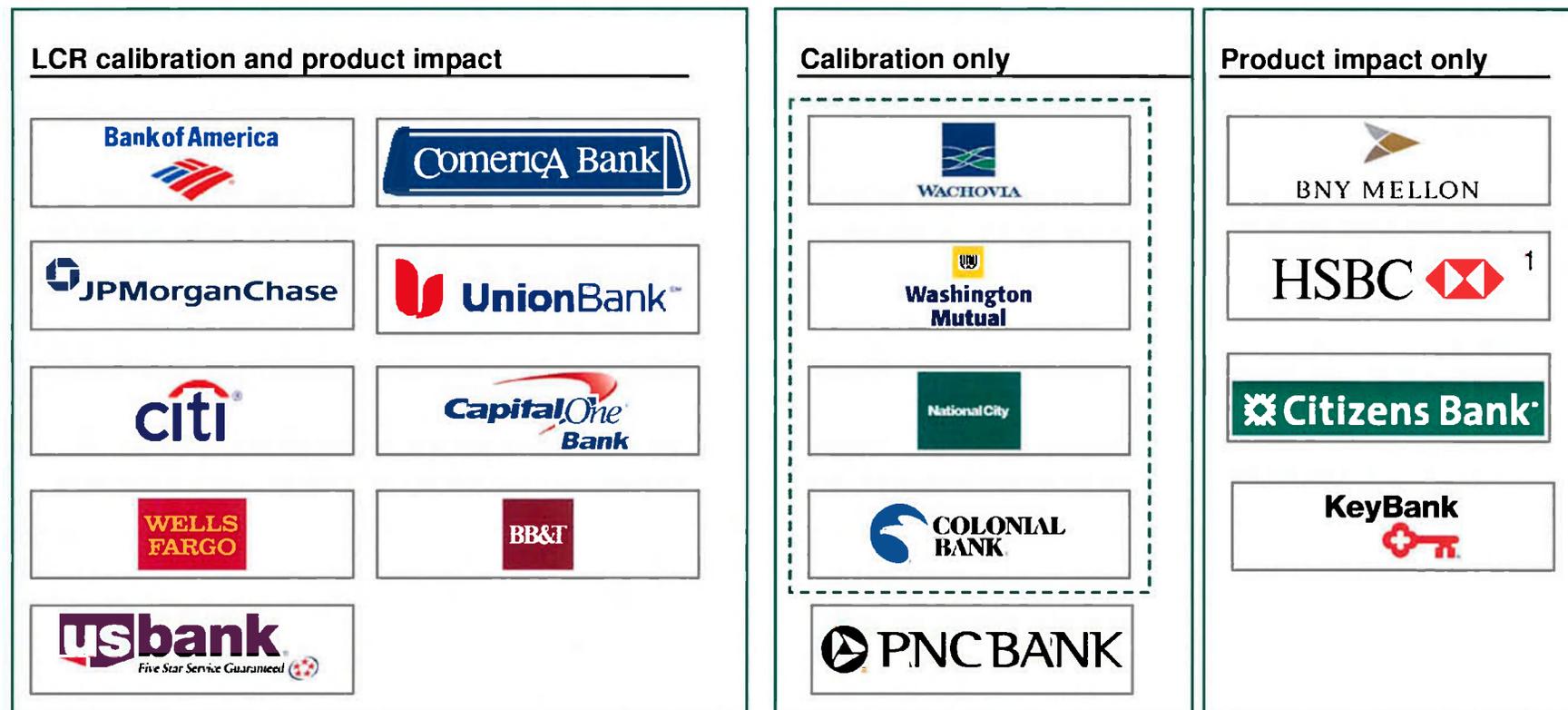
Executive summary (4/4)

Changes to balance sheet management

- As a result of the discrepancy between the liquidity that banks hold today, based on historical experience, and the LCR assumptions, the industry will need to increase the liquid asset buffer by \$1.4 Tr to meet an LCR of 100% (currently at ~60%)
 - Banks will also need to increase liquid assets because of the limit on L2 assets counting towards the liquid asset buffer (L2 cap)
 - For LCR outflows, the liquid asset shortfall is driven primarily by those products where a large discrepancy exists between current bank assumptions and the LCR assumptions
- To meet the liquid asset shortfall, banks have indicated that they will take a number of actions at the central level:
 - Increase the adjusted liquid asset buffer (i.e., post L2-cap) by exchanging L2s for L1s or issuing additional debt to fund purchase of L1s
 - Decrease LCR outflows selectively by decreasing off balance sheet liquidity line commitments, decreasing non-operational deposits, and decreasing the volume of short-term funding (e.g., overnight repos)

Analyses for LCR impact on products and calibration are based on data from 14 banks and 4 acquired institutions

 Acquired banks



Total assets (including banks in either calibration or product impact)

Bn	9,430
(% of U.S. market as of Q4 2010)	58

1 North America only

SOURCE: SNL Financial; data from Q4 2010. Note that not all banks submitted data for all analyses

Caveats and limitations

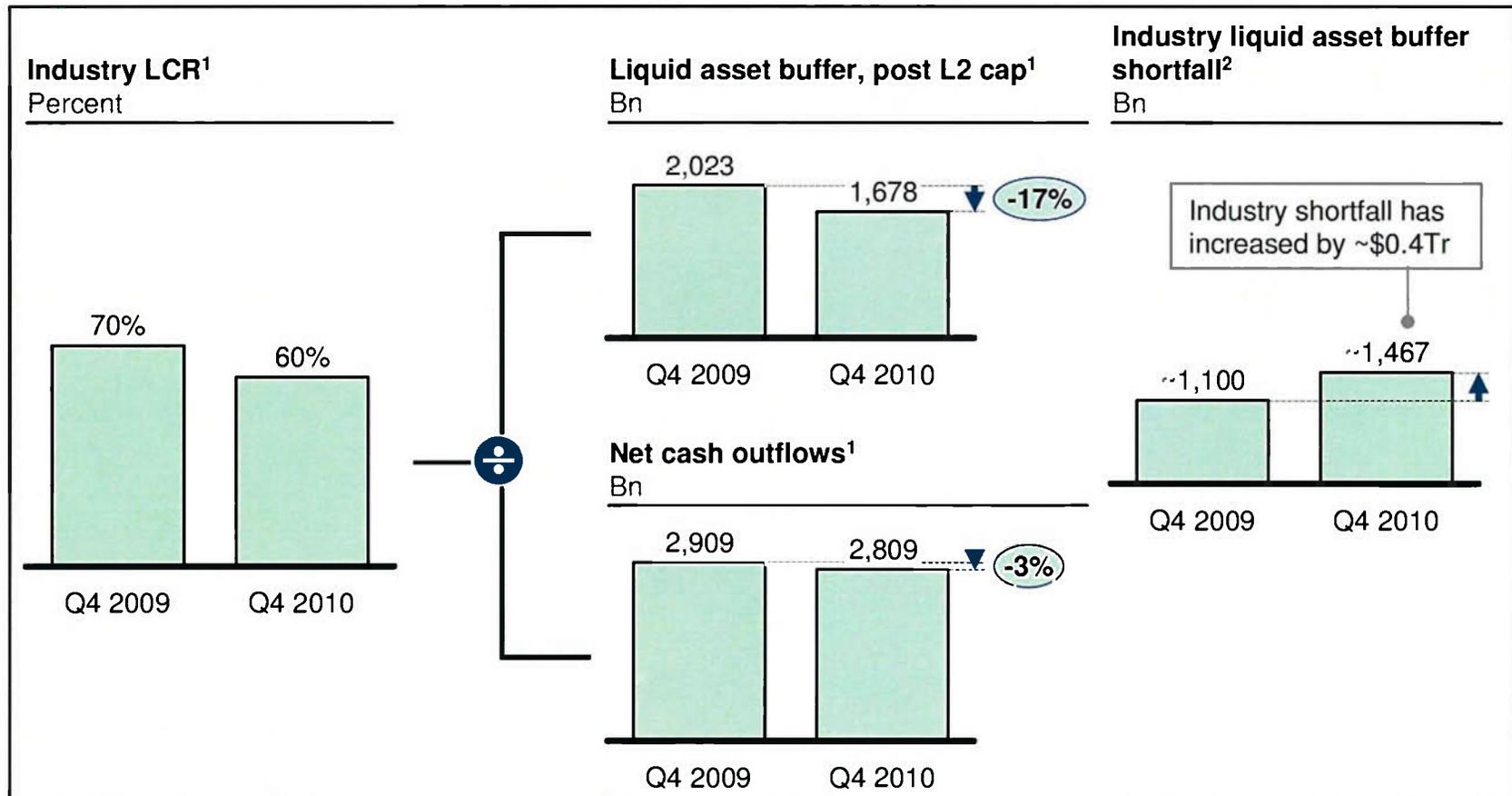
- This report contains the results of an **observational study**, which aggregates information from a **sample** of US banks, reflecting **recent historical** and **current experience** of those sample of banks
- Results from banks outside this sample, in non-US geographies, or from other historical or future periods may differ from the results reported here
- The reporting of data was based on Quantitative Impact Study definitions and instructions; if such definitions or instructions were to change, results may differ

Contents

- **Current industry LCR**

- Calibration
- Other liquidity sources
- Overall sensitivity analysis
- Product and balance sheet impacts

The U.S. banking industry LCR has decreased from 70 to 60% since 2009 primarily due to a drop in the recognized liquid asset buffer



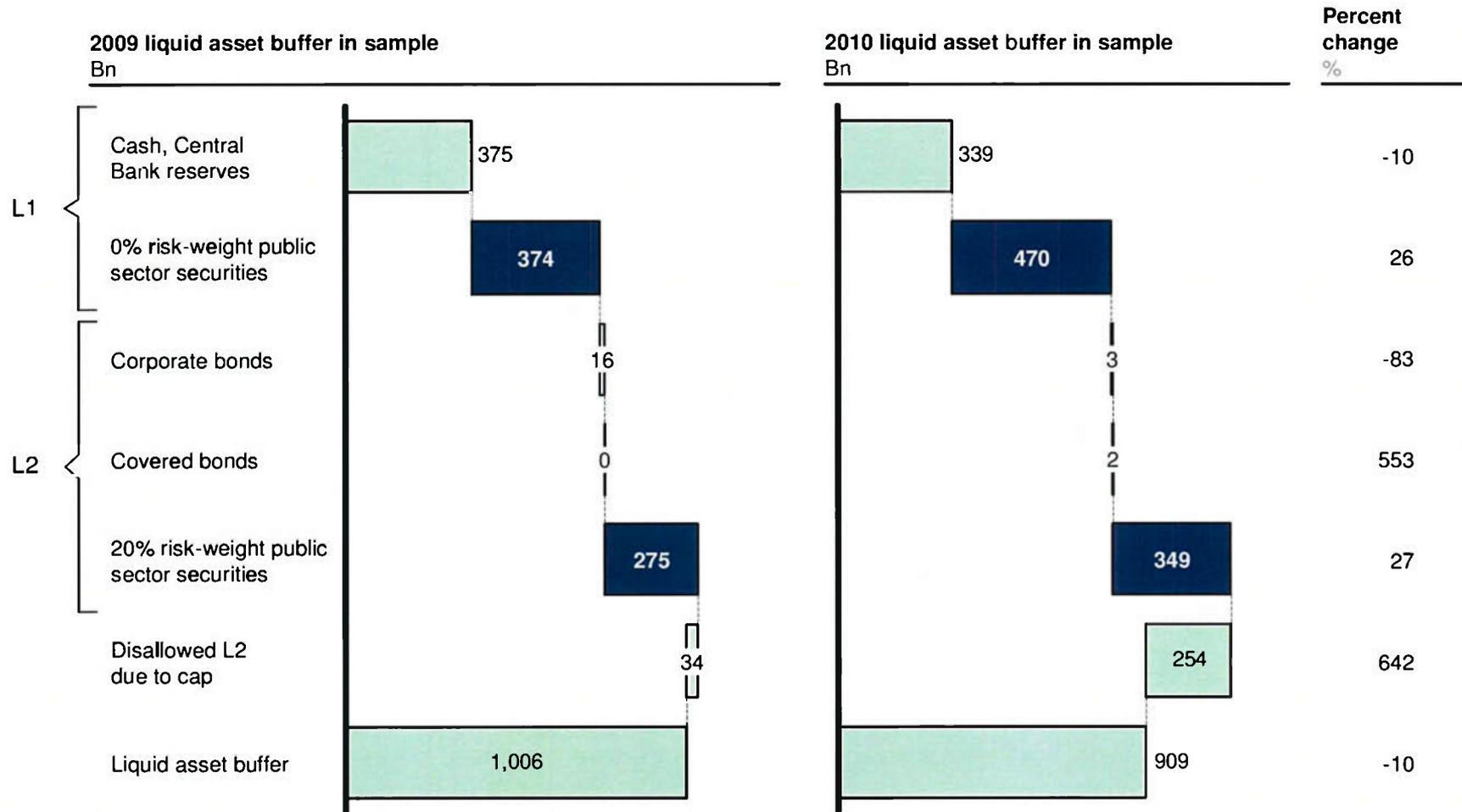
Note: Industry numbers were estimated by scaling up based on total assets

1 The industry LCR, liquid asset buffer, and net outflow were computed using all banks in the sample including those with a liquid asset surplus

2 The shortfall did not include banks with a liquid asset surplus, given that the excess liquidity of these banks is not fungible across the industry

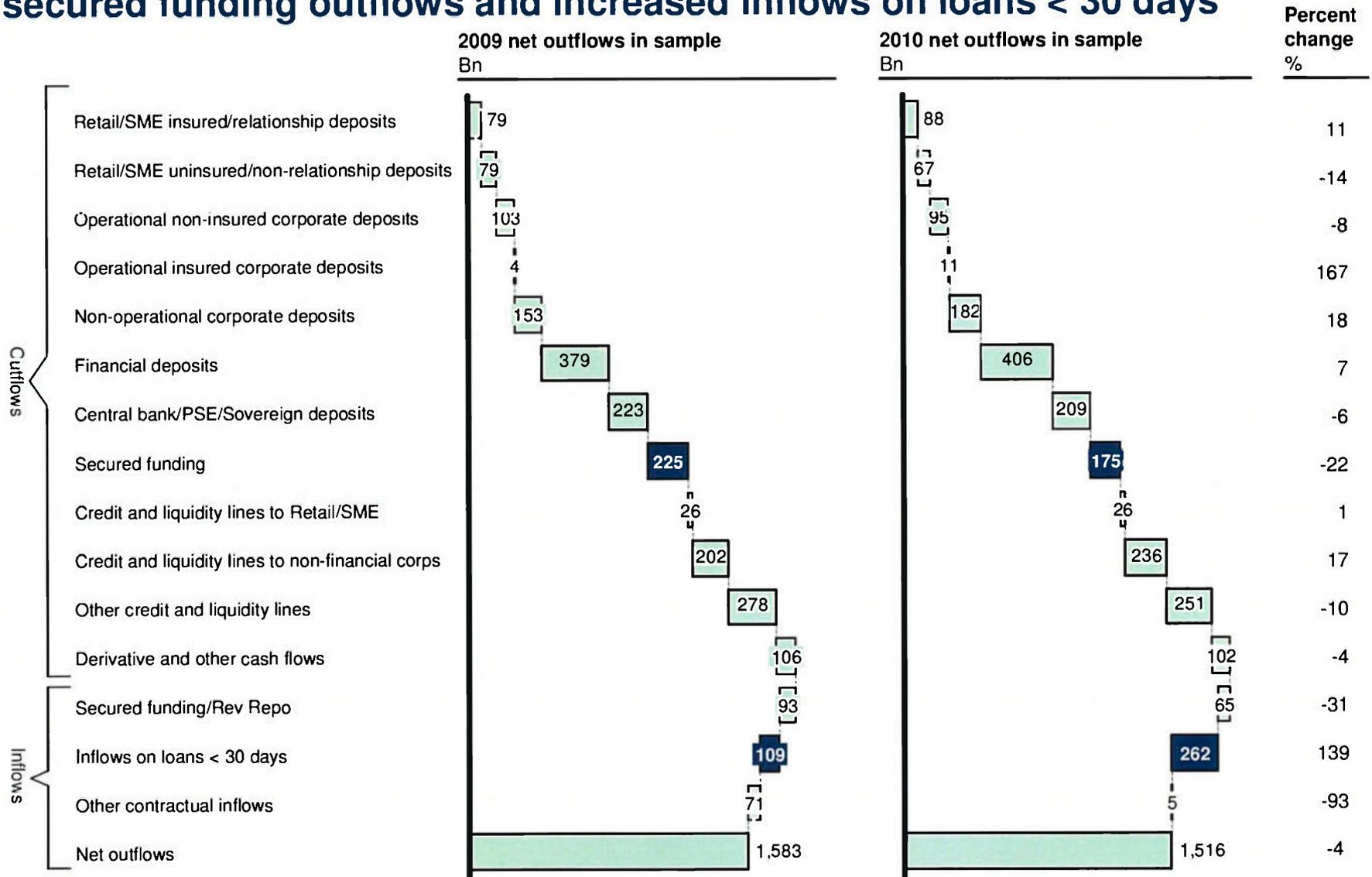
SOURCE: SNL Financial, TCH member banks' Q4 2009 and Q4 2010 QIS submissions

While banks have increased their liquid assets since 2009, the liquid asset buffer has declined due to the L2 cap



SOURCE: Q4 2009 and Q4 2010 QIS from banks submitting both datasets

Net outflows did not change significantly, but there were decreased secured funding outflows and increased inflows on loans < 30 days

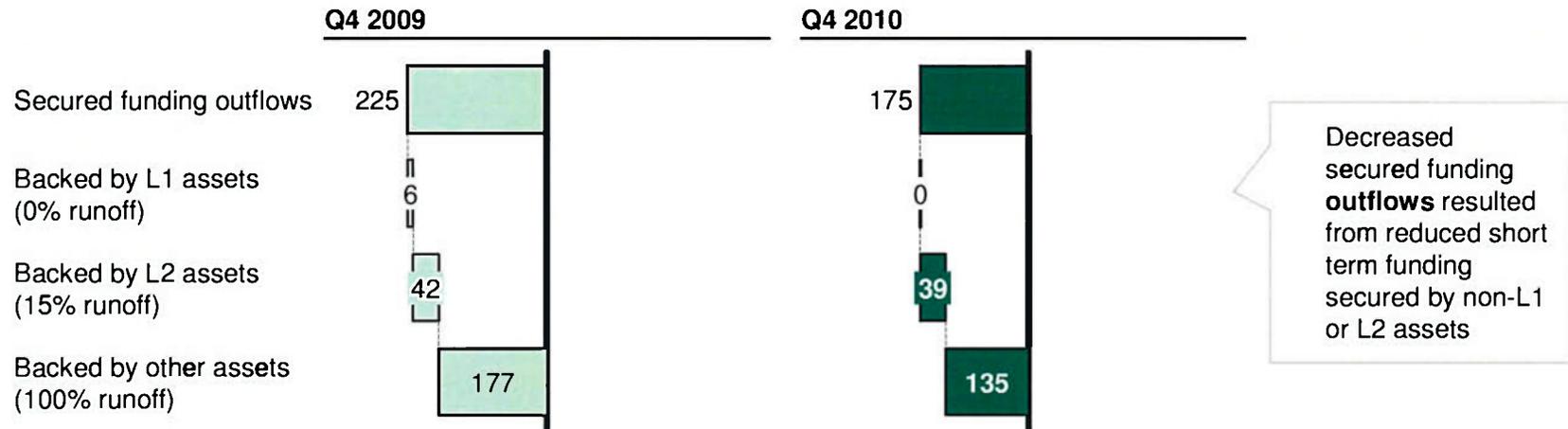


SOURCE: Q4 2009 and Q4 2010 QIS from banks submitting both datasets

Decrease in secured funding outflows was driven by funding backed by other assets and increase in loan inflows was driven by loans to FIs

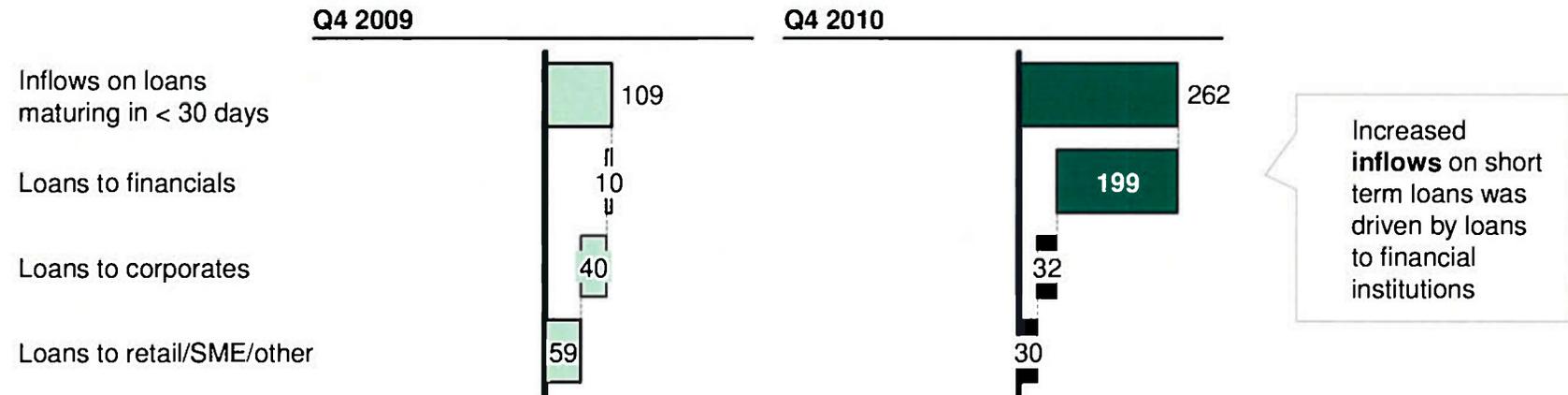
Secured funding outflows in sample

Bn



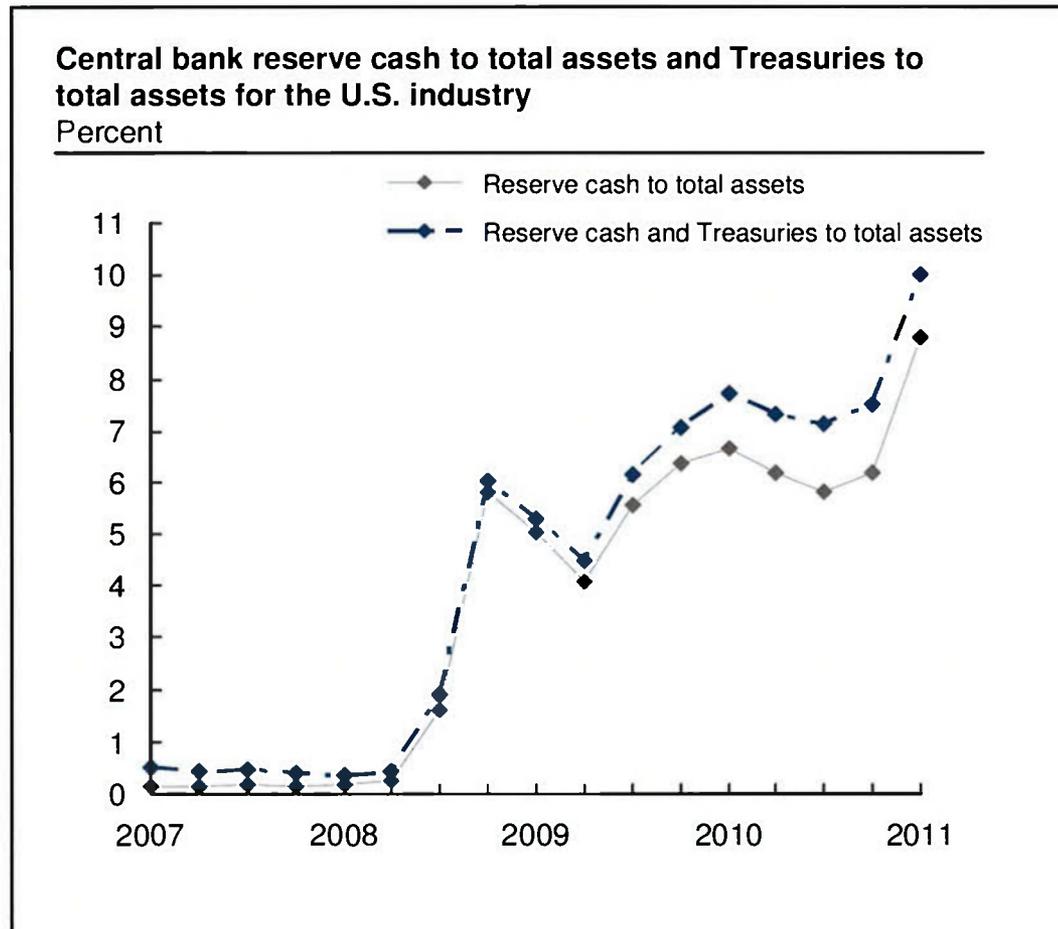
Inflows from loans maturing in < 30 days in sample

Bn



SOURCE: Q4 2009 and Q4 2010 QIS from banks submitting both datasets

Banks are holding 10% of total assets today as reserve cash and Treasuries, both of which increase the observed LCR

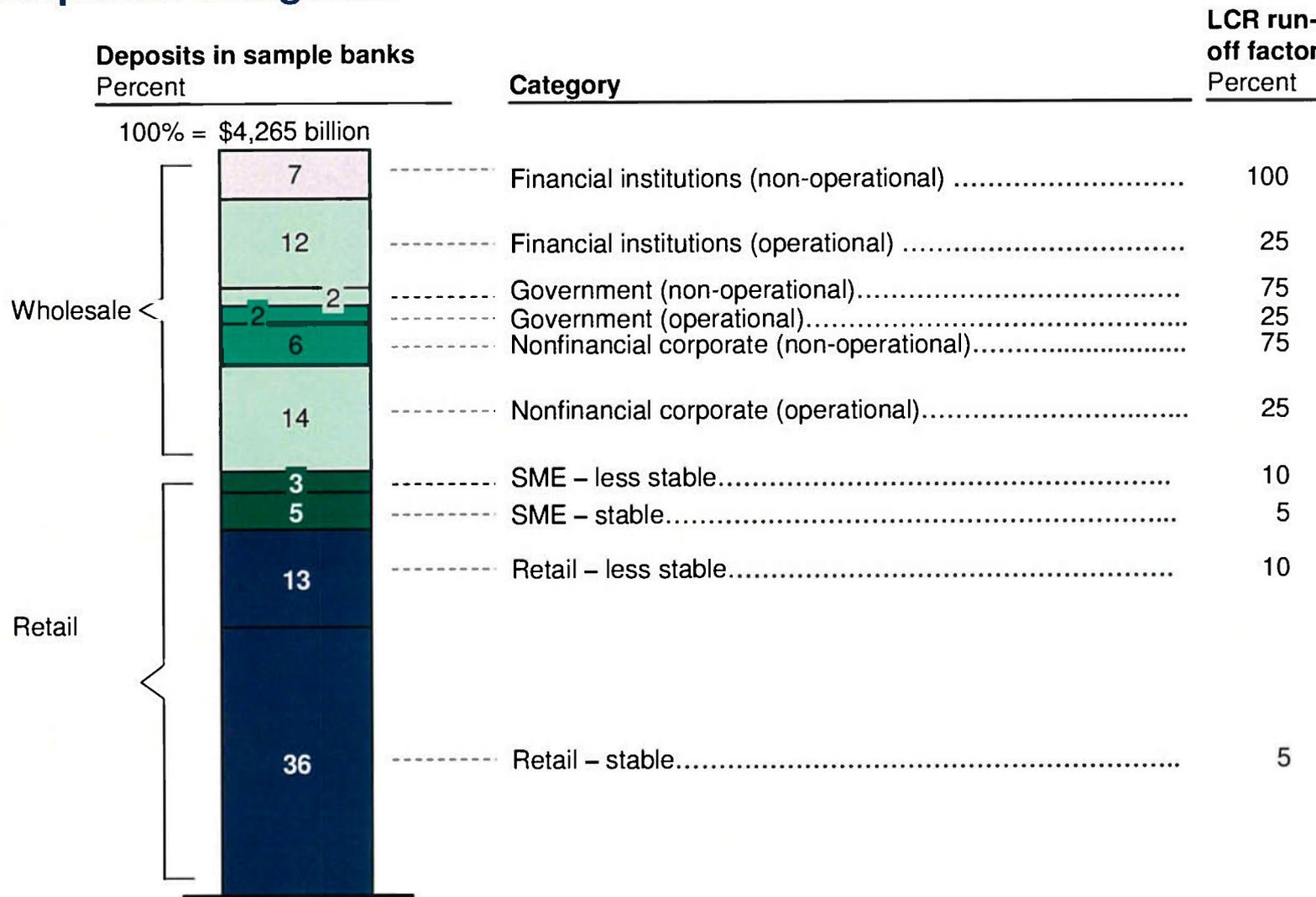


- Banks are holding almost 10% of total assets as reserve cash and Treasuries
- If the LCR were computed using the Q1'2007 ratio of cash and Treasuries to total bank assets, the LCR could decline from 60% to approximately 40%, and the liquid asset buffer shortfall could increase to \$1.8 Tr

Contents

- Current industry LCR
- **Calibration**
 - **Deposits**
 - Credit and liquidity lines
 - Diversification
- Other liquidity sources
- Overall sensitivity analysis
- Product and balance sheet impacts

Most deposits fall into retail and non-financial corporate categories

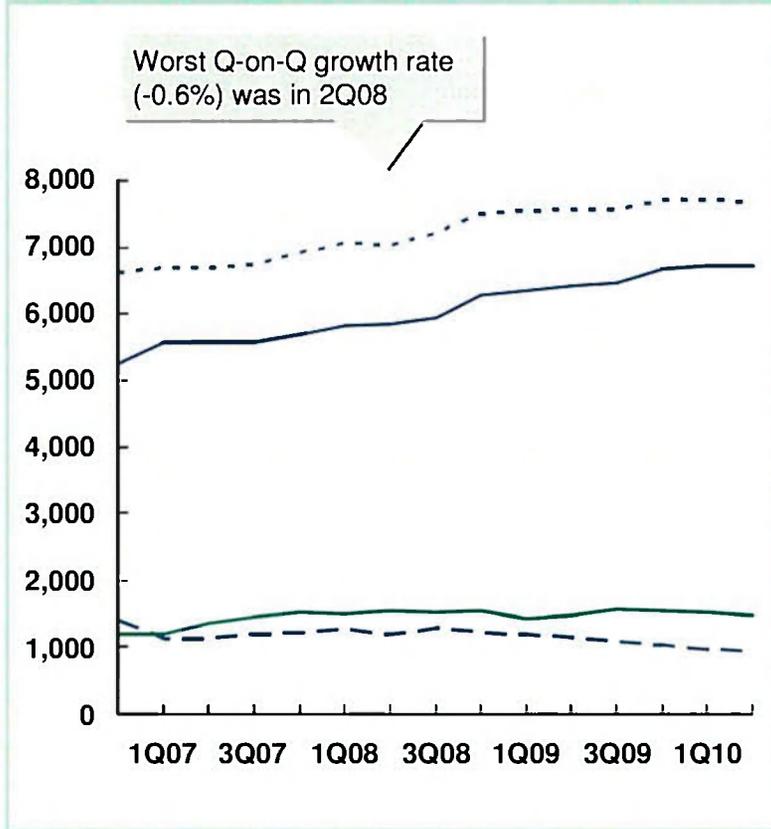


1 Sample banks have a lower proportion of retail deposits relative to industry mix

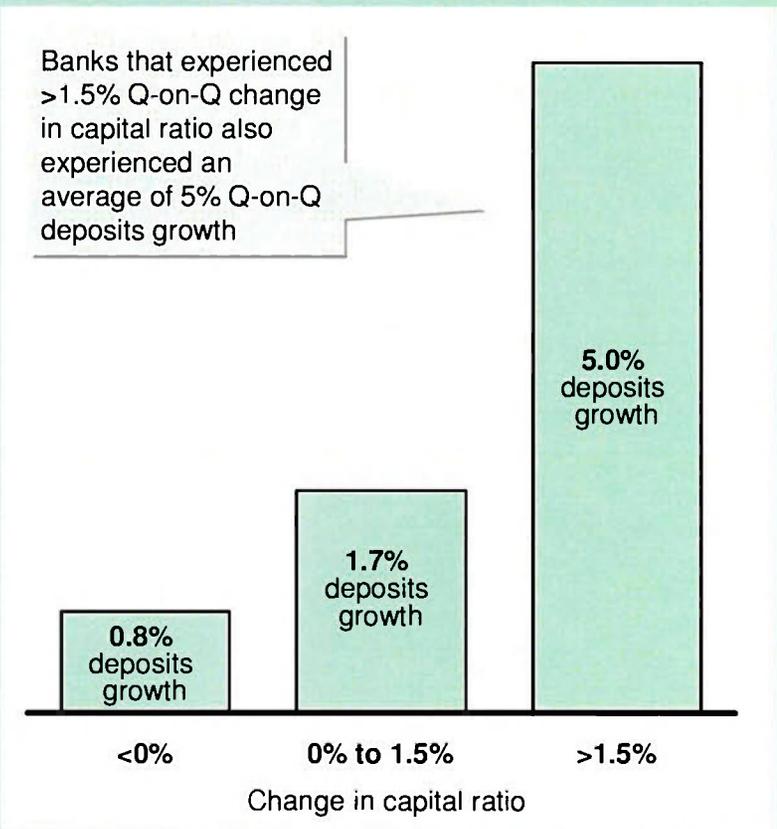
SOURCE: TCH member banks' QIS data Q4 2010; BIS

In aggregate, deposits continued to increase during the crisis, especially for stronger banks

Deposits in US commercial banks and thrifts
\$ Billions



Change in deposits vs. change in capital ratio²
Percent

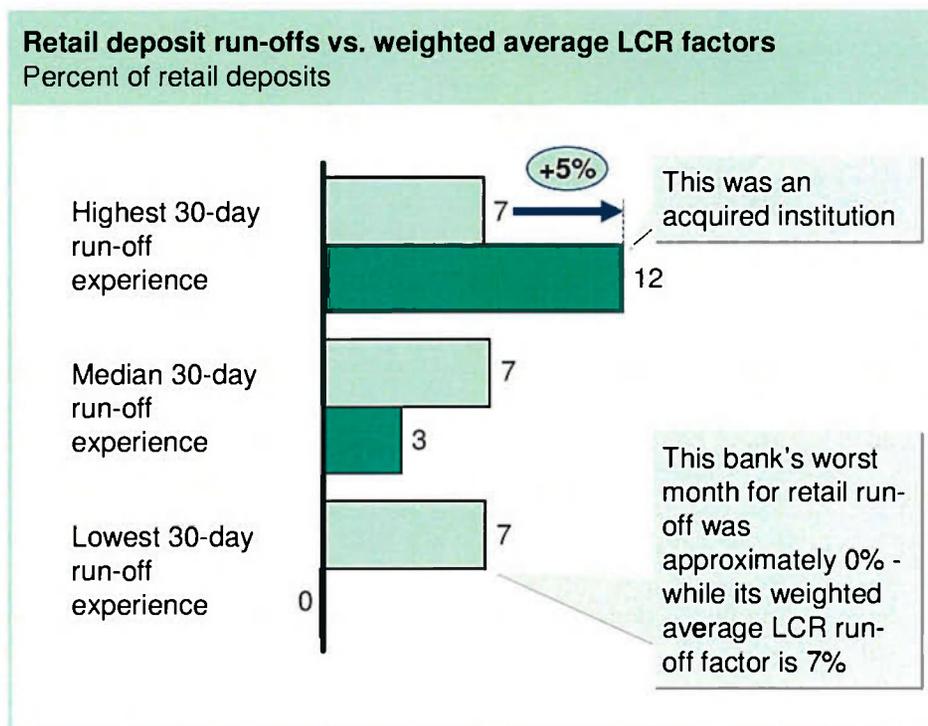


¹ Foreign deposits includes both wholesale and retail deposits

² Analysis shows the Q-on-Q change in deposits vs. Q-on-Q change in capital ratio (T1C/RWA). Analysis based on 8 banks' data, including 2 acquired banks, between 1Q07 and 2Q10

LCR factors for retail deposits exceed the median industry experience but are below the worst-case run-off experience observed during the crisis

- Weighted average LCR run-off factor
- Observed



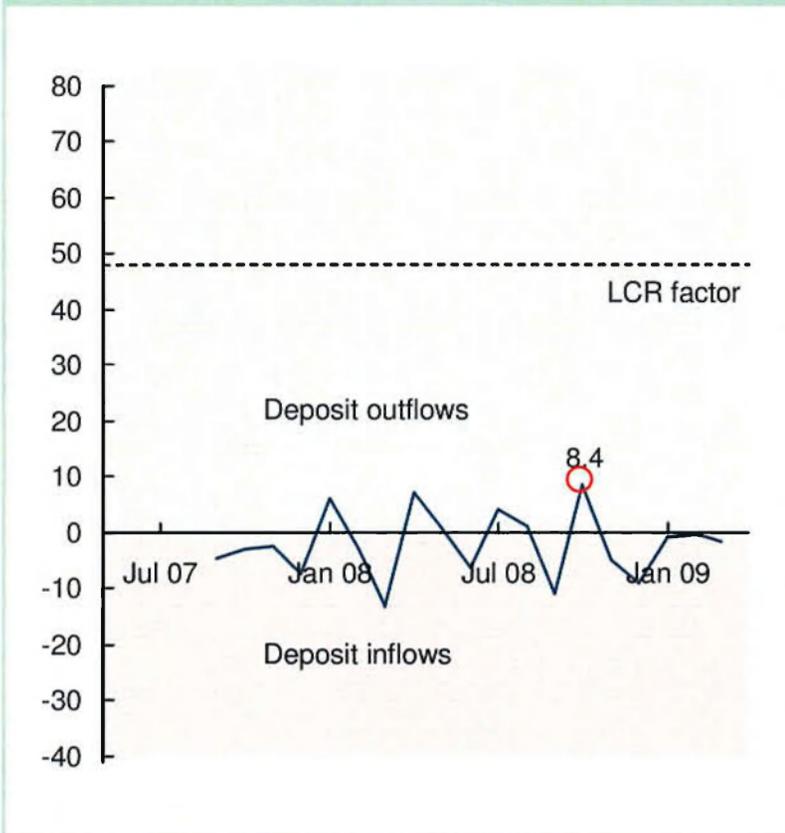
- On average, **most banks** experienced run-off that was **4% less than the weighted average LCR run-off factor**
- However, for the bank with **highest 30-day run-off experience**, actual run-off **exceeded average LCR factor by 5%**
- Based on data from **11 banks; including 3 acquired institutions**

- Because institutions have not tracked retail deposit run-off by LCR categories, we calculated the weighted average LCR run-off factor for each institution for retail deposits in total, considering the mix of deposits by LCR category
- The chart shows, for retail deposits, the worst single month deposit run-off experience for the institution with the lowest, median, and highest 30-day run-off and shows these banks' weighted average LCR factors

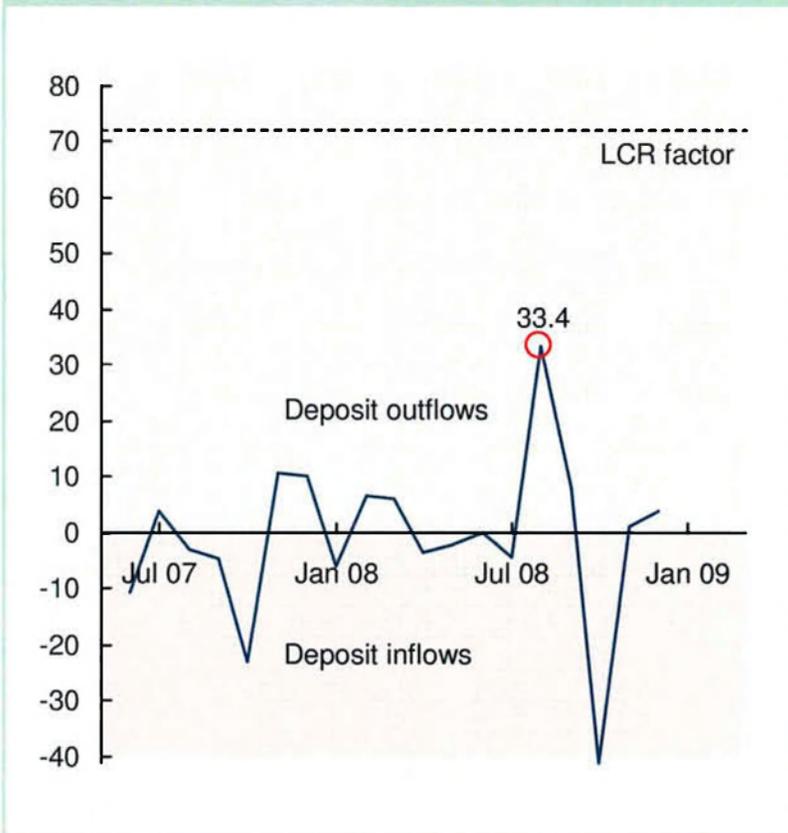
Both the median quartile and the worst banks' run-off rates observed during the crisis for wholesale deposits were below the LCR calibration

----- Basel-calibrated LCR factor¹
 ○ Highest 30-day run-off

Median quartile bank's 30-day wholesale deposits run-offs
 Percent



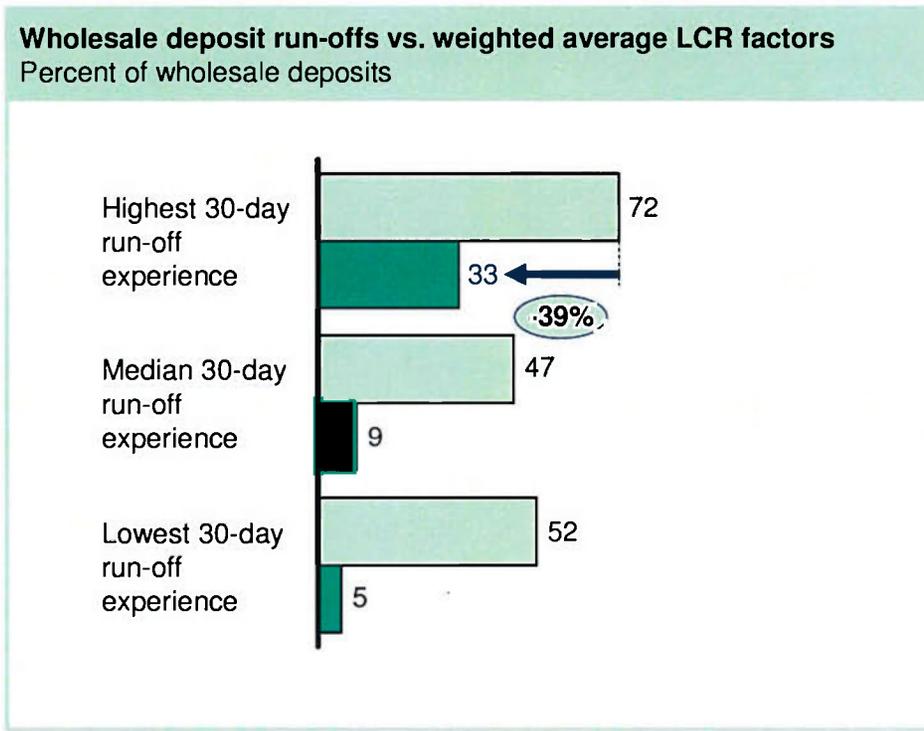
Worst bank's 30-day wholesale deposit run-offs
 Percent



¹ Basel-calibrated LCR factor is estimated as the weighted average LCR run-off for wholesale deposits based on each bank's product mix. This factor will vary between banks

LCR factors for wholesale deposits exceed even the worst-case industry run-off experience during the crisis

- Weighted average LCR run-off factor
- Observed
- Analyses on following pages

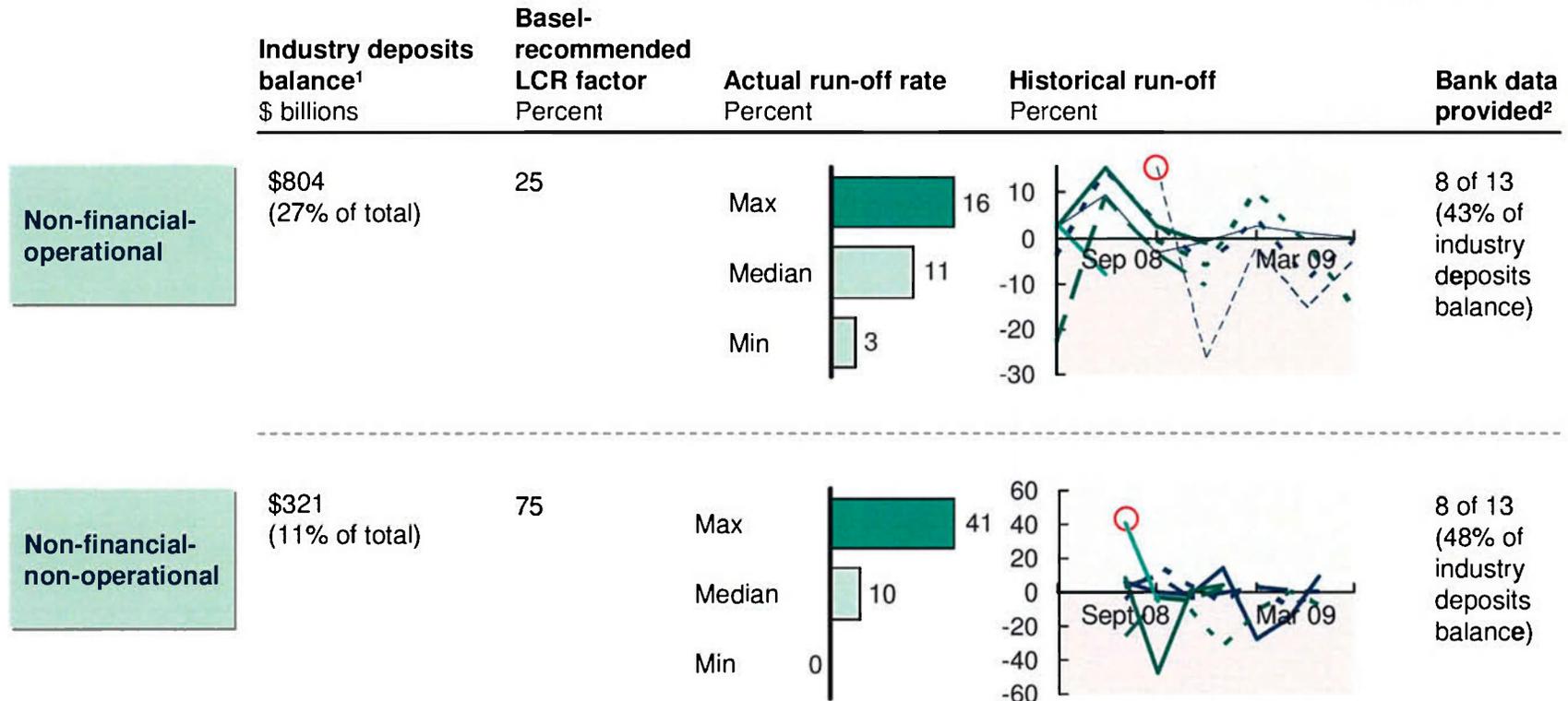


- **The highest run-off was ~40% below average LCR factor**
- **Based on data from 12 banks; including 2 acquired institutions**
- **Further analyses indicates that the Basel-recommended LCR factor is higher than actual worst experience for all 6 wholesale deposit categories**

- In this analysis, we calculated the weighted average LCR run-off factor for each institution for wholesale deposits in total, considering the mix of deposits by LCR category
- The chart shows, for wholesale deposits, the worst single month deposit run-off experience for the institution with the lowest, median, and highest 30-day run-off and shows these banks' weighted average LCR factors

The LCR factors for non-financial institution deposits are ~10-35 percentage points higher than the worst-case crisis experience

- Deposit outflows
- Deposit inflows
- Highest experienced 30-day run-off



¹ Deposits balance as a proportion of industry wholesale deposits; 9% of wholesale deposits are categorized “Other”

² Total number of banks excludes banks that are not material participants in these products

SOURCE: TCH member banks' QIS data; TCH member banks' supplemental data

The LCR factors for government deposits are ~10-15 percentage points higher than the worst-case crisis experience

- Deposit outflows
- Deposit inflows
- Highest experienced 30-day run-off

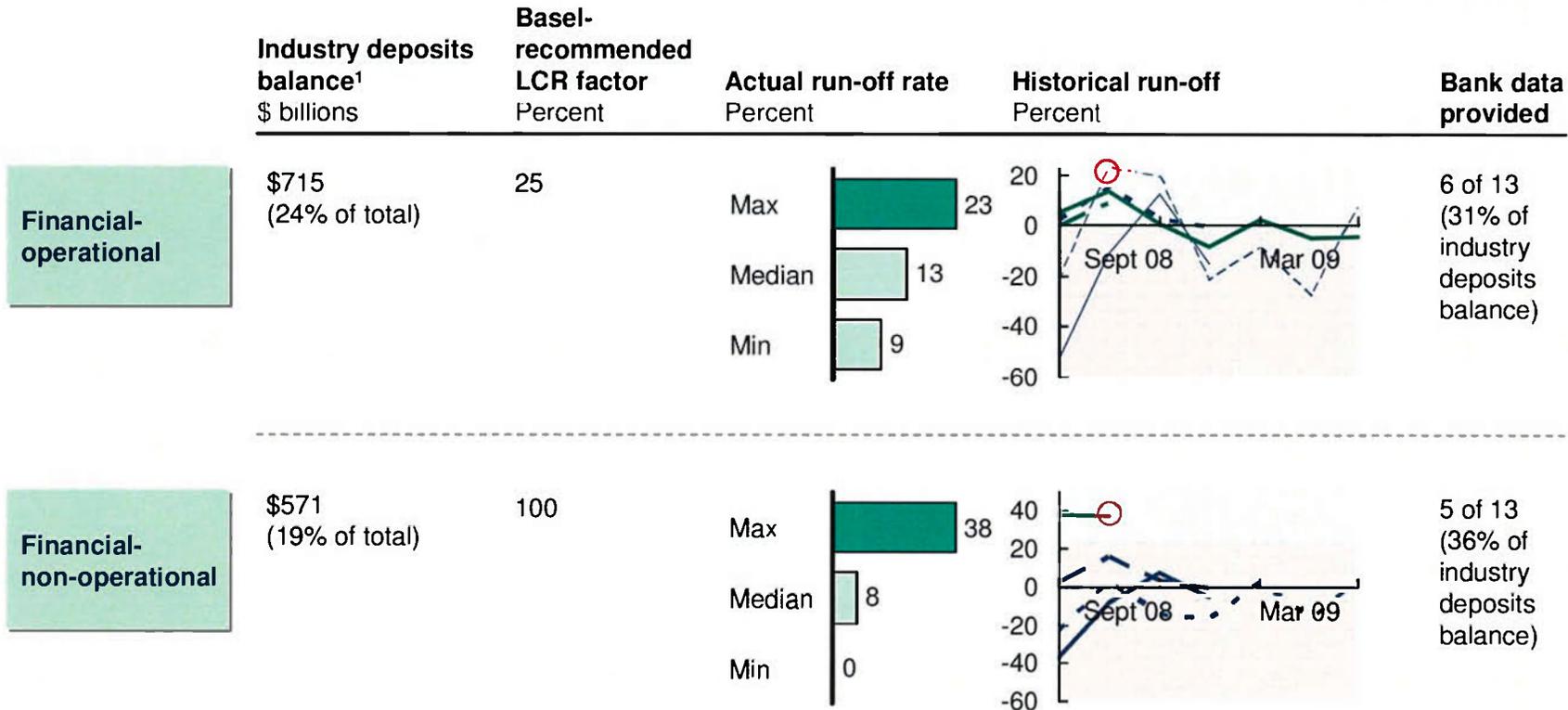
	Industry deposits balance ¹ \$ billions	Basel-recommended LCR factor Percent	Actual run-off rate Percent	Historical run-off Percent	Bank data provided ²
Government-operational	\$169 (6% of total)	25	Max 15 Median 5 Min -9		6 of 13 (55% of industry deposits balance)
Government-non-operational	\$102 (4% of total)	75	Max 60 Median 11 Min 4		7 of 13 (59% of industry deposits balance)

¹ Deposits balance as a proportion of industry wholesale deposits; 9% of wholesale deposits are categorized "Other"

² Total number of banks excludes banks that are not material participants in these products

The LCR factors for non-operational financial institution deposits are ~60 percentage points higher than the worst-case crisis experience

- Deposit outflows
- Deposit inflows
- Highest experienced 30-day run-off



1 Deposits balance as a proportion of industry wholesale deposits; 9% of wholesale deposits are categorized "Other"

2 Total number of banks excludes banks that are not material participants in these products

SOURCE: TCH member banks' QIS data; TCH member banks' supplemental data

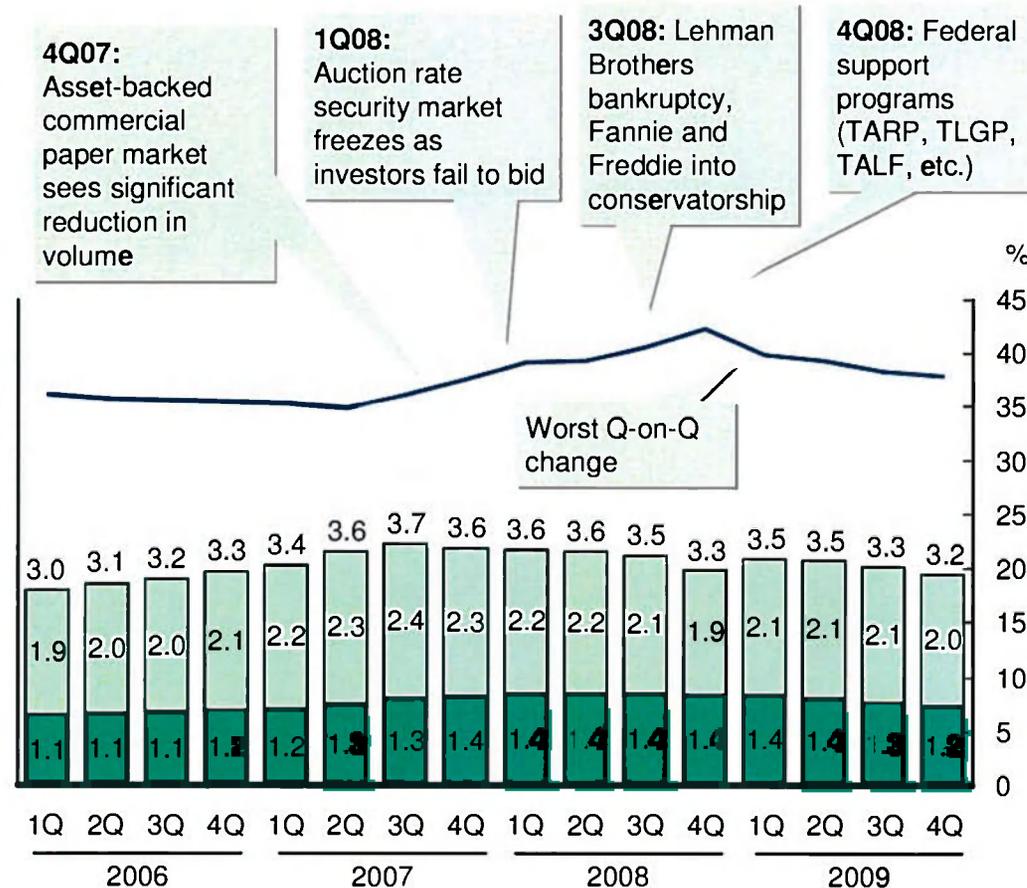
Contents

- Current industry LCR
- **Calibration**
 - Deposits
 - **Credit and liquidity lines**
 - Diversification
- Other liquidity sources
- Overall sensitivity analysis
- Product and balance sheet impacts

Industry-wide utilization increased by 6 percentage points over the crisis, primarily due to reductions in commitments

— Utilization¹
 □ Undrawn commitment
 ■ Outstandings

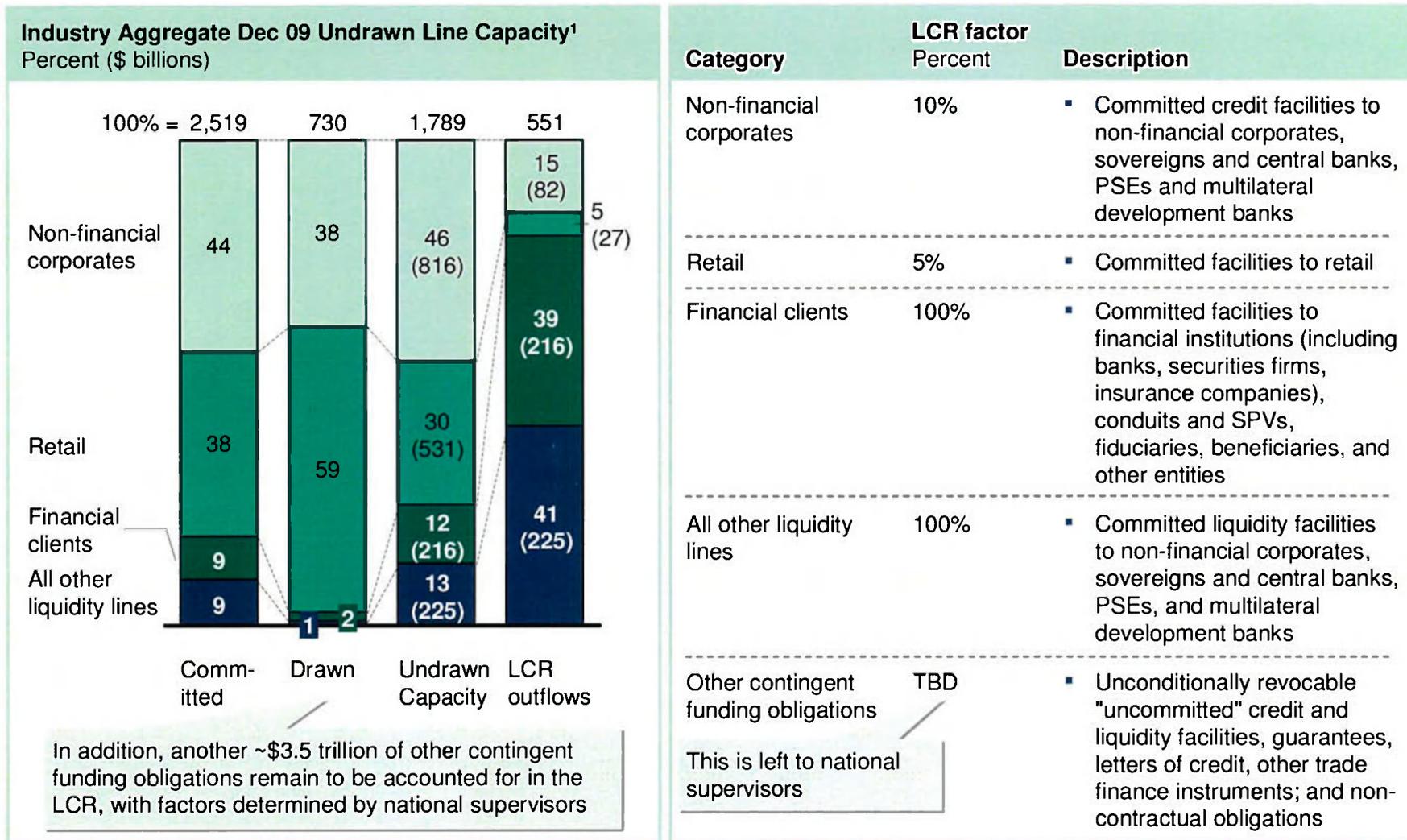
Utilization rates¹ of C&I lines and financial credit and liquidity lines
 \$ Trillion and Percent



- Over the period of 4Q07 – 4Q08, the 6 percentage point increase in line utilization was driven by a reduction in commitments
 - Undrawn commitments decreased by 16% or ~\$360 billion
 - Outstandings increased by 2% or ~\$27 billion
 - For the worst quarter (4Q08):
 - Undrawn commitments decreased by 9% or ~\$180 billion; and
 - Drawn amounts decreased by 2% or ~\$30 billion
 - “Utilization increases through the crisis were driven largely by aggressive reductions in committed lines”
- Commercial and industrial loans drove the bulk of the draw increase, contrasted with a very small decrease in loans to financial institutions

¹ Utilization rate is calculated as the ratio of outstandings vs. the sum of outstandings and undrawn commitments

Committed lines to financial clients and non-financial liquidity lines have the largest impact on the LCR

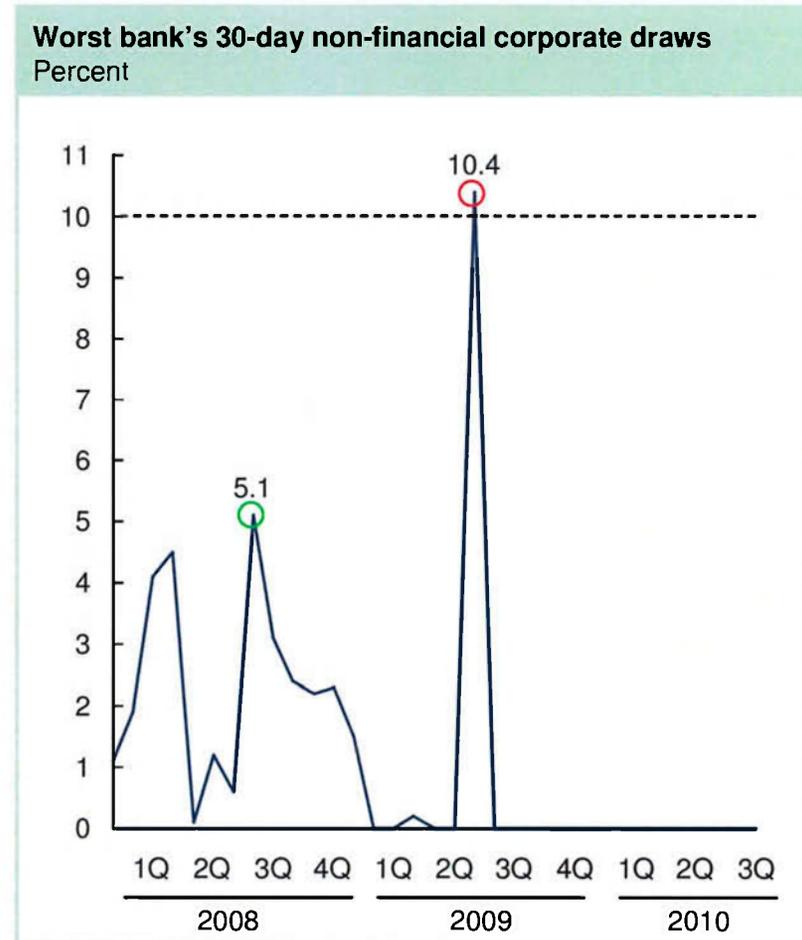
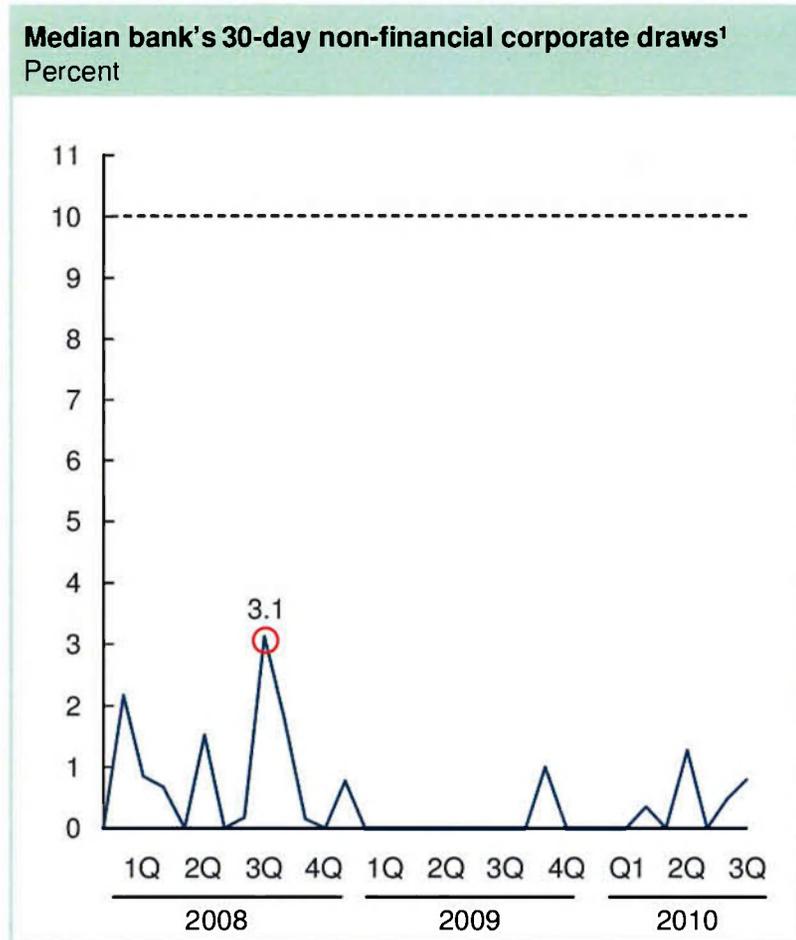


¹ Industry aggregate estimated by scaling up TCH member bank data by assets

SOURCE: TCH member banks' QIS data; TCH member banks' supplemental data; BIS

LCR calibration for corporate credit lines is roughly aligned with worst-case crisis experience

---- LCR calibration
 ○ Highest 30-day draw
 ○ 2nd Highest 30-day draw

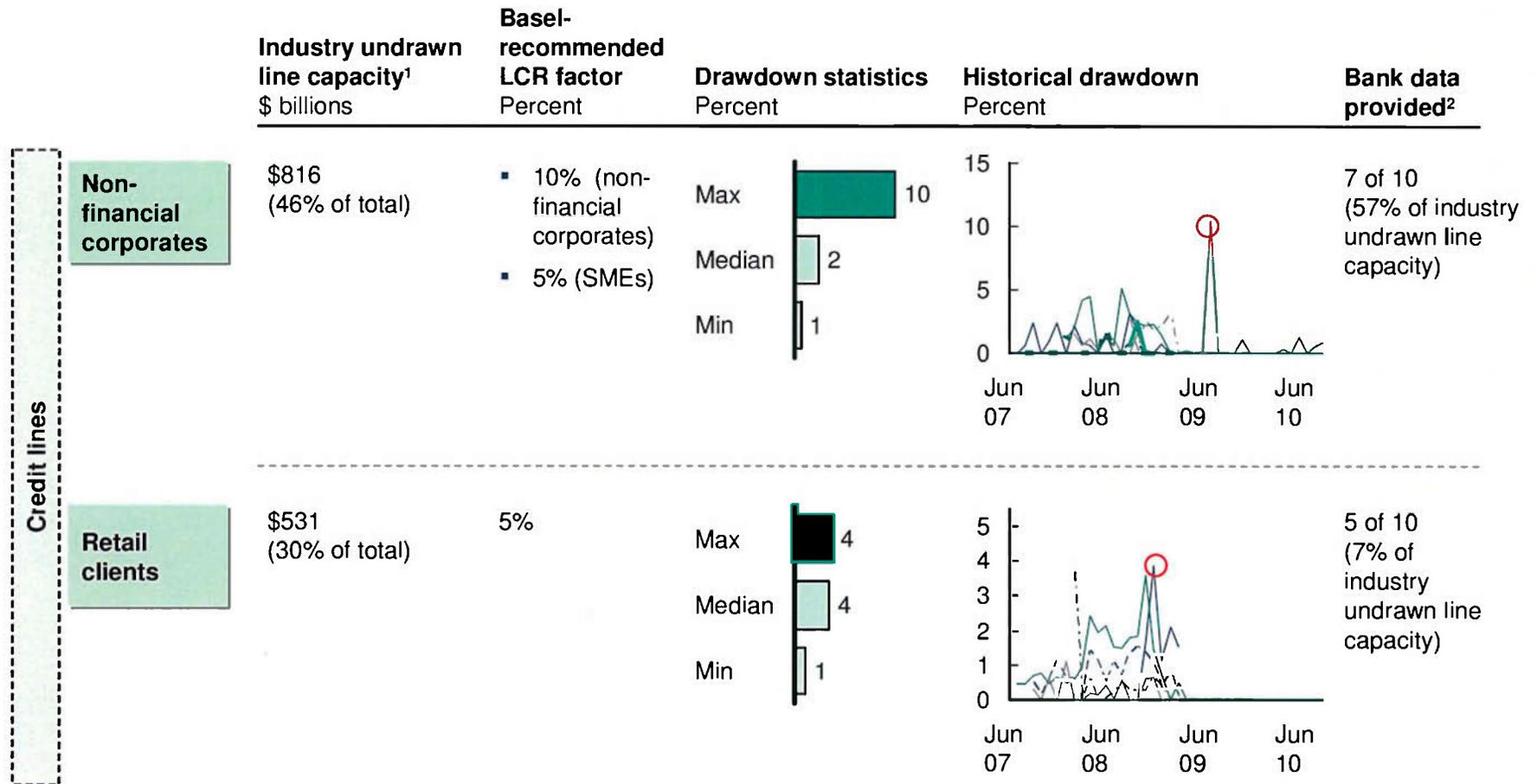


¹ In order to show a broader comparable time period, the bank representing the median bank is the bank that had above the median worst draws

SOURCE: TCH member banks' QIS data; TCH member banks' supplemental data

The LCR's calibrations for non-financial and retail credit lines are roughly aligned with historical drawdown rates during the crisis

○ Highest experienced 30-day draw



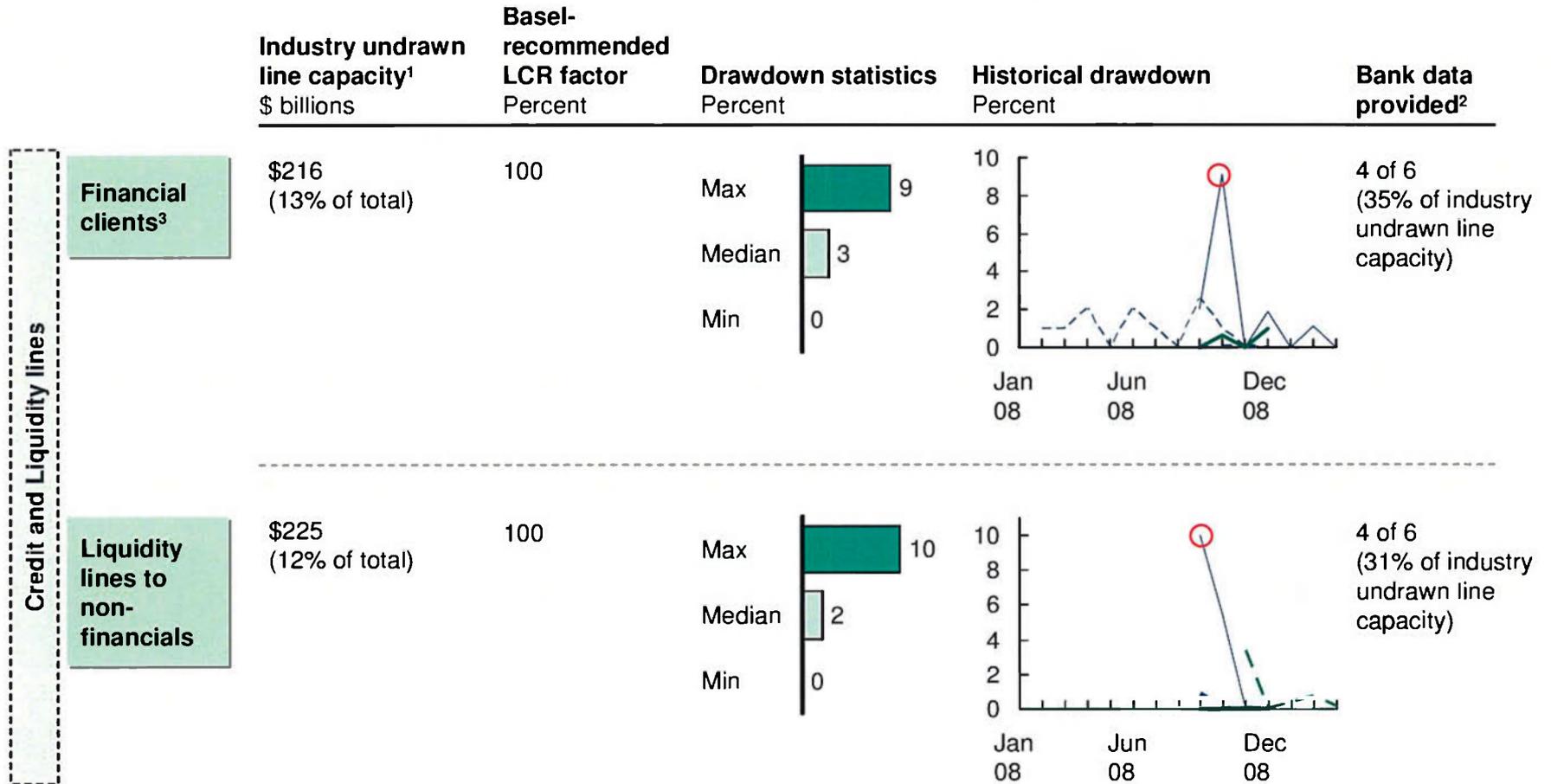
1 Undrawn line capacity as a proportion of total industry credit and liquidity undrawn capacity

2 Total number of banks excludes banks that are not material participants in these products

SOURCE: TCH member banks' QIS data; TCH member banks' supplemental data

The LCR's calibrations for lines to financials and liquidity lines are significantly higher than historical drawdown rates during the crisis

○ Highest experienced 30-day draw



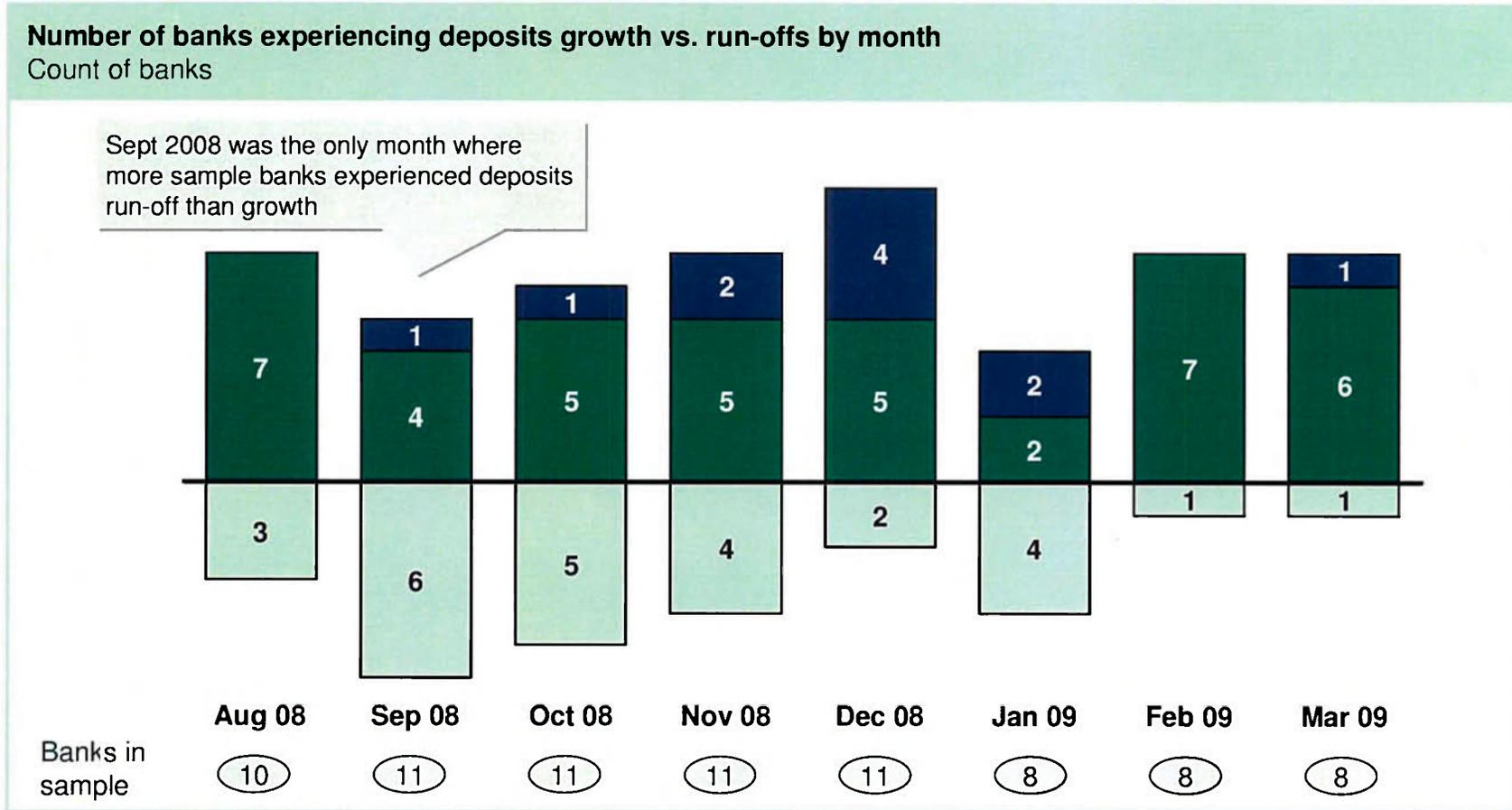
1 Undrawn line capacity as a proportion of total industry credit and liquidity undrawn capacity
 2 Total number of banks excludes banks that are not material participants in these products
 3 Includes all commitments to financial clients whether they are designated 'credit' or 'liquidity' lines

Contents

- Current industry LCR
- **Calibration**
 - Deposits
 - Credit and liquidity lines
 - **Diversification**
- Other liquidity sources
- Overall sensitivity analysis
- Product and balance sheet impacts

As some banks experienced deposit run-offs in a given month, other banks were experiencing deposit growth

- >5% change in deposits
- 0%-5% change in deposits
- <0% change in deposits



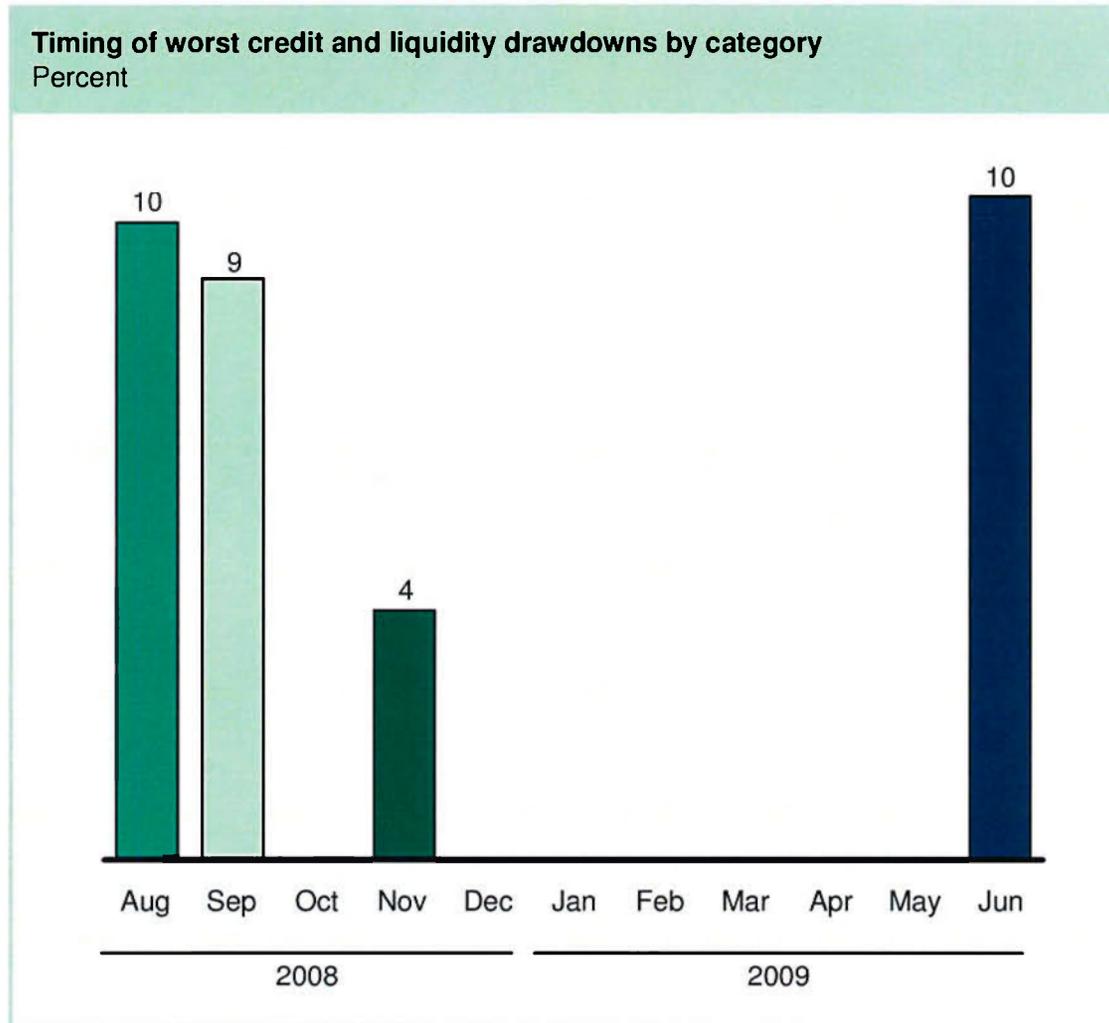
Worst deposit run-offs by category occurred in different months across different banks

■ Worst-of-the worst

Run-off by worst bank per wholesale deposits category Percent					
LCR category	Sep 08	Oct 08	Nov 08	Dec 08	Worst-of-the-worst
Financial operational	5	23	20	(1)	23
Financial non-operational	38	37	8	0	38
Government operational	5	15	4	(0)	15
Government non-operational	38	15	22	60	60
Non-financial operational	3	16	16	(1)	16
Non-financial non-operational	41	15	4	14	41
Weighted average	17	22	13	4	27

- The **worst run-off** across the 6 LCR categories occurred at **4 different banks**
 - **No bank** experienced the worst run-off in **more than 2 LCR** categories
- The **worst run-off in 2 LCR categories** occurred at an **acquired bank**

Similarly, worst drawdowns for each credit and liquidity line occurred in different months, at non-failed banks



- Lines to financial institutions
- Liquidity lines
- Lines to retail clients
- Lines to non-financial corporates

- **Line draws were driven by the needs of the customer, not the solvency position of the bank**
 - “We think our customers are concerned about their own business and **profits...they’re not going to borrow money they don’t need because they think the bank might not be around.**”
 - “I’ve never understood the theory underlying **why customers would draw on lines because a bank was failing.**”

Worst C&L drawdowns by category occurred in different months across different banks

Worst-of-the worst

Drawdowns by worst bank per credit and liquidity lines category Percent					
LCR category	Sep 08	Oct 08	Nov 08	Dec 08	Worst-of-the-worst
Retail credit lines	2	2	4	4	4
Non-financial corporate credit lines	3	3	3	2	10
Financial clients' lines	3	9	2	2	9
Other liquidity lines	10	5	3	~0	10
Weighted average	3.5	3.5	2.9	2.5	8.3

Worst-of-the-worst for non-financial corporate credit lines occurred in June 2009

- The worst drawdowns across 3 of the 4 LCR categories occurred at 1 bank
- None of the worst drawdowns occurred at acquired banks

5% below

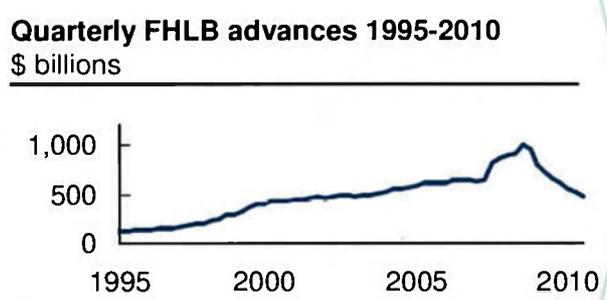
Contents

- Current industry LCR
- Calibration
- **Other liquidity sources**
 - **FHLBs**
 - L2 assets
- Overall sensitivity analysis
- Product and balance sheet impacts

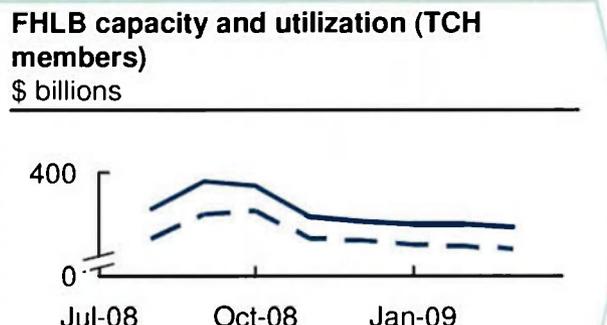
Banks drew on FHLB capacity during the crisis, and the LCR would improve if FHLB capacity were included

— Capacity
 - - Utilization

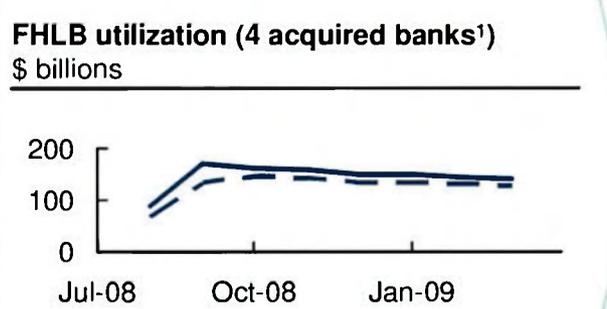
FHLB continued to provide liquidity even during the crisis



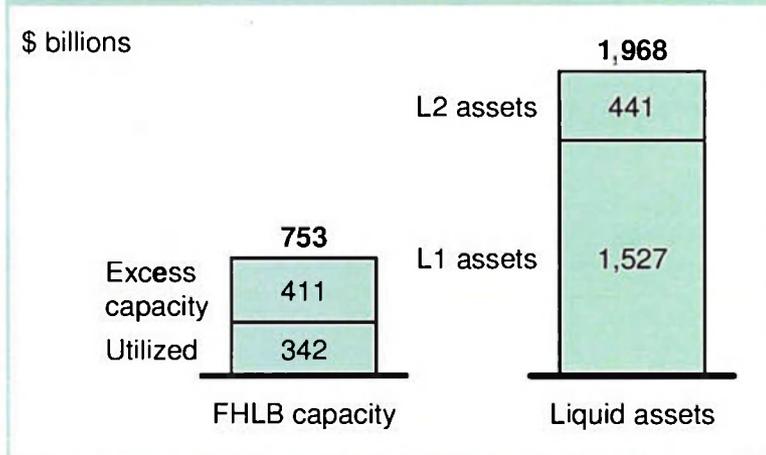
Capacity and utilization increased during the crisis while excess capacity remained relatively constant



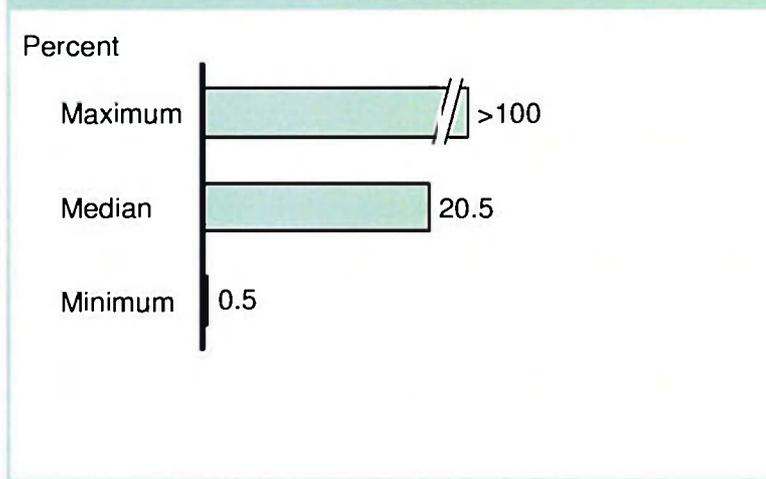
Acquired banks increasingly drew on FHLB advances during the crisis



Industry FHLB capacity and liquid assets (Dec 09)



Bank-by-bank LCR improvement post-FHLB

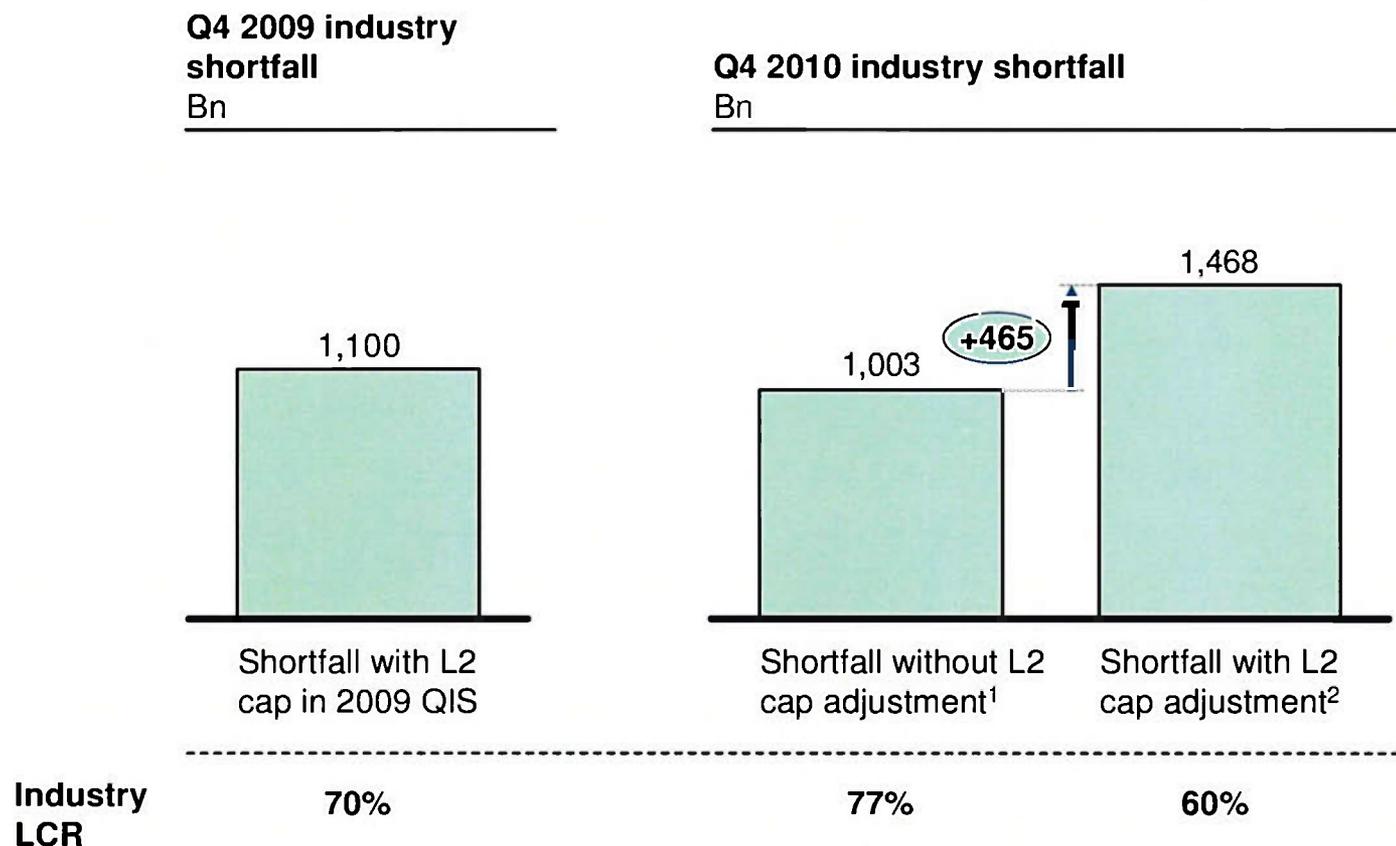


¹ Last available utilization rate for acquired banks was used for post-failure or post-acquisition dates
 SOURCE: Fed Flow of Funds; TCH member banks' supplemental data; TCH member bank interviews

Contents

- Current industry LCR
- Calibration
- **Other liquidity sources**
 - FHLBs
 - **L2 assets**
- Overall sensitivity analysis
- Product and balance sheet impacts

At the industry level, the L2 cap results in a ~\$0.5T increase in the liquid asset buffer shortfall



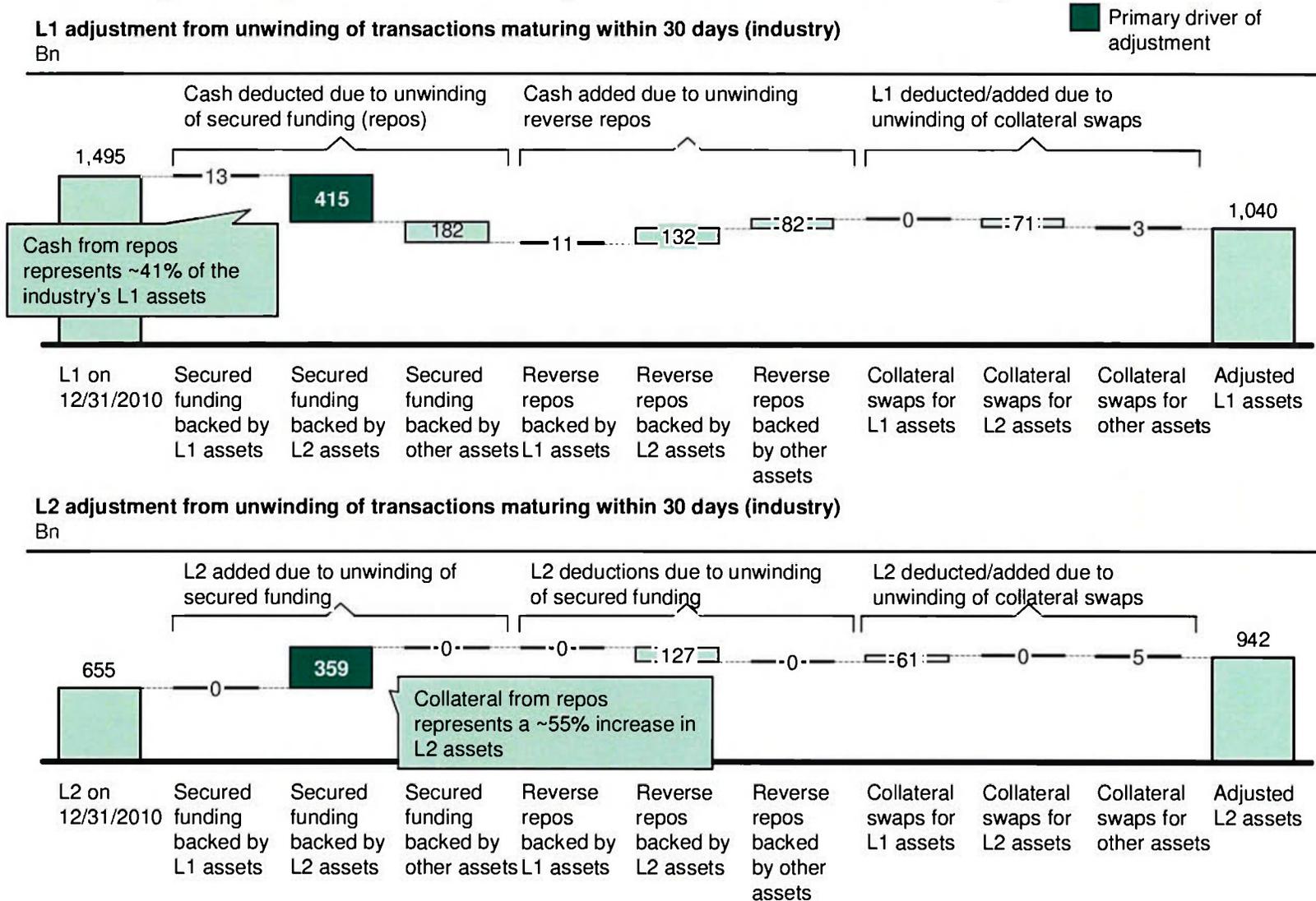
Note: Industry numbers were estimated by scaling up based on total assets

1 Shortfall without cap calculates liquid asset buffer without any cap on L2 assets

2 Shortfall with L2 cap allows for 40% maximum L2 assets if all secured funding, secured lending and collateral swaps were completely unwound

SOURCE: SNL Financial, Q4 2009 and Q4 2010 QIS from participating banks

The cap impact is driven by a decrease in L1 and an increase in L2 after unwinding of repos, reverse repos, and collateral swaps



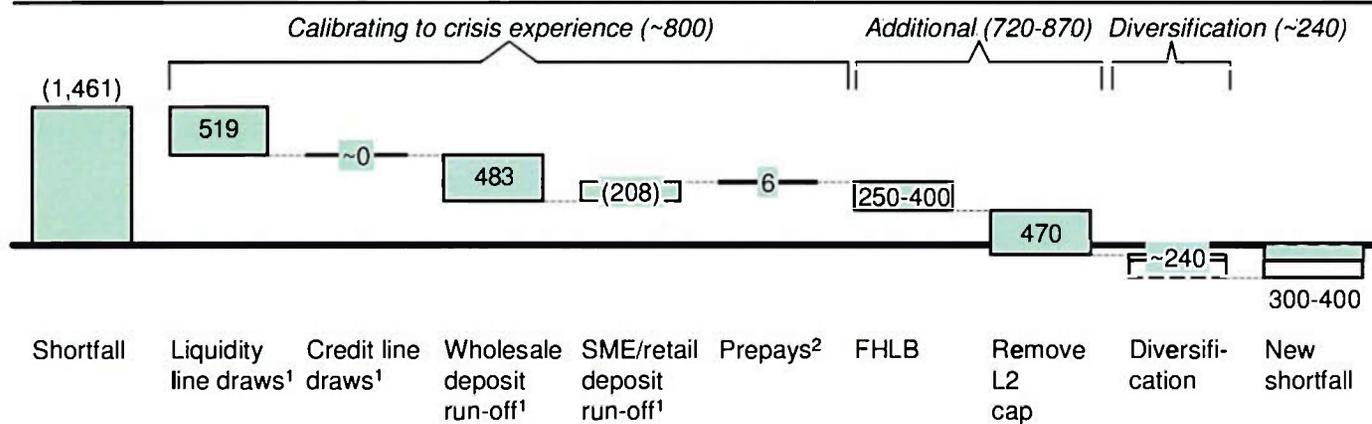
SOURCE: Q4 2009 and Q4 2010 QIS from participating banks

Contents

- Current industry LCR
- Calibration
- Other liquidity sources
- **Overall sensitivity analysis**
- Product and balance sheet impacts

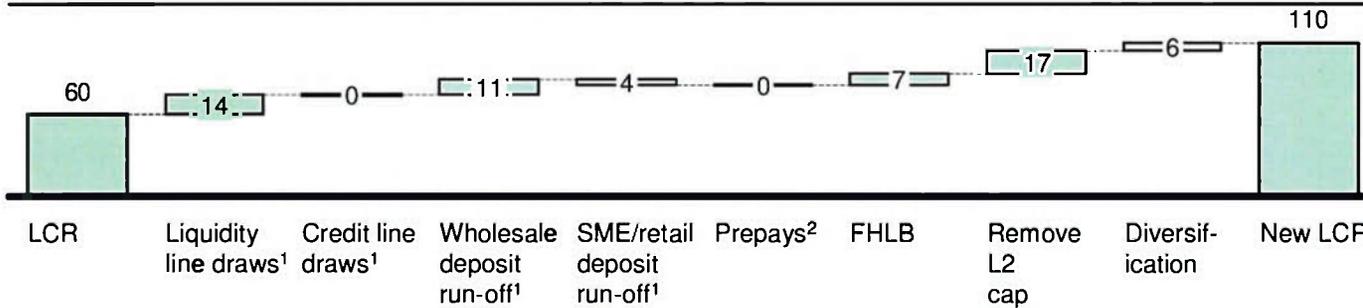
Sensitivity analysis of LCR shortfall

U.S. industry liquid asset buffer shortfall (as of December 31, 2010)
\$ billions



▪ The shortfall waterfall tracks the shortfall reduction for the banks in our 12/31/10 QIS sample that had shortfalls, scaled up by asset size to an industry level

Weighted average LCR ratio (as of December 31, 2010) of 9 TCH banks
Percent



1 Impact calculated by applying worst-case behavior per LCR category from any bank to all banks in place of LCR-assigned factors

2 Impact calculated by incorporating adjustment for all banks based on actual holdings/ average behavior

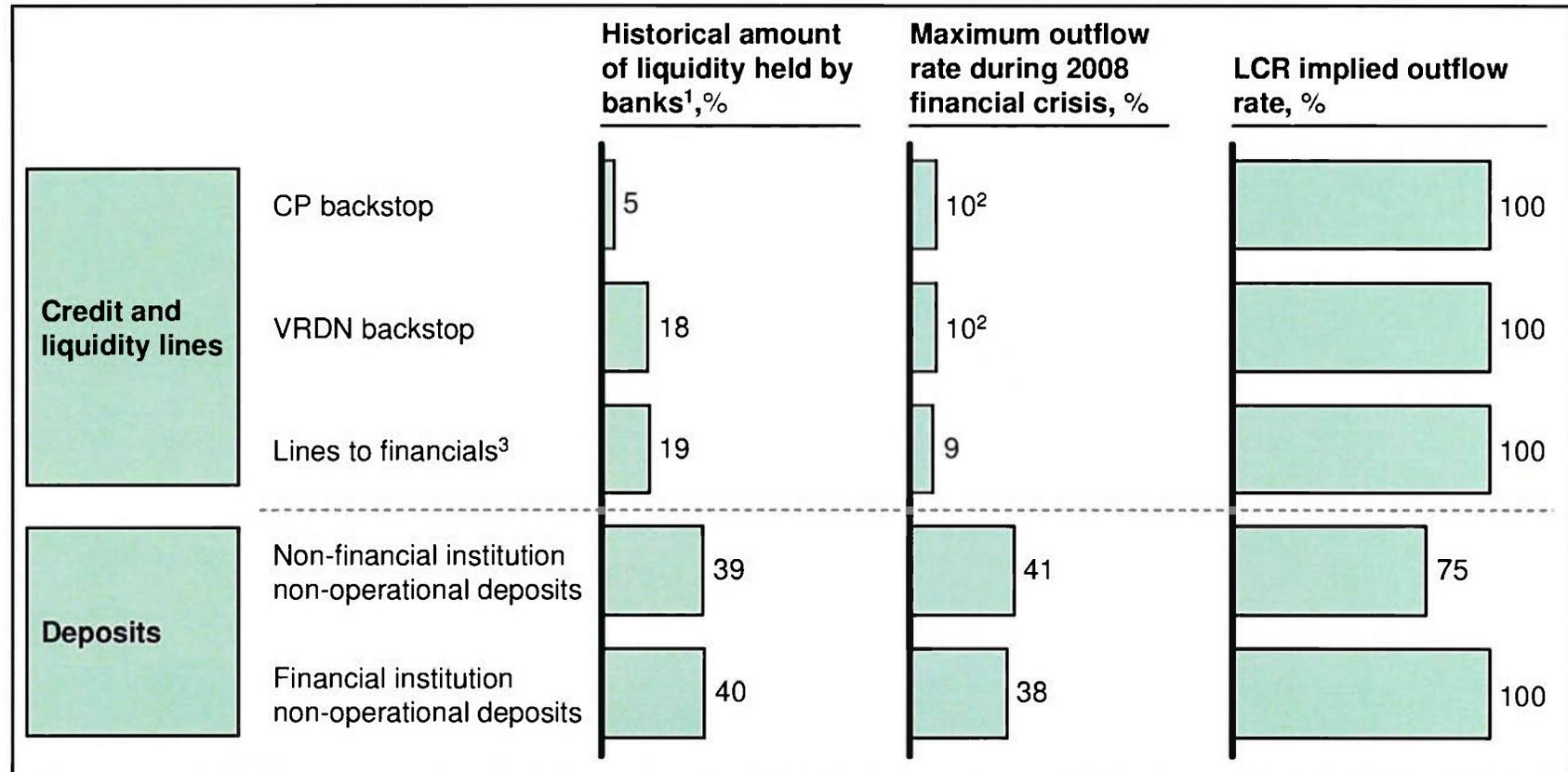
Contents

- Current industry LCR
- Calibration
- Other liquidity sources
- Overall sensitivity analysis
- **Product and balance sheet impacts**
 - Bank product impact
 - Changes to bank balance sheets

Summary of LCR liquidity cost impact to products analyzed in this study

	Product	Typical customers and investors
Higher liquidity cost impact	▪ VRDN backstop	▪ Municipalities, money market funds
	▪ CP backstop	▪ CP issuers (large corporates), money market funds, other investors
	▪ Non-bank FI lines	▪ Sellers of assets (e.g., auto finance, credit card companies), money market funds, consumers
	▪ Non-operational non-FI deposits	▪ Corporate customers
	▪ Non-operational FI deposits	▪ Pension funds, insurance companies, money market funds, other financial institutions
Moderate liquidity cost impact	▪ FI DDA	▪ Pension funds, insurance companies, money market funds, other financial institutions
	▪ Municipal DDA	▪ Municipalities
Lower liquidity cost impact	▪ Corporate DDA	▪ Corporates
	▪ SME credit line	▪ SMEs
	▪ HELOC	▪ Consumers
	▪ Corporate credit BBB-rated and A- rated	▪ Corporates
	▪ Corporate sweep account	▪ Corporates
	▪ Municipal CD	▪ Municipalities
	▪ FI sweep account	▪ Pension funds, insurance companies, money market funds, other financial institutions
	▪ Consumer credit cards	▪ Consumers

LCR factors for liquidity lines and non-operational deposits are higher than banks' internal models and historical values from the crisis



1 Simple averages used from banks who provided this data

2 Using data for non-financial institution liquidity line draws, i.e., combines both CP and VRDN backstop draws

3 Includes all committed facilities to financial clients, whether designated as credit or liquidity

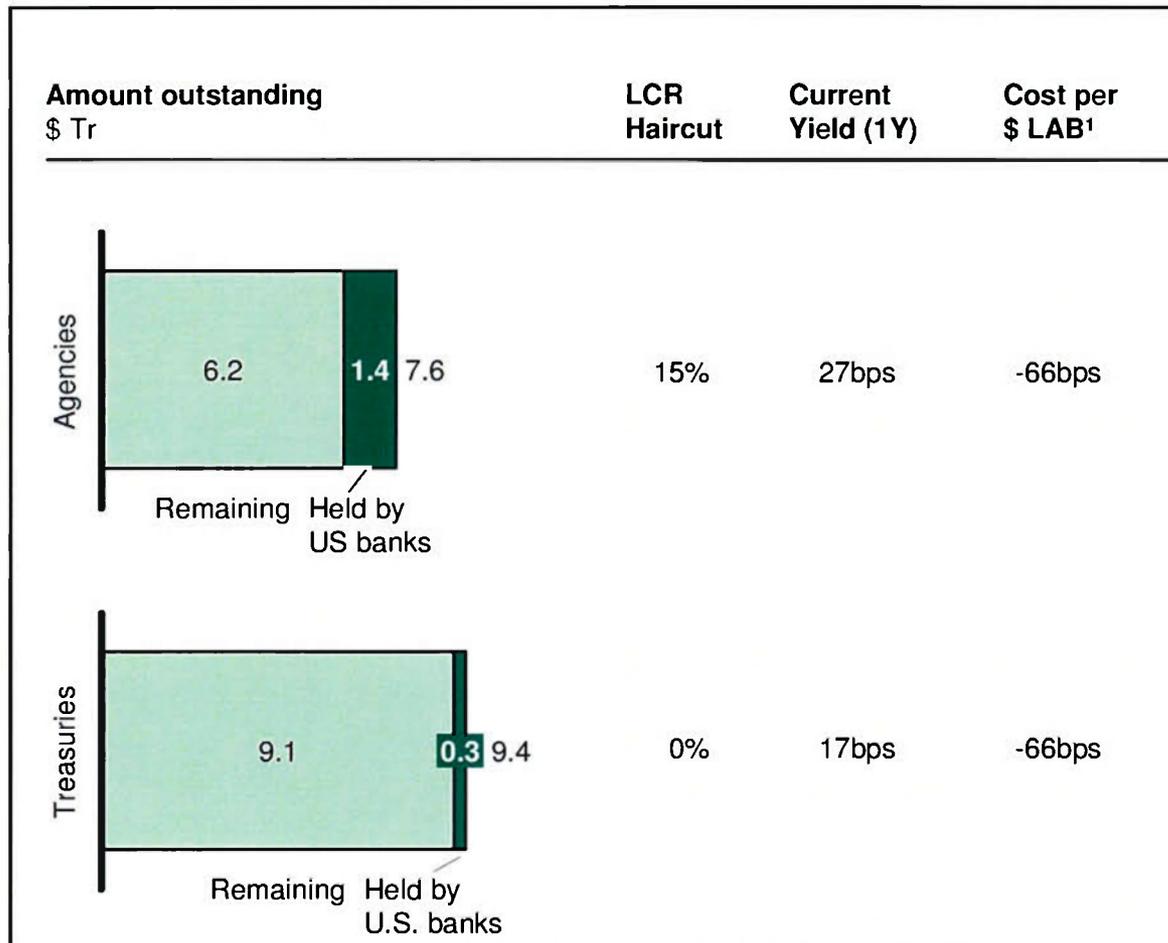
SOURCE: TCH member banks' supplemental data, BCBS Basel III liquidity framework

There are a range of approaches open to banks for meeting the LCR

		Implication for markets	Impact for bank
①	Increase liquid asset buffer	Changing mix of L1/L2	<ul style="list-style-type: none"> Decline in NIMs for industry Increased volatility in Accumulated Other Comprehensive Income, leading to additional capital cushion <ul style="list-style-type: none"> Securities held as Available for Sale may increase volatility of capital and require additional cushion
		Increase in liquid asset buffer	
②	Decrease outflows	Increase term of lending and secured funding	<ul style="list-style-type: none"> Increased long-term bank issuance in capital markets
		Expand retail and operational deposit base	<ul style="list-style-type: none"> Increased emphasis on operational deposits with decreased emphasis on non-operational deposits
		Decrease commitments with 100% draw-down	<ul style="list-style-type: none"> Reduced availability of facilities that support liquidity

SOURCE: TCH member bank treasurer interviews

1 Banks may reduce their holdings of Agencies due to the haircut and cap treatment of L2 assets



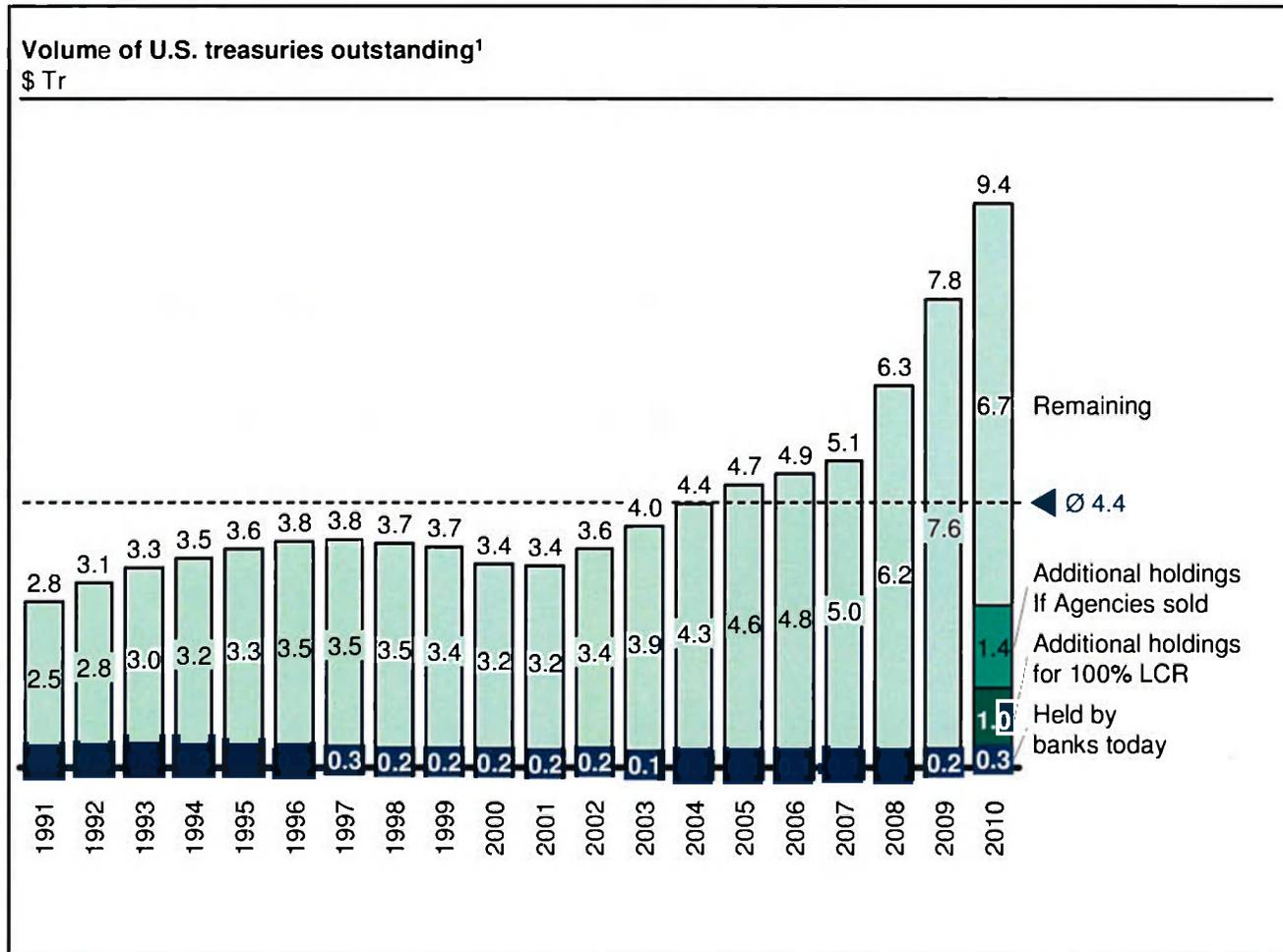
- **Based on current yields, banks have little incentive to hold agencies after the LCR:**
 - The 15% haircut on Agencies decreases their utility for the liquid asset buffer
 - The L2 cap further disadvantages Agencies
 - Depending on a bank's liquid asset buffer composition, selling Agencies and buying Treasuries may be necessary to comply with LCR requirements

- **However, some banks may continue to hold some Agencies:**
 - If yield spreads between agencies and Treasuries widen, Agencies could become more attractive despite the L2 cap and haircut
 - Banks with lower cost of funds will be less impacted by the haircut and might be able to take advantage of higher agency yields

¹ Cost per \$LAB is calculated by (Asset Yield – Cost of Funds) / (100% - Haircut), cost of funds set at 83 bps

SOURCE: Federal Reserve Flow of Funds, BCBS liquidity framework, Bloomberg (yields on Aug 3, 2011)

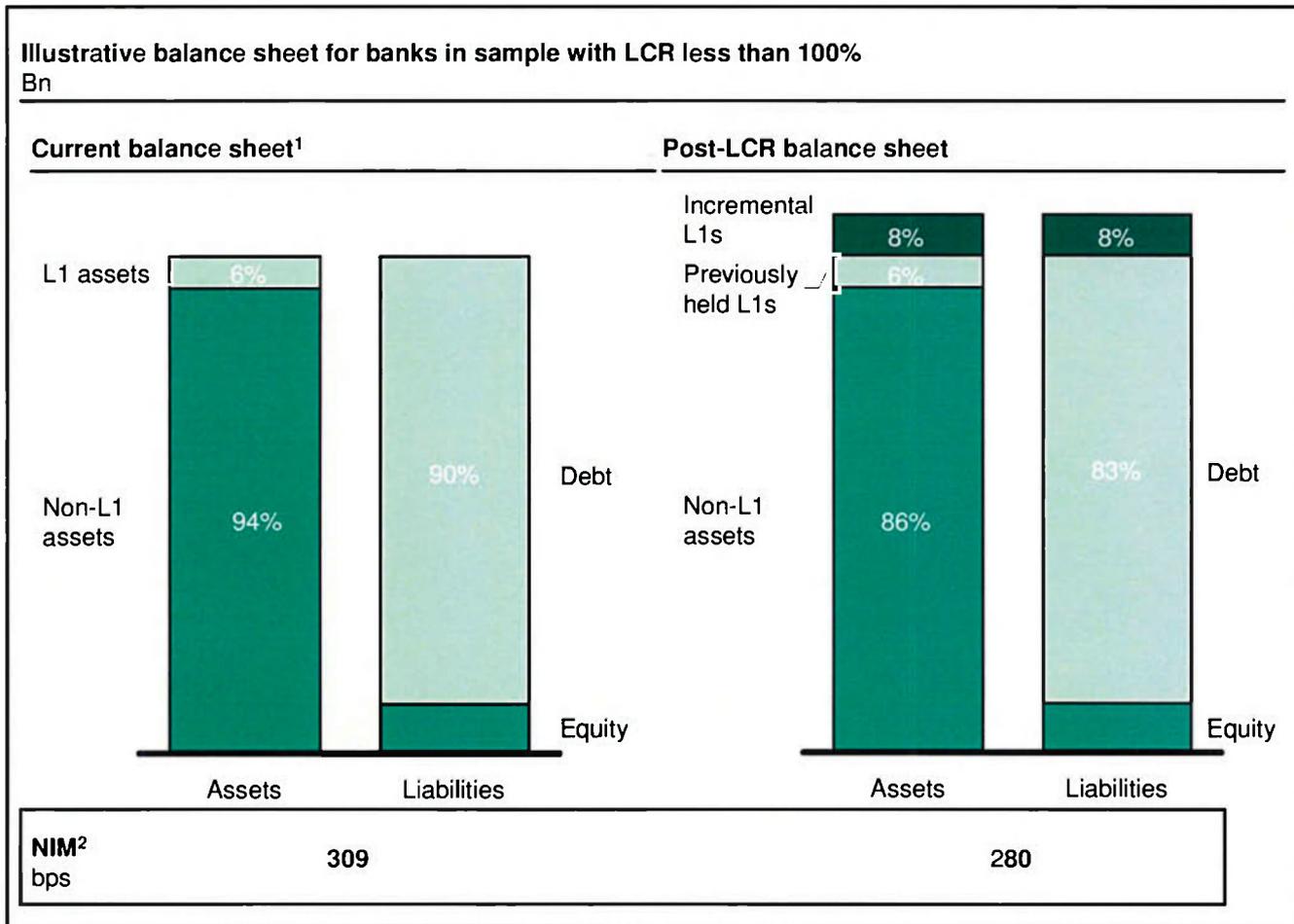
1 Banks would need to hold ~14% of total U.S. Treasuries outstanding to meet the LCR solely through increasing Treasury holdings



- To meet the LCR shortfall by buying L1 assets, banks would need to **increase their Treasury holdings from 3.2% of total outstanding treasuries to 14.0%**
- If banks determine that holding agencies are less attractive than Treasuries after the LCR, **banks could hold up to a maximum of 28.0% of total outstanding Treasuries if they start exchanging their Agency holdings for Treasuries**
- If the volume of Treasury outstandings return to more historical levels (e.g., \$4-5Tr), banks could hold an even larger share of US government debt

¹ Money market funds hold \$335.4 bn of treasuries; non-money market mutual funds hold \$297.4 bn of treasuries

1 If banks expanded their balance sheet to meet the LCR, NIMs would decline by ~30 bps for banks in the sample



- Banks have indicated they are likely to meet the LCR by growing the balance sheet
- Assuming this expansion, NII would decline by \$4.3 bn and NIM would decline by ~30 bps

1 Includes sample banks with LCR < 100%, based on Q4 2010 QIS submission

2 Post-LCR calculation assumes a 79 bps cost of carry on L1 assets, calculated as the spread to treasuries of multiple issues of term bank debt (3m, 6m, 1yr, 3yr, 5yr and 10yr); Nil changes from \$203 bn to \$199 bn

Studies – Tab 3



**The Basel III Liquidity Framework: Impacts and
Recommendations**

November 2, 2011

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Introduction

The Clearing House Association L.L.C. (The Clearing House), an association of major commercial banks,¹ and our members are committed to effective liquidity-risk management and strongly support efforts by the Basel Committee on Banking Supervision (Basel Committee or BCBS), the Financial Stability Board (FSB) and U.S. regulators to improve both regulatory standards and banking-industry practice in this area. The cornerstone of the regulatory community's efforts to enhance liquidity-risk management is the Basel Committee's final liquidity framework issued in December 2010 (Basel III liquidity framework).²

The Clearing House has closely followed the development of the Basel liquidity framework, submitting comment letters both to the Basel Committee and the U.S. regulators.³ We have made substantial effort to inform our views with quantitative analysis. We have prepared and shared with U.S. regulators as well as the BCBS several quantitative analyses of the impact of Basel III, both liquidity and capital, on U.S. banks. We are enclosing with this white paper an analysis entitled Assessing the Liquidity Coverage Ratio (the Liquidity Study).⁴

Although this white paper reflects our views as to the strengths and deficiencies of the Basel III liquidity framework as reflected in comment letters and the aforementioned studies, our objective in preparing this white paper, as well as the Liquidity Study, is broader – namely, to present an assessment of certain financial-market, public-policy and borrower implications of the Basel III liquidity framework and address more generally improvements in approaches to liquidity-risk management that banks have implemented since the onset of the financial crisis, focusing on the liquidity coverage ratio (LCR), which is the 30-day liquidity measure, in that framework.⁵

¹ Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

² BCBS, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 16, 2010), available at <http://www.bis.org/publ/bcbs188.pdf>.

³ Letter from The Clearing House to the BCBS (April 16, 2010); Letter from The Clearing House to Timothy F. Geithner, Secretary, U.S. Department of the Treasury, Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, John G. Walsh, Acting Comptroller of the Currency, John E. Bowman, Acting Director, Office of Thrift Supervision, and William C. Dudley, President, Federal Reserve Bank of New York (November 5, 2010). Both letters are available on The Clearing House's website at <http://www.theclearinghouse.org>.

⁴ Some of the results in the Liquidity Study are based on proprietary information and are thus provided only under confidential conditions to U.S. regulators, although conclusions drawn from that information are addressed in this white paper where possible and appropriate.

⁵ We are not addressing in any length in this white paper the other new liquidity measure included in the Basel III liquidity framework – the one-year liquidity measure referred to as the net stable funding ratio (NSFR). As

A. Executive Summary

Key observations and conclusions presented in this paper include the following:

- **The U.S. banking industry's estimated LCR shortfall has increased, from approximately \$1.1 trillion at December 2009 (representing a 70% industry-wide LCR) to approximately \$1.4 trillion at December 2010 (representing a 60% industry-wide LCR), both as reflected in the Liquidity Study.** The \$1.4 trillion estimated shortfall at December 2010 is a conservative, and likely understated, amount for two reasons. First, it reflects the liquidity shortfall necessary for U.S. banks to achieve a 100% LCR, as opposed to a higher LCR ratio (110%, for example) that we expect banks will manage to in order to avoid the supervisory and other consequences of an LCR deficiency. Second, the \$1.4 trillion is based upon bank balance sheets as of December 2010, which are atypical, reflecting for a variety of reasons disproportionate holdings of cash, cash equivalents and Treasury securities. Assuming banks ultimately manage to a 110% LCR, and based on a more normalized pre-crisis balance sheet with more loans and less cash, cash equivalents and Treasury securities, the differential could be as much as \$2.0 trillion. The enormity of this shortfall might suggest that U.S. banks are at undue liquidity risk. However, this is simply not the case. The shortfall is primarily driven by the specific prescriptions and quantitative calibrations of the Basel III framework that are neither based on sound empirical research nor supported by industry experience during the 2008 financial crisis. The mere fact that the U.S. banking industry's liquid asset shortfall under the LCR increased between year-end 2009 and 2010, while during the same period banks increased the proportion of their assets consisting of cash, cash equivalents, Treasury securities and other liquid assets and reduced their net cash outflows over a 30-day horizon, illustrates the importance of revisiting and revising elements of the LCR. See Section I of this white paper.
- **U.S. implementation of the LCR needs to take into account the unique circumstances of U.S. banks and U.S. banking, financial and housing markets.** Certain of the LCR's provisions produce unduly conservative measures of liquidity for U.S. banks, failing to accurately capture their liquidity positions. These fall into two areas. The first is calibrations – run-off factors for deposits and other liabilities and assumed draw rates on credit and liquidity facilities – that are much more conservative than the experience of even the most stressed banks during their most stressed periods during the financial crisis (i.e., worst case/worst period experience). The second is sources of liquidity that (i) are unduly limited because they are treated as Level 2 (L2) assets subject to a cap equal to 40% of Level 1 (L1) assets, notwithstanding that they may have better credit characteristics and were demonstrably more liquid throughout the financial crisis than some L1 assets (for example, Fannie Mae and Freddie Mac MBS and debentures as compared to certain European sovereign securities), or (ii) that are not even recognized as a source of liquidity (borrowing capacity with Federal Home Loan Banks (FHLBs), for example). See Section II of this white paper.

indicated in our comment letters referred to in footnote 2, while we believe that the LCR is a sensible measure similar to standards applied by most banks for management purposes, the NSFR is a much less common approach and, we believe, requires a more fundamental review and revision before serious consideration could be given to its implementation.

- **In implementing the LCR, international regulators must balance the desirability of uniform international standards against the need to accommodate unique considerations in specific jurisdictions.** It is already becoming apparent that regulators in jurisdictions other than the United States are measuring strict implementation against the need to craft a meaningful domestic liquidity-risk regulatory regime. At least pending refinement of the LCR through the observation period to better adapt to unique national circumstances, it is extremely important that the U.S. regulators show similar flexibility. See Section III of this white paper.
- **It is important that policy makers understand and study the impact of the Basel III liquidity framework on end-users – that is, bank customers.** The Liquidity Study analyzes five products that will be affected through price, structure or availability for customers. See Section IV.A of this white paper.
- **Prescriptive arithmetic liquidity ratios are not, taken alone, a sufficient response to the need for more robust liquidity risk management.** We strongly endorse the on-going efforts of banks, with the assistance of their regulators, to enhance their liquidity risk management practices. Formulaic ratios are just one tool and, inevitably, have deficiencies. In Section V, we describe our member banks' enhanced practices in this area.
- **Research addressing the assumptions underlying the Basel III liquidity framework is limited and inconclusive.** While economists at the Bank for International Settlements (BIS) have been unable to confidently qualify the impact of the liquidity rules, the BCBS has prescribed these rules using assumptions of uncertain validity. Academic and regulatory research makes it clear that even the Basel Committee and the BIS have significant qualms about the assumptions on which these rules are premised. See Section VI.C of this white paper.

Finally, we have also addressed in this white paper certain other problematic policy and market consequences of the framework's implementation (Section IV) and certain other qualitative considerations that bear upon the implementation of the Basel III framework (Section VI).

B. Recommendations

The Basel III liquidity framework is a work in progress that in many respects reflects substantial improvements in liquidity risk management and supervision but also has significant deficiencies. The framework itself, as initially released in December 2010, recognizes the work-in-progress aspect by providing for observation periods during which banks will report to supervisors but not be subject to the LCR or NSFR as binding constraints.⁶ The Liquidity Study and the related discussions in this white paper point to the major deficiencies in the LCR in its current form, at least as applied to U.S. banks, and frame our recommendations, as follows:

⁶ The observation period for the LCR runs through mid-2013, with the LCR to be introduced on January 1, 2015. The observation period for the NSFR runs through mid-2016, with the NSFR to be introduced as a minimum standard by January 1, 2018. The Basel III final framework recites that the BCBS "is prepared to make revisions to specific components of the standards if this proves necessary in light of the analyses conducted and the data collected during the observation period." *BCBS, Basel III liquidity framework, supra* note 2, at ¶197.

- **Reconciliation of consistent application across jurisdictions and recognition of unique national circumstances:** it is essential that final rules result in consistent application across jurisdictions in order to ensure a level playing field from a competitive perspective. Consistent application does not, however, require identical rules. At least pending refinement of the LCR through the observation period to better adapt to unique national circumstances, it is extremely important that the U.S. regulators show the same flexibility that regulators in other countries are showing. In order to ensure consistent application across jurisdictions, we believe that national regulators should expand the review process contemplated for a number of aspects of the Basel III liquidity and capital frameworks to ensure that deviations from “base” Basel III liquidity rules do not detract from the rigor and cross-border substantive equivalence of the Basel III liquidity rules but instead are justified based on the circumstances of particular countries.

- **Adjustments to reflect U.S. national circumstances:** four adjustments to the LCR should be made by U.S. regulators to reflect U.S. experience and circumstances – both worst case/worst period experience during the financial crisis and the operations of U.S. markets (including how they finance mortgage originations). These changes should be made at inception – that is, before the observation period begins. They are:
 - The Basel III liquidity framework’s run-off factors for non-operational deposits (75% for non-financial institution deposits and 100% for financial institution deposits) should be adjusted to percentages that are closer to U.S. banks’ worst case/worst period experience during the financial crisis (41% for non-financial institution non-operation deposits and 38% for financial institution non-operational deposits).
 - The Basel III liquidity framework’s assumption that the draw-down rate on liquidity lines will be fully drawn (that is, a 100% draw-down rate) should be modified to reflect an assumed draw-down rate that is closer to U.S. banks’ worst case/worst period experience during the financial crisis (which was in the 9% to 10% range depending on the type of facility backed by the liquidity line).
 - Fannie Mae and Freddie Mac mortgage-backed securities (MBS) and debt securities should be recognized as L1 assets with no haircut. Agency MBS and debt securities proved to have better or more sustained convertibility during the financial crisis than many sovereign debt securities, with U.S. Treasury securities and Japanese Government Bonds (JGBs) being the only securities with deeper markets.
 - The FHLB system is unique to the United States. It proved itself to be a reliable source of liquidity for U.S. banks throughout the financial crisis. As discussed in Section II.C of this white paper, we urge the U.S. regulators and the FHLBs to discuss improvements to the FHLB advance system that may address concerns regulators have expressed – for example, as to the appropriateness of giving liquidity credit for over-night advance facilities. Broadly stated, however, we strongly believe that the LCR should recognize committed FHLB facilities as a source of liquidity.

- **Research and process:** there has been a relative dearth of research focused either on the assumptions on which the Basel III liquidity framework’s rules are based or the macroprudential

and macroeconomic effects of enhanced liquidity-risk standards as compared to the attention that has been given to the assumptions and effects of enhanced core capital requirements. This is true with respect to both research generated by the regulatory community and the academic community. The Clearing House has attempted to address for U.S. banks one piece of this in the Liquidity Study – namely, key assumptions underlying the LCR’s calibrations. We urge policymakers at all levels – legislative as well as regulatory – to acquire sound research and analysis addressing in particular macroprudential and macroeconomic effects of the Basel III liquidity framework along with other reforms that effect those considerations. We are particularly concerned with the negative consequences of the LCR and other reforms, considered together, for the U.S. housing market and the potential distortions they may introduce into global markets, including the markets for sovereign debt.

* * *

Although regulators who review this white paper will be well versed in the details of the Basel III framework and supervisory approaches to liquidity risk management more generally, other policymakers may not. We have included as an Appendix to this white paper a background section describing the Basel III liquidity framework and other supervisory initiatives.

I. QUANTITATIVE ASSESSMENT OF THE LCR – THE SHORTFALL

A critical element in evaluating any rule is a quantitative assessment of its impact if implemented. The Basel Committee provided an initial quantitative impact study (QIS) of the Basel III liquidity rules when they were released in December 2010,⁷ using bank data as of December 2009. The Basel Committee's QIS made separate calculations for "Group 1 banks", which is defined as 94 banks that have Tier 1 capital in excess of €3 billion, are well diversified and internationally active, and "Group 2 banks", which is defined as all other banks for which data were gathered. The Basel Committee's QIS study was not, of course, limited to U.S. banks. It showed an average LCR of 83% for Group 1 banks and 98% for Group 2 banks, respectively, as of December 2009, with an aggregate liquid asset shortfall for all banks in the sample (that is, Group 1 and Group 2 banks) of €1.73 trillion. Although the QIS is conducted on an ongoing, semi-annual basis, with a more recent exercise including bank data submitted as of December 2010, the Basel Committee's conclusions from this exercise have yet to be publicly released.

The Clearing House prepared the Liquidity Study in an effort to itself quantitatively assess the impact of the LCR on U.S. banks if implemented. The Liquidity Study analyzes the LCR's impact both as of December 2009 and as of December 2010.⁸ The data were compiled based on the template issued by the Basel Committee in mid-2011 for its ongoing QIS, incorporating results into the revised framework that include changes in the calculation of the cap on L2 assets.

Assuming that the impact conclusions in the BCBS QIS (albeit not broken out separately for banks by jurisdictions) are generally consistent across jurisdictions, the Liquidity Study shows that the Basel Committee's QIS results substantially understate the likely LCR shortfall across the banking industry at December 2009. It also shows that the shortfall largely results from a handful of assumptions embedded in the LCR's calibrations that are extremely conservative as compared to U.S. banks' worst case/worst period experience during the financial crisis. Moreover, the Liquidity Study shows that, for U.S. banks, the shortfall increased between December 2009 and December 2010, notwithstanding that U.S. banks had substantially higher levels of liquid assets and had taken meaningful steps to reduce net cash outflows between those two dates. Specifically:

- The Liquidity Study shows for U.S. banks:

⁷ BCBS, *Results of the comprehensive quantitative impact study* (Dec. 16, 2010) available at <http://www.bis.org/publ/bcbs186.pdf>. The Basel Committee's QIS sets forth an estimated aggregate LCR shortfall for the 263 banks in the study, expressed in Euro, and an average LCR as of December 2009 for the two groups of banks in the study. It does not, however, provide any of the underlying data and analysis supporting that information.

⁸ The December 2009 analysis is based on data as of that date from ten existing banks, representing 54% of U.S. banking assets (\$8.8 trillion). The December 2010 analysis is based on data from 14 existing banks, representing 58% of U.S. banking assets (\$9.4 trillion). The data were compiled based on the template issued by the Basel Committee in mid-2011 for its ongoing QIS, incorporating results into the revised framework that include changes in the calculation of the cap on L2 assets. Except as otherwise indicated, financial and statistical data included in this white paper either appear in or were derived from information in the Liquidity Study or were developed in connection with the preparation of the Liquidity Study.

- as of December 2009, an industry-wide LCR of 70%, which means a liquid asset shortfall of approximately \$1.1 trillion; and
- as of December 2010, an industry-wide LCR of 60%, which means an LCR shortfall of approximately \$1.4 trillion.
- The approximately \$1.4 trillion shortfall at December 2010 is actually understated. The total practical shortfall as determined using the December 2010 data may be as high as \$2.0 trillion. There are two reasons for the difference:
 - Banks will not manage to or target a 100% LCR. In order to avoid regulatory criticism and sanctions, as well as market penalties, that could result from having an LCR less than the minimum regulatory requirement (that is, 100%), banks inevitably will manage to a targeted LCR that includes a “cushion” above the 100% minimum – for example, manage to a targeted ratio of 110% (with a ratio of 110% adding another approximately \$200 billion to the shortfall).
 - Banks’ balance sheet composition at December 2010 was abnormal. Due to ongoing financial market instability, banks have stockpiled L1 and L2 assets, holding historically high levels of cash and U.S. Treasuries, while credit demand remains subdued. Under normal market conditions, banks would not generally hold these assets in such large volumes. As demand for loans picks up, banks would normally decrease cash and other low-yielding liquid funding sources and substitute loans for liquid assets, exacerbating the LCR’s adverse implications and worsening the unintended consequences of the LCR, which are discussed in Section VI of this white paper. As market conditions normalize, the shortfall could rise by an additional \$400 billion if banks re-balanced their asset composition to pre-crisis proportions.
- The increase in the LCR shortfall between December 2009 and December 2010, notwithstanding the fact that banks have moved their asset compositions to historically high levels of cash and U.S. Treasuries, as discussed further below, highlights the flaws in the LCR and the need to reconsider certain of its provisions. The most important contributor to this counterintuitive (and, we believe, manifestly wrong) result for U.S. banks is the interplay between (i) the treatment of MBS guaranteed by Fannie Mae and Freddie Mac, as well as Fannie Mae and Freddie Mac debentures as L2 instead of L1 liquid assets and (ii) the requirement, which was a change in the LCR methodology after the Basel Committee’s initial QIS analysis⁹ that LCR calculations be based upon an assumed unwind of repos on those assets.
- As to outflows, the liquid asset shortfall is driven primarily by products where a large discrepancy exists between current bank assumptions and those on which the LCR is premised. However, as discussed in the Liquidity Study, there are significant empirical discrepancies between actual market performance under even acute stress and the LCR’s assumptions. Thus, it cannot be concluded that banks in this QIS are in fact at such risk that \$1.4 trillion, or even more, in additional liquid assets is warranted.

⁹ BCBS, *Basel III framework for liquidity frequently asked questions* (July 5, 2011) available at <http://www.bis.org/publ/bcbs199.pdf>.

The drop in the LCR year-over-year demonstrates the deficiencies in the LCR as presented in the Basel III liquidity framework because, parallel to the drop in the LCR, the banks in the sample used for this study in fact dramatically increased their holdings of liquid assets and improved net outflows, and are thus considerably more liquid.

- *Improvements in the Stock of Liquid Assets.* L1 and L2 assets increased, improving the industry LCR by 9% and 10%, respectively, between 2009 and 2010. Additionally, the percent of central bank reserve cash to total assets for the U.S. industry has dramatically increased since 2009. As of the first quarter of 2009, cash holdings to total assets were just above 5% but increased to over 7% in 2010, and shot up significantly to approximately 10% in the first quarter of 2011. The ratio of Treasuries held by banks to total assets followed a similar trajectory. The ratio was approximately 5% as of the first quarter of 2009, increased to around 6% throughout 2010, and shot up to 8.8% in the first quarter of 2011.
- *Improvements in Cash Flow.* An increase of cash inflows and secured funding improved the U.S. industry LCR by 6% and 5%, respectively, between 2009 and 2010. Further, compared to the fourth quarter of 2007, banks in the first quarter of 2011 have increased both deposits and Tier 1 common equity by 19%. Conversely, less stable funding sources, such as repos and debt, declined by 35% and 18%, respectively, since 2007. Finally, the percent of wholesale funding with tenor less than 30 days has decreased from 21.8% in 2007 to 6.1% in 2011, which has also contributed to reduced LCR outflows.

Banks in the Liquidity Study have indicated that, if the LCR is implemented as finalized in 2010, they will need to make fundamental adjustments, impacting both customers and key financial markets (including those for U.S. Treasury securities and agency mortgage-backed securities). These actions include exchanging L2 assets for L1 assets and issuing more debt in order to hold more L1 assets, a move that would put banks at other risks (e.g., interest rate risk) and adversely affect credit availability, because proceeds of these new debt issues would need to be diverted to large holdings of sovereign obligations and similar assets, not the less liquid assets that meet market and macroeconomic needs. Banks will decrease the liquidity lines they make available for customers, reduce non-operational deposits and/or curtail other short-term funding sources. The discussion of the product and market impacts provided in Section IV.A. addresses these actions, making clear that, while several may have beneficial liquidity results, they pose significant problems for customers in affected market segments.

II. EMPIRICAL EVIDENCE SUGGESTS MODIFICATIONS TO THE BASEL III STANDARDS

The Basel III liquidity framework specifies that the LCR

“aims to ensure that a bank maintains an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe stress scenario specified by supervisors.”

The highlighted phrase lends itself to nuanced interpretations, but the nuances – and different outcomes that can flow from them – are critical. For example, are the rules based on failed banks or stressed banks? If the standards are designed to ensure that no bank ever fails due to liquidity risk, then they will establish so high a liquidity-risk threshold that few, if any, banks could operate under them as efficient providers of credit intermediation services because the cost of matching all potential claims (e.g., on lines of credit) would be prohibitive. In contrast, if the rules are designed to ensure that banks (i) are able to absorb liquidity stress even in system-wide stress scenarios and (ii) reflect in the pricing of their products the costs of that amount of liquidity, so that in most cases regulators can exercise discretion as to when and how to intervene as opposed to feeling compelled to intervene because the consequences of non-intervention are so severe, that goal is laudable and regulatory standards to achieve it are appropriate.

We have discussed below aspects of the LCR that concern us because they tend to support a “no bank ever fails due to liquidity risk” goal as opposed to goals oriented toward reflecting true liquidity costs in the pricing of products and preserving flexibility for regulators and governments more generally in times of stress. A robust banking system, and prudential standards designed to achieve it, should not be premised on government intervention as the solution, even in scenarios that are highly stressed. However, neither should such a system be premised on a “no bank ever fails due to liquidity risk” goal. Achieving the correct balance between goals, on the one hand, and calibrations, on the other hand, requires a transparent and empirical analysis of liquidity metrics (whether the convertibility of a particular class of assets or an analysis of cash inflows and outflows that produce a realistic measure of net cash outflows).

Our empirical focus has been on U.S. banks and the U.S. market, largely because of resource constraints. If the BCBS and other policy makers are concerned that U.S. experience is not representative of international experience, we encourage them to replicate our analysis in other jurisdictions.

A. Basel III Assumptions About Liquid Assets; Convertibility of Agency Securities

The Basel III rules are based on the Basel III liquidity framework’s definition of “liquid assets” for LCR purposes – i.e., assets that can be converted into cash during the time periods specified in the LCR, even during a period of system-wide stress. However, this critical definition in the Basel III rules is based on incorrect assumptions not supported by the actual liquidity of varying asset classes in the marketplace.¹⁰

¹⁰ The enhanced practices for liquidity risk management outlined in Section V of this paper are intended to provide a consistent framework for assessing liquid assets, which should be based not solely on the issuer – as is done in the Basel III rules – but importantly on how readily a bank can convert an asset into cash under stress.

The data presented in this Section II.A assess assets based on what makes them in fact readily convertible: the ability to transact in large size with only minimal loss under stress. Measures of the liquidity of an asset class are varied, but key ones include daily volume traded, traded bid-ask spreads (which factor in volatility and indicate market depth), the size of a market, and the existence of an active and robust “repo” market. Although the Basel Committee has provided composite assessments of the impact of the liquidity standards,¹¹ it has not provided the empirical analysis on which the LCR and NSFR are premised. It is essential that it do so because, absent transparent analytics on which to assess the LCR’s calibrations, critical assumptions underlying the rules are unknown and, thus, their policy impact remains at best uncertain.

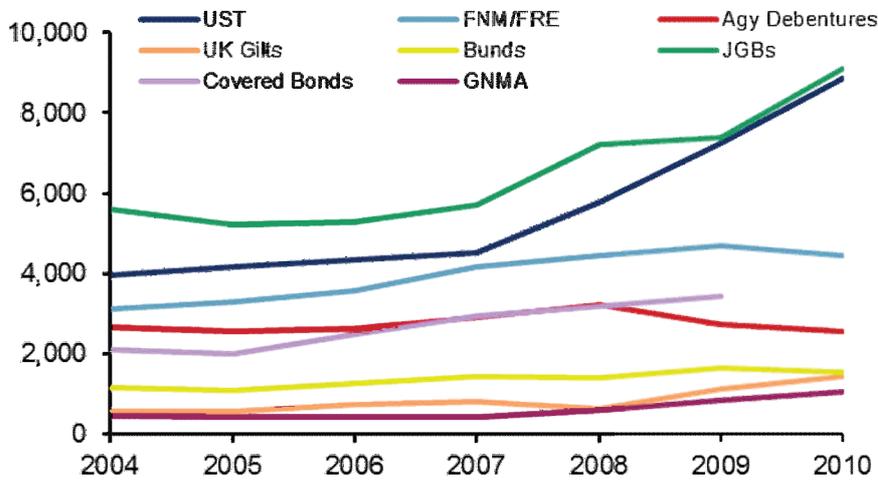
The charts below compare liquidity characteristics of various asset classes, including both those proposed as L1 and those not granted favorable L1 status. With regard to the U.S. market, these include securities issued or guaranteed by U.S. government sponsored agencies,¹² particularly mortgage-backed securities (MBS) issued by Fannie Mae and Freddie Mac (agencies) (agency MBS) and debt securities issued by the agencies, that have not been granted L1 status despite exhibiting superior liquidity characteristics. Data on some of the convertibility criteria are proprietary (e.g. bid offer spreads), but the charts below demonstrate the depth and transparency of the agency MBS markets as compared to other L1 and L2 assets. For example, outside of U.S. Treasuries and JGBs, the agency MBS market is the next largest in terms of outstanding notional values, with outstanding Fannie Mae and Freddie Mac securities at approximately \$4.5 trillion and Ginnie Mae securities around \$1 trillion in 2010.¹³

¹¹ BCBS, *QIS*, *supra* note 7.

¹² For purposes of these charts, unless otherwise noted or broken out, “agency debentures” include debt securities issued by Fannie Mae, Freddie Mac, Farmer Mac, the Federal Home Loan Banks, the Farm Credit Banks and federal budget agencies (for example, the Tennessee Valley Authority), and “agency MBS” include mortgage-backed securities issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae.

¹³ See *infra* note 45.

Total Securities Amount Outstanding End of Year (USD \$bn equivalent)¹⁴

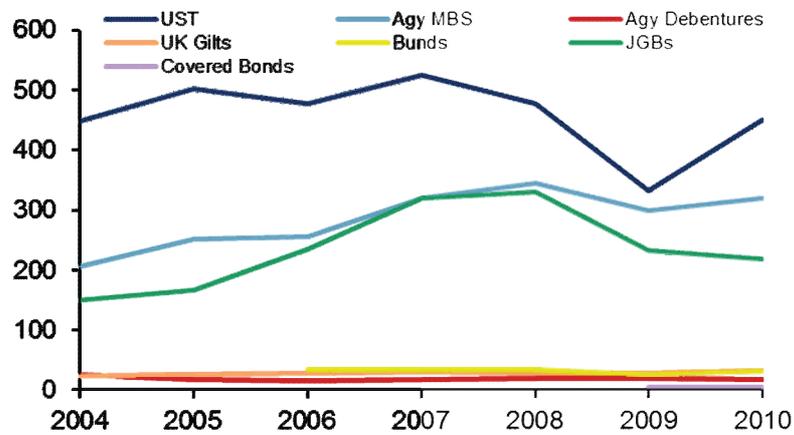


Additionally, Fannie Mae and Freddie Mac MBS market depth and convertibility to cash are readily apparent when considering daily trading volume and ability to repo as measures of liquidity. As demonstrated below, the annual daily trading volume of agency MBS since 2004 has been second only to U.S. Treasuries.¹⁵

¹⁴ U.S. dollar (USD) equivalents for the following charts are calculated using then current foreign exchange rates.

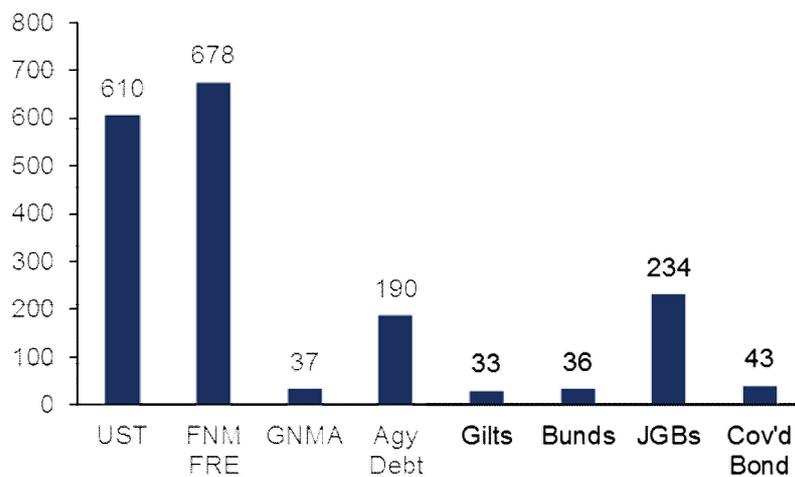
¹⁵ Sources: SIFMA, UK DMO, Federal Republic of Germany Finance Agency, JSDA.

Daily Trading Volume (USD \$bn equivalent - excludes Bills except as indicated)



Finally, as shown below, the estimated daily repo volume of Fannie Mae and Freddie Mac MBS is on par with that of U.S. Treasuries and is larger than any other asset class, which demonstrates the ability to easily liquidate these assets via the repo markets.¹⁶

Daily Repo Volume (USD \$bn equivalent)



¹⁶ *Id.*

B. Calibrations In Some Areas Are More Conservative Than U.S. Banks' Worst Case/Worst Period Experience

The Liquidity Study focused on the Basel III liquidity framework's calibrations – that is, the required assumed run-off rates for deposits and other liabilities and drawdown rates for credit and liquidity facilities.¹⁷ The data made available by the banks participating in the Liquidity Study generally was on a monthly basis from August 2008 through March 2009.

In comparing run-off rates and drawdown rates of banks participating in the Liquidity Study to the Basel III requirements, the study uses the worst case data point – that is, (i) with respect to run-off rates as to a particular type of deposit, the highest run-off rate for any bank in the sample in any month during the period covered by the study and (ii) for drawdown rates as to a particular type of facility, the highest drawdown rate for any bank in the sample in any month during the period covered by the study (referred to in this white paper as the “worst-case/worst-period” result). The study included data from four banks that failed or effectively failed – Wachovia, Washington Mutual, National City and Colonial.

The Liquidity Study shows that in some areas (run-off rates for retail deposits and credit lines to corporate customers) the Basel III assumptions are generally reflective of worst-case/worst-period experience. But it also shows that in other areas, the Basel III requirements are extremely conservative and not remotely reflective of U.S. experience. The primary examples in this regard are the run-off factors for non-operational wholesale deposits (where the worst-case/worst period maximum run-off rates were 38-41%, depending on the type of deposit, compared to required assumed run-off rates of 75-100%) and drawdown rates on liquidity lines to nonfinancial and financial customers (where the worst-case/worst-period drawdowns during the crisis were 9-10% compared to the LCR's assumed 100%).

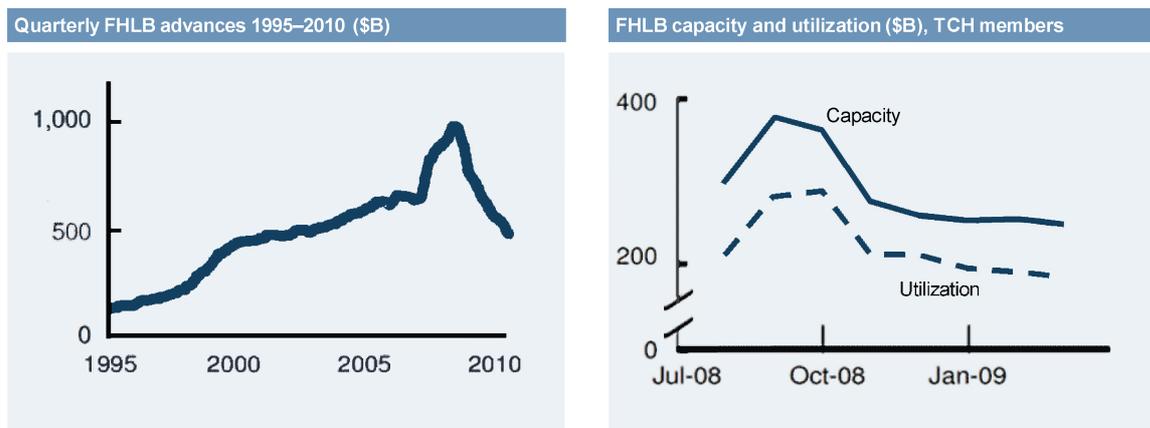
The Liquidity Study's comparison of the LCR's calibrations to U.S. experience are set forth at pages 16 to 20 and 24 to 27 of the study, with the data concerning the areas where there is the greatest divergence – non-operational wholesale deposits and drawdown rates on liquidity lines to non-financial and financial customers – appearing at pages 19 to 20 and 27. We share the regulatory community's view that an area for further inquiry suggested by these results is an analysis of the consequences for end users (that is, customers). We have made some efforts in that regard, addressed at pages 40 to 46 of the Liquidity Study and discussed further in Section IV.A, below. However, evaluating end user consequences (for example, potentially higher fees or interest rates for some products and reduced availability for others) presents a number of challenges. These include the complexities (and perhaps even impossibility) of conducting a dynamic evaluation that takes into account alternative products, as compared to the analysis in the Liquidity Study which was conducted on a static basis, and the uncertainties in predicting real-life customer behavior in response to future events. We do not think regulators should be accepting of incorrect calibrations merely because the consequences are uncertain or cannot be proven *ex ante*. Instead, we strongly believe that sound regulation requires a clear statement of the goal (see the introduction of this Section II) and calibrations based on empirical analysis that can reasonably be expected to implement that goal (without a bias to either excessive conservatism or excessive leniency).

¹⁷ See *supra* note 8 concerning the banks that participated in the Liquidity Study.

C. Federal Home Loan Bank Advances

It is both important and appropriate in implementing the LCR that national regulators take into account circumstances unique to their countries where empirical data supports adjustment for those circumstances, as noted in the Introduction and discussed further in Section III. In the United States, the most important unique circumstance insofar as the LCR is concerned is the Federal Home Loan Bank System (FHLB System).

As demonstrated by the charts below, the FHLB continued to provide liquidity that banks could draw upon during the crisis, in addition to other markets that maintained liquidity.



- FHLB continued to provide liquidity even during the crisis

- Capacity and utilization increased during the crisis while excess capacity remained relatively constant

Source: Fed Flow of Funds; The Clearing House LLC member banks' supplemental data

Established by law in 1932,¹⁸ FHLBs provide “advances” – that is, loans collateralized by eligible mortgages and other assets – to support residential-mortgage finance by member institutions. Members – now more than 8,000 for the FHLB System as a whole¹⁹ – are large and small banking organizations, as well as certain other eligible firms.

The FHLB System increased its lending to members in every part of the country by over 50% – or \$300 billion – between the second quarter of 2007 and the third quarter of 2008.²⁰

¹⁸ Federal Home Loan Bank Act of 1932, Pub. L. 72-304, 12 U.S.C. §§ 1421-1449.

¹⁹ The Federal Home Loan Banks, *FHLBanks White Paper*, available at <http://www.fhlbanks.com/assets/pdfs/sidebar/FHLBanksWhitePaper.pdf>.

²⁰ *Id.* at 3.

Some in the official sector have expressed concern that the FHLB role does not warrant recognition because the FHLBs pose taxpayer risk. However, a taxpayer subsidy would only occur in the event the FHLB System incurred a loss. Levels of protection exist to make this highly unlikely because:

- the Banks are 100% privately capitalized with member stock and retained earnings;²¹
- joint and several liability within the FHLB System protects individual district FHLBs;²²
- FHLB haircuts on the collateral that must back all advances are conservative, generally ranging from 25% to 50%;
- no FHLB has experienced a credit loss on advances;²³ and
- none of the FHLBs required government assistance during the financial crisis.

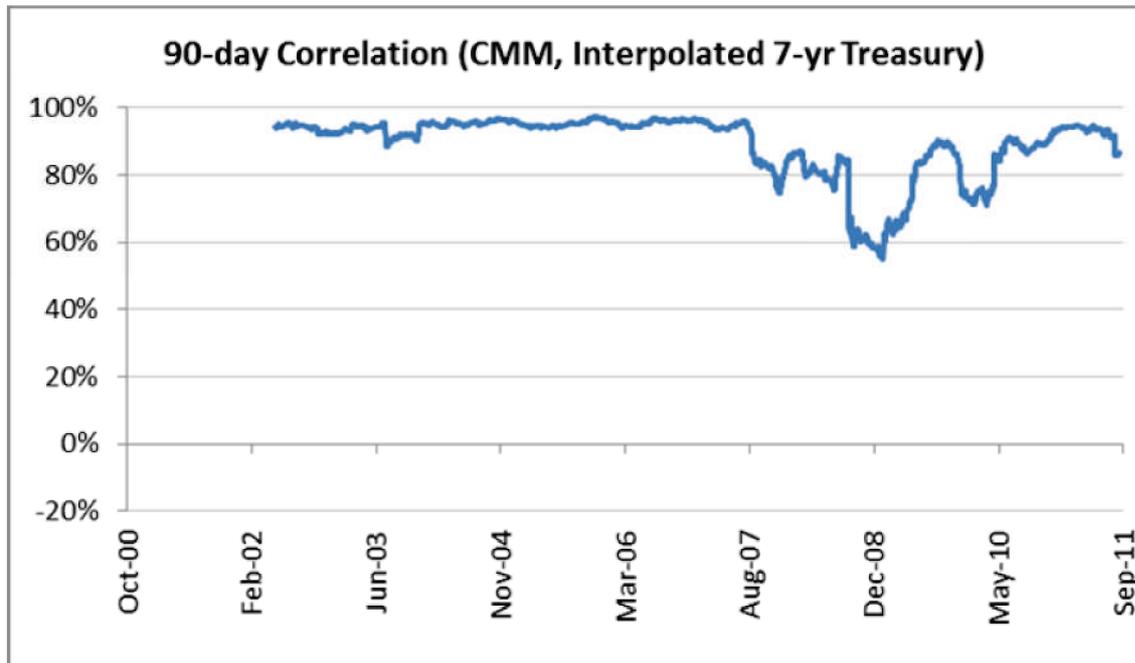
FHLB advances may be provided on an overnight or a term basis. The U.S. banking agencies have expressed concern as to whether a bank's ability to borrow on an over-night basis from an FHLB should be recognized for LCR purposes in either the numerator or denominator, given that over-night borrowings would be negated by the obligation to repay within 30 days were the funds actually drawn down. The treatment for LCR purposes of overnight FHLB facilities requires further consideration. The FHLBs, in discussion, with The Clearing House, have indicated an openness to potentially revising facility terms in order to address the U.S. banking agencies' concerns.

FHLB advances are a critically important liquidity source for U.S. banks, demonstrably available to U.S. banks throughout the financial crisis. The LCR as formulated in the Basel III liquidity framework does not recognize the liquidity value of banks' undrawn FHLB commitments, either as a "liquid asset" in the LCR's numerator or a cash inflow in the LCR's denominator. Subject to the open questions with respect to over-night FHLB advances discussed in the preceding paragraph, we believe it should.

²¹ *Id.*

²² Moody's Investors Service, *Credit Opinion: Federal Home Loan Banks* (Aug. 5, 2011), available at http://www.fhlb-of.com/ofweb_userWeb/resources/MoodysCreditAnalysis080511.pdf.

²³ *Id.* at 3.



D. Case History Suggests the Evidence is Unreliable

Wachovia Corporation (Wachovia) was the largest U.S. bank or thrift holding company to fail – that is, either file for bankruptcy or, in order to avoid a bankruptcy filing, be acquired by a more healthy bank holding company (Wells Fargo & Company (Wells Fargo) in the case of Wachovia) – during the financial crisis. An examination of Wachovia’s actual experience with respect to

- its ability to borrow in the repo market against agency MBS and debentures,
- draw-down experience on liquidity facilities, and
- run-off experience with respect to wholesale deposits

demonstrates the extreme conservatism of the assumptions underlying the LCR’s calibrations. The Wachovia experience also highlights the impact of important material differences in deposit insurance schemes on run-off rates for insured deposits.

Wachovia was a typical commercial bank with an equal mix of commercial and retail activities, but was a very troubled institution throughout much of 2008.²⁴ After the bankruptcy of Lehman Brothers on September 15, 2008, Wachovia came under severe liquidity pressure. On October 3, 2008, at a point when Wachovia was liquid, Wachovia agreed to be acquired by Wells Fargo. Wells Fargo provided liquidity support that day to ensure Wachovia’s balance at the Federal Reserve was greater than zero.

²⁴ See, e.g., David Milenberg, *Wachovia Has Record \$8.9 Billion Loss, Cuts Dividend* (July 22, 2008), available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a3cStztOg8pk>.

1. Wachovia Bank, National Association Repo by Collateral Type

Wachovia's balance sheet performance at this time demonstrates that, even for a failed bank, the Basel III LCR calibrations are incorrect. For example, repos of L1 and L2 assets provided significant liquidity for Wachovia at the height of its crisis. Wachovia raised funds in September 2008 during its period of most severe stress through repo funding of Treasuries, agency debentures and agency MBS.

The chart below shows that repo funding continued into October at declining balances due to the availability of other sources.²⁵Error! Not a valid link.

2. Credit and Liquidity Facility Draw Assumptions

Similarly, Wachovia's actual crisis experience for credit facility draws, in addition to corporate and financial institution deposit run-offs, suggest the LCR factors are either significantly mis-calibrated or do not reflect differences in national banking practices. As can be seen in the charts below, the Basel III factors provide for dramatically more severe conditions than the actual Wachovia experience.

(\$ billions)		8/31/2008	9/30/2008	10/31/2008	30 Day Change in Utilization	Basel Factor	Basel Factor vs Experience
Non-Financial							
Corporate Draws	Commitments	358.3	350.8	\$ 349.0			
	Outstandings	193.6	198.6	201.0			
	Utilization	54.0%	56.6%	57.6%	1.0%	10.0%	10.1 x
Retail Draws	Commitments	\$ 85.7	\$ 84.8	\$ 83.9			
	Outstandings	29.0	29.3	29.7			
	Utilization	33.8%	34.6%	35.4%	0.8%	5.0%	6.2 x

Additionally, the worst liquidity line drawdowns were well below LCR factors. Liquidity lines to financials and non-financials experienced 9% and 10% maximum drawdowns, respectively, during the crisis, while the LCR provides for 100% draws for both.

²⁵ Wachovia historical data is provided by Wells Fargo.

3. Corporate and Financial Institution Deposit Experience

<i>(\$ billions)</i>	<u>9/15/2008</u>	<u>10/15/2008</u>	<u>% change</u>	<u>Basel Factor</u>	<u>Basel Factor vs Experience</u>
<u>Operational Deposits</u>					
Non-Financial	\$ 31.0	\$ 27.1	-12.5%	-25.0%	2.0 x
Financial	3.2	2.9	-8.0%	-25.0%	3.1 x
<u>Non-Operational Deposits</u>					
Non-Financial	33.6	25.0	-25.4%	-75.0%	2.9 x
Financial	6.4	3.7	-42.4%	-100.0%	2.4 x
Total	\$ 74.1	\$ 58.7	-20.7%	-54.1%	2.6 x

Wachovia's experience was not unique. Indeed, analysis of broader industry crisis data similarly supports recalibrating the LCR, especially for non-operational deposits and liquidity lines. For example, financial institution non-operational deposits experienced a maximum outflow rate of 38% during the crisis, but the implied LCR outflow rate is 100%. Similarly, non-operational deposits for non-financial corporates saw a 41% outflow in 2008, but the LCR implied outflow is 75%.

4. Deposit Insurance

The Basel III liquidity framework should allow national discretion in determining retail and small and medium-size enterprise (SME) deposit LCR run-off factors to recognize important national differences in deposit insurance schemes. The factors should be based upon not only the presence of deposit insurance, but also the level of coverage and the strength of the guarantor. The data below from a failed institution, Wachovia, demonstrates a marked difference in run-off rates between insured and uninsured deposits. As the chart demonstrates, the insured deposits run-rates are essentially nil, while the uninsured deposit run rates are multiples of the Basel III factors.

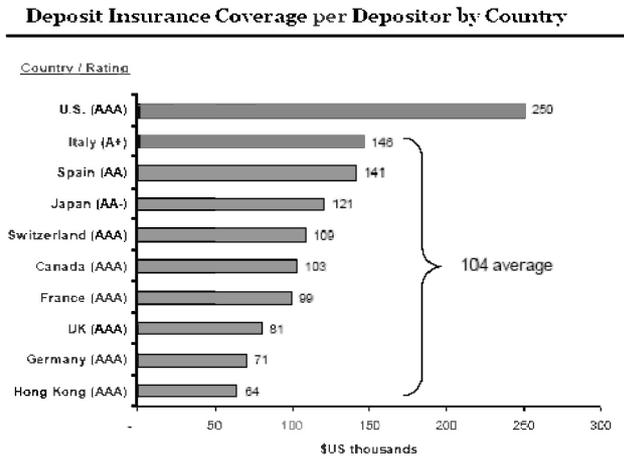
LCR Factors for Retail and SME Deposits are Several Times Actual Experience

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Further, the use of an "average" rate under the Basel III proposals is not appropriate because it fails to recognize the strong national deposit insurance scheme present in the U.S. The chart below shows the U.S. has on average more than double the amount of deposit insurance per customer than other large

countries.²⁶ It is important to note that banks are already paying for this insurance and that holding excessive amounts of liquid assets adds an additional cost.

Deposit Insurance Coverage per Depositor by Country



²⁶ *Deposit Insurance Coverage per Depositor by Country*, McKinsey research based on FDIC and World Bank data.

III. THE COMPETITIVE LANDSCAPE

The Basel III rules are intended as a global framework for all member nations.²⁷ It is important, therefore, to consider the Basel III rules not just in their own light and in the context of pending U.S. regulatory actions to craft a meaningful domestic liquidity-risk regulatory regime (see Section C of Appendix 2), but also in light of whether other BCBS member nations in fact implement Basel III as finalized. If only the U.S. implements Basel III as prescribed in the final standards released by the Basel Committee, the U.S. not only would be adhering to rules that do not appropriately reflect U.S. crisis experience and market functions, but it would also place U.S. banks at undue risk because other nations will permit banks that compete with U.S. banks or are their counterparties to take liquidity risk that could be captured through meaningful compliance and robust enhanced practices.

It is essential that final rules result in consistent application across jurisdictions in order to ensure a level playing field from a competitive perspective. Consistent application does not, however, require identical rules – for example, disregard of a liquidity source that is unique to a particular country (in the United States, most importantly, agency MBS and debentures and FHLB advances) or that calibrations of run-off factors and assumed draw-down rates on credit and liquidity facilities be identical notwithstanding that experience may differ country-by-country, depending upon the circumstances in particular countries (in the United States, most importantly, non-operational wholesale deposits and liquidity facilities). At least pending refinement of the LCR through the observation period to better adapt to unique national circumstances, it is extremely important that the U.S. regulators show the same flexibility that regulators in other countries are showing. In order to ensure consistent application across jurisdictions, we believe that national regulators should expand the peer review process contemplated for a number of aspects of the Basel III liquidity and capital frameworks to ensure that deviations from “base” Basel III liquidity rules do not detract from the rigor and cross-border substantive equivalence of the Basel III liquidity rules but instead are justified based on the circumstances of particular countries.

A. European Union

The European Commission (EC) finalized Capital Requirements Directive IV (CRD IV)²⁸ and presented it to the European Parliament for final action in July 2011. A framework for implementing the Basel III liquidity standards is among a panoply of regulatory provisions included in CRD IV. CRD IV potentially permits a looser definition of eligible liquid assets under the LCR and does not commit to implementation of the NSFR. For example, while Basel provides the prescriptive definition of L1 and L2 assets as outlined in Section B.1 of the attached appendix, CRD IV allows a broad definition of liquid assets that includes “transferable assets that are of extremely high liquidity and credit quality” and

²⁷ BCBS members come from: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

²⁸ Press Release, European Commission, *Commission wants stronger and more responsible banks in Europe* (July 20, 2011), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/915&format=HTML&aged=0&language=EN&guilanguage=en>.

"transferable assets that are of high liquidity and credit quality."²⁹ Although the directive includes various suggestions as to ratios the European Banking Authority (EBA) should consider in assessing a bank's liquidity over a thirty-day horizon, the directive requires only that a bank demonstrate its resilience, not that it actually meet the LCR as prescribed by the Basel Committee. Additionally, the EC will only "consider proposing an NSFR after an observation and review period in 2018."³⁰

EU legislative deliberations will likely take place through the end of 2011 and could potentially reshape the liquidity rules mandated in CRD IV. National guidelines will follow this and are expected to be released in 2012 in order to satisfy the Basel deadline of January 1, 2013 implementation.

B. Asia

Asian nations are similarly working towards implementation of the Basel liquidity standards, but are encountering challenges, such as a significant shortage of eligible liquid assets that qualify under the LCR. Specifically, in countries such as Australia, Hong Kong and Singapore, there is a limited supply of government securities, which constitute L1 assets, and non-bank corporate debt, which qualify as L2 assets.³¹ These nations are currently considering a number of options on how to address this problem. For example, the Reserve Bank of Australia plans to establish a government liquidity facility which will cover LCR shortfalls in exchange for a market-based fee and qualifying collateral.³² The size of the facility and final rules are under consideration and pending consultation during 2011 and 2012. Notably, establishment of a government facility that is essentially paid by banks for services that facilitate compliance would not appear to meet Basel III's goals of ensuring that banks themselves institute robust liquidity-risk management protocols in conformity with the rule. This raises significant questions both about the degree of real international implementation and the subsequent competitiveness and regulatory-arbitrage implications resulting from approaches such as those under consideration in Australia.

The Hong Kong Monetary Authority (HKMA) is similarly weighing how to address the dearth of qualifying liquid assets, with banks told to adjust portfolios to address an overreliance on bank-issued paper that does not qualify under the LCR, and a current lack of qualifying sovereign, central bank and non-financial

²⁹ European Commission Proposal for a Regulation, *On Prudential Requirements for Credit Institutions and Investment Firms, Part III* (July 20, 2011), at 85, available at http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/20110720_regulation_proposal_part3_en.pdf.

³⁰ European Commission Proposal for a Regulation, *On Prudential Requirements for Credit Institutions and Investment Firms, Part I* (July 20, 2011), at 6, available at http://ec.europa.eu/internal_market/bank/docs/regcapital/CRD4_reform/20110720_regulation_proposal_part1_en.pdf.

³¹ Rachel Armstrong, *Basel Liquidity Rules Pose Risks for Asia-Pacific Banks*, Reuters (Mar. 21, 2011) available at <http://www.reuters.com/article/2011/03/21/us-asia-basel-liquidity-idUKTRE72KOSG20110321>.

³² Reserve Bank of Australia, *Australian Implementation of Global Liquidity Standards* (Dec. 17, 2010) available at <http://www.rba.gov.au/media-releases/2010/jmr-10-31.html>.

corporate debt.³³ Again, it is unclear how binding this approach will be, in contrast to the prescriptive ratios adopted by the Basel Committee. The HKMA is discussing options for covering liquidity shortfalls revealed by 2010 and 2011 QIS results, and will prepare draft legislative amendments by the third quarter of 2011, which will be introduced in the 2011-2012 legislative session.³⁴ Similarly, in the wake of the QIS results released in December 2010 that showed South Korean banks were below average global liquidity ratios,³⁵ South Korea established a task force composed of various regulators and academic experts to determine how it should implement the Basel liquidity standards.³⁶

Interestingly, the China Banking Regulatory Commission (CBRC) issued guidance earlier this year stating that the LCR and NSFR will come into effect on January 1, 2012, with only two-year and five-year observation periods, respectively, but banks should meet the ratios by the end of 2013 and 2016, respectively.³⁷ In a follow-up release, the CBRC noted that “quantitative impact measurements show that the majority of domestic banks have already reached or will reach shortly the regulatory requirements on liquidity.”³⁸

³³ Viren Vaghela, *HKMA's Yuen Urges Banks to Take Action Now on Basel III LCR; Warns of Negative Impact for Corporate Debt Markets* (Mar. 29, 2011), available at <http://www.risk.net/asia-risk/news/2038355/hkma-s-yuen-urges-banks-action-basel-iii-lcr-warns-negative-impact-corporate-debt-markets>.

³⁴ HKMA, *Circular – Implementation of Basel III in Hong Kong* (Jan. 16, 2011) available at, http://www.info.gov.hk/hkma/eng/guide/circu_date/20110126e1.pdf.

³⁵ Financial Services Commission and Financial Supervisory Service, *Basel III Quantitative Impact Study and Its Implications* (Dec. 17, 2010), available at www.fsc.go.kr/downManager?bbsid=BBS0048&no=72729.

³⁶ Financial Services Commission, *Financial Services Commission has Launched a Task Force to Follow Up With G20 Agreement* (Mar. 10, 2011), available at <http://fsc.korea.wordpress.com/2011/03/10/financial-services-commission-has-launched-a-task-force-to-follow-up-with-g20-agreement/>.

³⁷ CBRC, *Guiding Opinions on the Implementation of New Regulatory Standards in China's Banking Sector* (Apr. 27, 2011), available at <http://www.lawinfochina.com/NetLaw/display.aspx?db=law&sen=rLdDdW4drhdDdWcdrLd5dWddrLdGdWPd9DdydWcdrddTdWudrDdTdWEd/DdDdWud/ddTdWud9Dd+&Id=8709&>.

³⁸ CBRC, *The CBRC Respond to Questions of the Press Relating to the Guiding Opinions on the Implementation of New Regulatory Standards in China's Banking Industry* (May 3, 2011) available at <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=20110613FCE47ABD05FA4204FF5BCBC854991A00>.

IV. POLICY AND MARKET CONSEQUENCES – PROBLEMATIC OR UNKNOWN

In its December 2010 release, the Basel Committee stated that it would review the LCR and NSFR for “unintended consequences” and, if these are found, revise the rule as needed.³⁹ We have highlighted below several areas where the likely consequences of the rules may be unintended and are problematic, or at the least may not be .

A. Market and Customer Implications

In connection with this project, the Liquidity Study analyzed five products (and related markets) that will be affected as a result of the LCR. The Clearing House chose these products for analysis because they are the products directly affected by the areas where the LCR’s calibrations most significantly diverge from U.S. worst case/worst period experience – namely, non-operational wholesale deposits and drawdown rates on liquidity lines to non-financial and financial customers.⁴⁰ The five products are commercial paper (CP) backstops, financial institution liquidity lines, variable rate demand note (VRDN) backstops, corporate non-operational deposits, and financial institution non-operational deposits.

The Liquidity Study shows that, as of December 2010, the amounts of liquidity held by banks used in the sample for the analysis with respect to the five products was roughly in line with the worst case/worst period outflow rates during the financial crisis.⁴¹ The analysis undertaken by The Clearing House attempted to quantify the impacts on these products of implementation of the LCR, as reflected in the Basel III liquidity framework, including the pricing and availability of these products. Because of the constraints imposed by antitrust laws, we are describing in this Section IV.A, and have included with the version of the Liquidity Study that accompanies this white paper, only a general discussion of the methodology used and its results. The Clearing House has presented the more detailed results to the U.S. banking agencies on a confidential basis.

1. Methodology

The Liquidity Study arrived at these conclusions by distributing the impact of the LCR among bank products based on the difference between the LCR runoff factors prescribed in the Basel III rules and internal bank outflow assumptions for each product. As indicated above, the main driver of product selection was based on discrepancies between the LCR runoff factor and the actual experience of banks during the crisis, although other considerations, including market size and constituencies of interest, were also taken into account. To develop a fact-based view of the LCR on banks, products, and markets, a coordinated approach was taken:

³⁹ BCBS, *Basel III*, *supra* note 2, at 2.

⁴⁰ See Section II.B of this white paper.

⁴¹ See page 42 of the Liquidity Study for a comparison of the historical amounts of liquidity held by banks against these products as compared to worst case/worst period outflow rates during the financial crisis and implied LCR calibrations.

- i. internal data on the current economics and cost impact of the LCR was collected across fourteen products and thirteen banks, which account for \$9.2 trillion in assets, representing 57% of total U.S. bank assets;
- ii) twenty-five product managers were interviewed across eleven banks in order to understand the implications for product pricing, structure, and availability in response to increased costs;
- iii) thirteen customers and investors were interviewed to understand the implications of the product impact for their cash-management, financing, and investing activities; and
- iv) ten bank treasurers were interviewed to understand the implications for overall balance sheet management (e.g., overall lending availability).

2. Commercial Paper Backstops

CP is a low-cost, short-term financing instrument used by large corporations, banks, and other financial institutions (e.g., money market funds), with a market size of \$1.1 trillion in the first quarter of 2011. Approximately \$500 billion of outstanding CP requires a liquidity line backstop to qualify as investment grade. Additionally, institutions have historically relied more significantly on CP, with the market size in 2007 at approximately \$2 trillion. From the sample of banks surveyed, the price of CP backstops is expected to rise and its structure may change as well due to the LCR. As noted above, the primary driver of the cost increase is the discrepancy between banks' internal liquidity models, historical outflow rates experienced during the 2008 crisis, and the LCR's implied outflow rate. For example, banks have historically held between three to 16% of liquidity against CP backstops. While this was proved insufficient in some instances, when considering that the maximum outflow rate during the 2008 financial crisis was as high as 10%, the LCR requires a stringent 100% coverage. This substantial discrepancy will lead to dramatic changes in the CP market and will change how current CP customers fund themselves.

3. Financial Institution Liquidity Lines

Financial institution (FI) liquidity lines are used by money market funds, broker-dealers, pension funds, insurance companies, and sellers of assets (e.g., auto finance, credit card companies). Using traditional definitions of FI, the market size of FI liquidity lines is approximately \$350 billion. However, the Basel III liquidity rules are based upon a much broader definition of FIs than is traditionally used in the industry. As a result, additional research likely is needed to understand the aggregate amount of credit and liquidity lines outstanding to firms that may fall within the LCR's broad definition of an FI. Again, the cost of providing these liquidity lines is expected to rise as a result of the LCR implied runoff rate, and the structure of the product may change as well. Historically, banks hold an average of 19% liquidity against these products, which experienced maximum outflows of 9% during the crisis. Nevertheless, the LCR factor again accounts for a 100% drawdown rate.

4. Variable Rate Demand Notes

Variable Rate Demand Notes (VRDNs) are low-cost, long-term financing instruments that are primarily used by municipalities, hospitals, and higher-education institutions to borrow long-term at short-term

rates. The market as of the second quarter of 2011 was approximately \$360 billion, which is down from \$420 billion prior to the financial crisis. The reasons for the decrease in VRDNs cited by banks include the fact that municipalities exited the market and that banks also exited the letter-of-credit (LC), or standby bond purchase agreements (SBPA) markets which provide the backstops necessary to qualify VRDNs as investment grade. Ultimately, the LCR may lead to a decrease in availability and an increase in price for VRDNs. Again the primary reason is the 100% LCR implied outflow rate, compared to 18% historically held by banks and a 10% maximum outflow during the crisis.

5. Non-Operational Deposits

Non-operational deposits are comprised of Money Market Deposit Accounts (MMDAs), term deposits, and a portion of Demand Deposit Accounts (DDAs), estimated to be approximately 15% of the deposit base. There is significant variability across banks in classification of deposits as operational or non-operational – for example, some banks treat sweep accounts as operational, while others consider them non-operational. This complicates analysis in this product category. However, under the Basel categorization, the market stands at approximately \$1.5 trillion. Non-operational deposits also represent approximately 30% of corporate short term cash and 10% of FI short term cash.

Again, the discrepancy between the Basel calibrations and the historical worst case run-off rates will cause price increases for these products. For example, while corporate non-operational deposits experienced a maximum outflow of 41% during the crisis, the LCR implied outflow rate is 75%. Similarly, FI non-operational deposits experienced a 38% maximum runoff in 2008 but the LCR requires 100% coverage.

B. The Impact of New Incentives to Increase Holdings in Sovereign Debt

The Basel III liquidity rules evidence a strong preference for banks to use sovereign securities to meet their LCR requirements. The underlying rationale for this preference would seem to be that sovereign securities that meet certain liquidity benchmarks may be just as good as cash during a stress scenario. The support for this argument is questionable and discounted not only by experiences with sovereign debt during the recent crisis in Europe, but also by a new supervisory study on sovereign credit risk published by the BIS Committee on the Global Financial System (CGFS).⁴² This is discussed further in Section VI.C., where key research related to the liquidity rules is assessed. Here, we focus specifically on the unintended customer and product implications of this reliance.

The LCR rules will lead to a substantially higher demand by banks for sovereign debt. The LCR divides the “stock of liquid assets”, which is the numerator in the ratio, into two categories: L1 (cash, central bank deposits and sovereign securities (0% risk weighting)); and L2 (agency MBS and debt securities, non-financial corporate debt and covered bonds (with a haircut)). To be LCR compliant, banks will need

⁴² BIS, *The Impact of Sovereign Credit Risk on Bank Funding Conditions* (July 11, 2011), available at <http://www.bis.org/publ/cgfs43.pdf>.

to carry a larger proportion of sovereign debt with explicit sovereign backing in their investment portfolios.⁴³

This will force banks' asset concentrations into relatively few asset categories, thus altering the economic appeal of those assets and market dynamics in those asset classes (i.e., potentially creating a shortage of liquid assets). Of course, the more banks concentrate in a few asset classes, the greater the risk to the bank and the financial system. First, a bank will have more capital at risk in a single asset class, thus limiting the prudential resilience that portfolio diversification provides.

Additionally, this asset concentration in sovereign obligations could also exert downward pressure on "risk-free" interest rates, especially at medium- and long-term maturities. In particular, the yields of liquid buffer eligible securities are expected to decline relative to those of non-liquid asset buffer eligible securities, so that yield spreads between them would become wider. These generally form the basis for pricing of both wholesale and consumer credit products, ultimately leading to higher costs of credit.

Further, the LCR liquid asset buffer, as defined, will result in a high degree of correlation across certain types of asset classes among financial institutions. Firms may be forced to take similar actions to reach compliance and, during market stress, this may well result in multiple financial institutions attempting to liquidate the same or similar types of assets (herd mentality) which will cause dislocation in market pricing. During the 2008-2009 credit crisis, many securities regarded as highly liquid in pre-crisis times suddenly became illiquid. What seems liquid today may be less liquid tomorrow (i.e., European sovereigns) or under specific circumstances (i.e., U.S. debt crisis/S&P downgrade). This argues for a wider classification of liquid assets (as outlined below) versus the current narrow definition. As seen with the European sovereign crisis, government securities are not always a consistent source of stability. With a broader spectrum of eligible assets, a financial institution is less likely to experience cliff effects (eligible today, not eligible tomorrow) and volatility.

In addition, LCR calibrations currently bifurcate the market into assets that generally either fully qualify or do not qualify at all, with limited exceptions for L2 assets that qualify but only with haircuts. This kind of bifurcation will significantly change how markets function in the future because today's markets capture the liquidity value within pricing and haircuts. A more diversified approach would mitigate this risk by providing at least some inclusion for a wider array of products based on liquidity characteristics.

The LCR's focus on sovereign debt has particular implications in the U.S. due to banks' holdings of agency securities (principally MBS and debentures), along with the importance of advances from the FHLB System as a liquidity source for U.S. banks. Specific issues relating to the role of agencies in the LCR are discussed in Section II.A. Here, we address the unintended consequences of the adverse treatment of agency obligations: bank investment portfolios will be less diversified going forward. There may also be a potentially significant decline in bank investment in agency MBS and debentures without any offsetting improvement in liquidity.

⁴³ In order to meet the LCR shortfall solely by buying L1 assets, U.S. banks would need to increase their U.S. Treasury holdings from 3.2% of total outstanding Treasuries to 14%. If these banks also determine that holding agencies is less attractive than Treasuries, banks could hold up to 28% of total outstanding Treasuries, and this ratio could rise even higher if Treasury issuances return to lower historical levels.

The chart below suggests a more diversified spectrum of liquid buffer assets that will help mitigate the risk of unintended consequences.

	Current LCR Rules	Liquid Asset Buffer should recognize as:
FHLB Capacity	0%	<ul style="list-style-type: none"> A source of liquidity during the crisis by 1st loss / equity owners
Gold	0%	<ul style="list-style-type: none"> Flight-to-quality asset; strong bid for gold during recent crisis
US Agency / Agency MBS	85%	<ul style="list-style-type: none"> Behaving similarly to treasuries, which are included at 100%
Investment Grade Munis	0%	<ul style="list-style-type: none"> Demonstrating, on average, better liquidity during the crisis than US corporate bonds
AAA ABS	0%	<ul style="list-style-type: none"> Behaving similarly to covered bonds, which are included in the liquid asset buffer
Listed Equities	0%	<ul style="list-style-type: none"> A liquid market that exists in all environments for most stocks Daily pricing and transparency

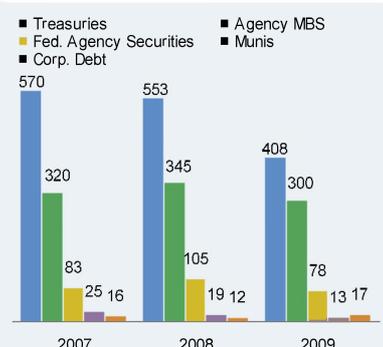
We have addressed the importance of FHLB advances as a liquidity source in Section II.B. The tables below outline why other additional assets should be included in the liquid asset buffer.

Gold:
Price of Gold vs. S&P Index



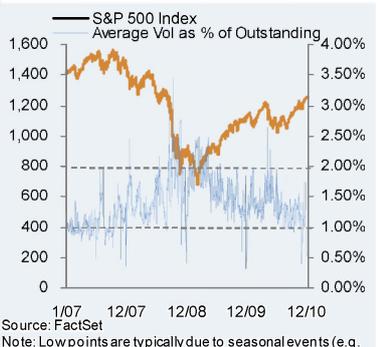
Source: FactSet

Agency / Agency MBS & Munis:
US bond market avg. trading volume (\$B)



Source: SIFMA

Listed Equities:
Avg. trading vol. as a % of outstanding



Source: FactSet

Note: Low points are typically due to seasonal events (e.g. the day before Christmas)

- Gold is considered a flight-to-quality asset. Strong bid usually occurs during a crisis
 - During the last crisis, Gold appreciated by ~35% between 3Q07 and 1Q09
- Gold is a deep and liquid market According to the WGC (World Gold Council) at YE 2009:
 - Total value of the gold market was estimated at \$5.2T+
 - ~\$1.8T is thought to be in the hands of private investors and official institutions
 - Avg. daily turnover in the gold market is ~\$100B
- Agency MBS: large, highly liquid market (around \$300B+ of agency MBS trades each day) that maintained liquidity throughout the recent crisis
- Munis: even though munis trading volumes dropped during crisis (from ~\$23-25B average daily trading volumes in 2006/07), trading volumes remained sizeable (\$13-19B daily trading volumes from 2008/10; ~\$3T munis outstanding) and higher in comparison to US corporate bonds (\$12-16B daily trading volumes from 2008-10)
- Most stocks maintained very high liquidity during the crisis
- Diversified equity positions tend to hold their value even during major crises
- Equity financing is available in times of distress
 - Futures markets – which are a form of equity financing – showed increased activity during the crisis
 - The tri-party repo market remained sizeable and fluid during the recent crisis

C. The Impact of Reduced Agency Holdings on the Mortgage Market

The Basel III liquidity framework’s adverse treatment of agency obligations will negatively (and likely materially over time) affect the U.S. housing market. Agency MBS purchases provide significant support to the U.S. housing market, and mortgage origination in the U.S. depends heavily on a functioning agency MBS market. This market allows lenders to sell their mortgages to issuers and guarantors of MBS, with Fannie Mae and Freddie Mac as the dominant players, to replenish their capital base in order to extend new loans. U.S. banks have a significant stake in these securities, holding approximately \$1.4 trillion, or 18%, of total agency securities outstanding. Agency MBS serve as a store of extremely liquid assets, as markets for them are far more transparent and deep relative to many other L1 and L2 qualifying assets. Outside of U.S. Treasuries and JGBs, the agency MBS market, with Fannie Mae and Freddie Mac securities at approximately \$4.5 trillion, and Ginnie securities around \$1 trillion, is the next largest in terms of outstanding notional.⁴⁴ The market depth of agency securities becomes particularly apparent when considering trading volume and ability to repo as measures of liquidity, discussed in Section II.A.

However, the LCR will force U.S. banks to replace substantial portions of their agency MBS portfolios with U.S. Treasuries. The LCR features that have that result are the treatment of agency MBS as L2

⁴⁴Sources: SIFMA, UK DMO, Dundesbank, Japan MOF, ECBC.

assets, which are limited to 40% of L1 assets, and the “at least” 15% haircut applied to all L2 assets, including agency MBS. Banks replacing agency MBS with U.S. Treasuries would significantly impair the U.S. mortgage market at a point when rapid recovery is needed in this vital area.

D. Perverse Prudential Implications of the Asymmetric Treatment of Financial Institution Liquidity Facilities

The LCR imposes an asymmetric treatment between lenders and borrowers of credit lines. All lines of credit to financial institutions (both credit commitments and liquidity commitments) are assumed to be 100% drawn for purposes of calculating net cash outflows, while all lines of credit from financial institutions are assumed to be unavailable for purposes of calculating net cash inflows during the LCR’s 30-day stress scenario. The rule assumes that “other banks may not be in a position to honor credit lines, or may decide to incur the legal and reputational risk involved in not honoring the commitment.”⁴⁵ But the point of the LCR is to ensure that banks are in a position to honor credit lines. If Bank A has a liquidity facility with Bank B, and both banks are subject to the LCR rules, then Bank B will have pre-funded the liquidity facility. Yet the rules do not allow Bank A to include the potential inflow from drawing on Bank B.

Even in a severe downturn, the expected availability of credit lines will almost always be greater than zero and utilization is extremely unlikely to be 100%. During the financial crisis, the total draw on lines of credit by financial institutions was less than 10% of the available outstanding lines. In the view of The Clearing House, these factors should include, among others, an assessment of the contractual clauses in the lines of credit, the jurisdiction-specific consequences of failing to honor such lines of credit and historical data regarding the availability of such commitments in periods of financial distress.

In addition, in computing the LCR as proposed, a financial institution would have to assume that all inter-company unfunded credit lines to all affiliates of the institution will be fully drawn while asymmetrically assuming no corresponding inflows to the receiving affiliate. This asymmetric treatment, when applied to intra-group liquidity inflows and outflows, could disincentivize groups from maintaining the types of group liquidity management arrangements that can greatly strengthen the resilience of an entity or the group to external shocks.

The consequence of this rule is that banks will dramatically reduce liquidity lines to other banks because the LCR’s required assumption that they are 100% drawn does not reasonably reflect real liquidity risk and imposes significant cost (especially in light of the incorrect treatment of L1 and L2 assets addressed). This is truly a perverse result, as of course liquidity lines provide tremendous support to stressed financial institutions and, thus, are essential shock-absorbers. Even absent stress, these liquidity lines are vital, as they make it possible for receiving banks to maintain reasonable funding levels secure in the knowledge that liquidity is only a call away if market conditions vary or unanticipated opportunities arise. Regulators are rightly concerned about “interconnectedness” – that is, the risk that intra-industry exposures can lead to reverberations of market stress that undermine otherwise sound financial institutions. However, this interconnectedness is being addressed in numerous venues (e.g., the significant change in regulatory capital imposed elsewhere in the Basel III rules for credit exposures to larger financial institutions and pending large-exposure limits). A sound liquidity framework requires

⁴⁵ BCBS, *Basel III liquidity framework*, *supra* note 2, at ¶ 111.

that bank lines of credit to others be appropriately funded, but the LCR's assumptions are punitive and unnecessary in light of recent, catastrophic-risk experience.

V. ENHANCED PRACTICES FOR LIQUIDITY-RISK MANAGEMENT

A. Introduction

Prescriptive arithmetic liquidity ratios, even if perfectly calibrated and internationally consistent, taken alone are not a sufficient response to the need for more robust liquidity risk management. Formulaic ratios are just one tool and, inevitably, have deficiencies. In response to the financial crisis, U.S. banks, with the assistance of their regulators, have made substantial progress in enhancing their liquidity risk management practices. Enhanced practices at these firms are rooted in forward-looking stress scenarios, disciplined corporate governance and comprehensive risk gradation of how a bank's various balance-sheet instruments will behave under stress. This section presents a composite description of what our member banks believe is the current approach to liquidity-risk management at larger (roughly \$50 billion in assets or greater) banking organizations in the U.S.⁴⁶

U.S. regulators played an important role in improving industry practices by establishing new policies on liquidity risk and by stepping up scrutiny of practices firm-by-firm. All of these changes have significantly enhanced liquidity, making the calibrations of the current rules still more quixotic given the increase (discussed in Section I) – not reduction as one would expect – in the liquidity shortfall uncovered in the analysis of QIS data from 2009 to 2010.

B. Recent Developments in Liquidity-Risk Management in the U.S.

Liquidity-risk management in the U.S. has evolved rapidly since the crisis. Financial institutions that survived the disruptions in the financial markets in 2007-2009 had to adjust their practices and risk tolerances to account for actual experiences that exceeded their prior worst case expectations. U.S. regulators also responded by issuing new regulations described in Section C of Appendix 2 and by increasing their focus on liquidity-risk management practices on a firm-by-firm basis.

1. Lessons Learned by Financial Institutions

Prior to the crisis, with the exception of a few larger institutions that actively used scenario analysis, most financial institutions relied on backward-looking balance-sheet liquidity metrics, such as liquid assets as a percentage of total assets, or static ones that track current funding spreads. It was generally assumed that a majority of a bank's assets could provide reliable liquidity through asset-based borrowing and securitization. As banks began to face illiquid markets for mortgages, commercial real estate, corporate loans, automobile and card assets, they were forced to revise their assumptions. Many banks began to do scenario analysis for the first time to assess their liquidity positions.

2. Core Principles Established by the U.S. Regulators

U.S. regulators also played an important role in guiding banks towards more conservative practices. Previously, guidance on liquidity-risk management largely took the form of guidance from examiners

⁴⁶ This description of enhanced practices is focused on depository institutions and therefore does not address the specific requirements of broker/dealers or trust banks, though many of the principles described herein apply to these types of institutions.

rather than explicit rules for U.S. banks. During the crisis, regulatory examiners substantially increased their scrutiny of liquidity-risk management and reviewed each bank's overall framework in-depth, focusing on longer-term stress testing, contingency funding plans (CFPs), corporate governance structure and organizational obstacles to enhanced practices. The issuance of proposed regulatory guidance in 2009,⁴⁷ finalized in 2010 as an Interagency Final Policy Statement on Funding and Liquidity Risk Management,⁴⁸ was a significant milestone, building on the Basel Principles of 2008.⁴⁹

However, the U.S. did not stop with the 2010 interagency statement. In June 2011, the agencies published Proposed Guidance on Stress Testing for Banking Organizations with More than \$10 Billion in Total Consolidated Assets that establishes core principles to meet stress scenarios for both capital and liquidity.⁵⁰ This guidance codifies the advice regulators had been providing banks for several years – that stress testing is an important risk management practice that supports forward-looking assessment of risk. This is not yet reflected in the Basel III rules. Further, the Federal Reserve has mandated several stringent stress tests for the nineteen largest banking organizations, most notably the Comprehensive Capital Analysis and Review (CCAR) stress tests in early 2011⁵¹ that incorporate aspects of liquidity risk to forward-looking capital planning. The Federal Reserve has now proposed far more stringent capital-plan standards⁵² that more directly link capital and liquidity stress-testing and forward-looking analysis, again going well beyond the Basel III standards.

C. Current Enhanced practices

In general, emerging enhanced practices at larger financial institutions integrate liquidity-risk management within overall strategic planning. Liquidity-risk management is recognized as an important risk management function that requires dedicated resources and oversight consistent with other risk areas such as credit risk, operational risk and market risk. In addition, acknowledgement of the interplay between credit, market, operational, and liquidity risks during the crisis has promoted stronger alignment and understanding across the risk functions and capital planning. Since liquidity risk is often the after-effect of adverse credit, operational or market events, an enterprise-wide approach to capital and liquidity stress testing is taken, ensuring that the various risk management and capital planning functions consider stress scenarios in concert, with iterative feedback loops that evaluate ultimate effects. Enhanced practices for the largest institutions have evolved towards the integration of forward-looking views of liquidity risk with the overall strategic planning for the institution. This is in sharp contrast to the "silo" approach taken in Basel III, where capital, liquidity, operational and market risks are addressed as if there were no interactions among them.

⁴⁷ *Proposed Guidance on Funding*, *infra* note 100.

⁴⁸ *Final Policy Statement*, *infra* note 101.

⁴⁹ BCBS, *Principles*, *infra* note 87.

⁵⁰ *Proposed Guidance on Stress Testing*, *infra* note 102.

⁵¹ Federal Reserve System, *Comprehensive Capital Analysis and Review: Objectives and Overview* (Mar. 18, 2011), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110318a1.pdf>.

⁵² FRB, *Capital Plans*, *infra* note 103.

Financial institutions should focus on both short-term liquidity and longer-term 'structural' liquidity ensuring that institutions fund long-term illiquid assets with long-term liabilities. Each requires its own framework and analysis, and is best communicated with metrics specific to the horizon. The objective of short-term liquidity is to ensure that there is an adequate liquidity buffer to address unexpected adverse developments over a short time period in which mitigating actions are not feasible. The objective of strategic liquidity analysis is to identify vulnerabilities in the institution's balance sheet or business model that may only manifest themselves over the course of months or years. When such vulnerabilities are identified, the firm can take proactive, deliberate steps to either remove them or to ensure that they are mitigated. The two approaches work in a complementary fashion.

1. Short-Term Liquidity

a. Typically U.S. institutions utilize overnight and other short-term horizons, such as seven days out to 30 days, to establish short-term liquidity buffers using quantitative metrics similar to the LCR. Recognizing that, in the short-term, the firm is less able to react to a substantial unexpected funding gap due to an operational error or sudden stress, these buffers incorporate a high degree of conservatism. Only highly reliable sources of liquidity are included in the buffer such as cash and asset-based funding sources that can be tapped readily with reliable counterparties (e.g., FHLB and repo counterparties).

b. As also noted in Section V.D below, the judgments that firms make in developing their internal liquidity metrics are complex and take into account firm-specific conditions, such as their current and potential financial position and standing in various markets. In contrast, the LCR and NSFR are formulaic and while useful as broad, standardized measures, firms, with supervisory review, are better able to evaluate the liquidity of their assets, liabilities and OBS items based on their client capacity, market participation, operational capability and current and potential financial condition.

c. Additional stress may be incorporated through adoption of formal scenarios, similar to those used in the longer-term strategic framework, focused on specific factors over a shorter survival horizon. Alternatively, the sources of liquidity can be increasingly restricted and/or haircut according to a pre-established schedule of escalating stress stages. In either methodology, measurement of liquidity buffers takes into account the diminished liquidity value of liquid assets due to idiosyncratic as well as market liquidity and funding liquidity developments.

2. Longer-Term Strategic Liquidity

a. Financial institutions conduct multiple stress scenarios over time horizons of one year or longer (survival horizons) that address the vulnerabilities of the institution. Such vulnerabilities may include over-reliance on certain funding sources, loan/investment portfolios that exhibit high credit risk or unreliable market liquidity, considerable off-balance sheet (OBS) commitments that would generate cash outflows in times of stress, and/or a business model that requires a minimum rating. The scenarios contemplate institution-specific events, systemic market disruptions and a combination of the two.

b. The development of stress scenarios is an iterative process whereby executive management and the board are actively engaged in the discussion of which scenario or scenarios

express the risk tolerance of the firm. The level of risk tolerance determines the severity of the scenario and, in turn, the results of the stress scenarios help management articulate both its risk tolerance and management of that risk. Once the level of risk tolerance is established, that stress scenario or set of scenarios that reflect management's risk tolerance are used to establish minimum liquidity buffers that are to be maintained throughout the designated survival period.

c. These liquidity buffers may take the form of minimum projected liquid assets that remain after all forecasted cash outflows in the scenario or a ratio of liquid assets as a proportion of such forecasted outflows.

d. Stress scenarios help optimize the mix of balance sheet liquidity and structural liquidity. Balance sheet liquidity, or highly liquid assets that can be readily converted to cash in stress, can be reduced to the extent that projected cash outflows in times of stress can be reduced. Projected outflows may be reduced by adding structural liquidity, or term funding that has no potential for early withdrawal under any circumstances. Just as credit risk management can minimize reserves for credit losses by maintaining a high quality loan portfolio, liquidity-risk management can minimize liquid asset holdings by maintaining a highly reliable liability portfolio through sufficient structural liquidity. The optimal mix of balance sheet and structural liquidity will depend upon a number of factors including the relative costs of each. Generally an overall targeted amount of structural liquidity is established given the institution's unique balance sheet structure. For example, many firms utilize a cash capital or working capital ratio, which is similar in nature to the NSFR, whereby structural liquidity is sized to cover the firm's least liquid assets.

e. Stress scenarios also inform contingency funding planning. Through stress testing, the reliability of the institution's deposits, wholesale funding sources and contingent assets are analyzed. Each of these will contribute to cash outflows during times of stress, though not always for the same reasons. CFPs describe the framework for managing adverse liquidity events and are a key component of the firm's stress tests. The CFP prescribes roles and responsibilities, management actions for various levels of stress, and identifies alternative contingent sources of liquidity to ensure that the firm may continue to fund normal operating requirements. Enhanced practices also dictate that risk capacity, as derived from stress test results, is linked with a firm's liquidity position as calculated on a daily basis.

f. Stress testing, limits on liquidity mismatches, and contingency funding planning are dynamic. As macroeconomic, market, and institution-specific conditions change, stress scenarios, liquidity mismatch limits, and CFPs are adjusted to ensure that they are relevant in light of current conditions.

D. Classification of Liquidity Risk and Benefits

A critical aspect of liquidity-risk management that underpins stress testing is the identification and classification of balance sheet instruments and QBS with respect to their liquidity risk characteristics, specifically how the various instruments will behave in stress conditions. Run-off factors for liabilities, draw-down factors for contingent assets and liquidity values for liquid assets are analyzed and assigned for each scenario.

Just as credit risk managers classify loans for ultimate sizing of reserves for credit losses and capital, liquidity risk managers grade assets, liabilities and OBS items to determine both the appropriate amount of high-quality liquid assets to maintain and the likely “time to liquidity”. However, unlike existing frameworks for measuring credit risk (accounting standards under U.S. GAAP or IFRS, and regulatory approaches under the Basel Committee’s capital frameworks), there is no standardized approach for liquidity risk classification. Liquidity risk managers apply a judgmental approach, taking into consideration industry data that demonstrate behavior in past crises, as well as input from subject matter experts in the lines of business. In current practice, regulatory examiners review management’s stress scenario assumptions to ensure that they are well thought out and are reasonable.

Liquid assets are carefully monitored to ensure that ongoing developments, both institution-specific and macroeconomic, are captured in estimating the liquidity value of liquid assets in stress conditions. Alignment and strong communication with colleagues managing market risk and credit risk, as well as front-line colleagues dealing directly with the financial markets, clients and operational considerations with respect to the firm’s investment and wholesale funding portfolios, are critical to ensure that liquidity risk managers have relevant information about liquidity value and timing. Assumptions about liquidity values and time to liquidity in stress conditions are made based on risk gradation of the various asset types, and these assumptions are reviewed on a regular basis.

The importance of risk and benefit classification cannot be emphasized enough. Analogous to capital allocation to cover credit and market risks through classification of appropriate risk-weighting of assets under Basel II, a bank’s assets, liabilities and OBS items must also be “risk-weighted”. There are many complicated factors to consider such as how the various liabilities and contingent assets operate in applicable markets and the particulars of the product features.

E. Incorporation of Liquidity Risk in Funds Transfer Pricing

The risk classification described above is used to allocate costs and benefits of liquidity to business lines to ensure alignment of their risk-taking incentives with the liquidity risk exposure their activities create for the institution as a whole. In addition to the normal operating costs and benefits of liquidity in a firm’s funds transfer pricing (FTP) program, financial institutions also assess the costs of contingent liquidity that must be reserved for products that give rise to increased liquidity needs during times of stress, when new funding is unlikely to be available. These institutions incorporate liquidity costs, benefits and risks in internal product pricing, performance measurement and the new product approval process for all material activities.

F. Conclusion

The Clearing House supports banks' and regulators' endeavors to develop a comprehensive liquidity risk monitoring framework that incorporates a standardized, properly calibrated quantitative approach to measuring liquidity risk. Metrics that capture an institution's liquidity position in a forward-looking stress scenario are unarguably the most meaningful and reflect enhanced practices at larger banks and, over time, the LCR and NSFR could serve as two quantitative metrics for liquidity risk to be incorporated as standardized measures that would be part of the overall liquidity risk management framework. However, we believe that these two measures should supplement, not supplant, internal measures of risk, and should be evaluated alongside the internal measures when evaluating the overall liquidity position of the firm. At the core of liquidity stress scenarios lies a liquidity risk/benefit classification scheme that predicts the behavior of an institution's liabilities and contingent assets under stress, as well as the liquidity value of its liquid assets under stress. Assessing the liquidity value of liquid assets is the easier of the two given that there is a limited set of liquid asset types that can be considered reliable in times of stress. U.S. financial institutions and regulators must work together to establish a comprehensive liquidity risk monitoring framework which ensures that risk classification of liabilities and contingent assets are appropriately calibrated and synchronized across firms before a standardized metric can be established.

VI. OTHER QUALITATIVE CONSIDERATIONS

A. Role of Government Liquidity Facilities During the Financial Crisis

As discussed in Section II and demonstrated in the Liquidity Study, the Basel liquidity rules employ run-off factors that fail to reflect actual experience of U.S. banks during the financial crisis. In contrast, the calibrations in the Liquidity Study, described in this paper, are derived from data received from The Clearing House member banks that reflect actual worst-case/worst-period experience generally in advance of the establishment of government liquidity support facilities deployed during the crisis.

Regulators have asked whether it is possible to filter out the impact of U.S. government support programs -- or more broadly the perception that the U.S. government may provide support -- from the worst case/worst period analysis of calibrations reflected in The Clearing House Liquidity White Paper. The question is a good one, and it is very difficult to completely remove government support -- actual or potential -- from this type of analysis. However, comparison of the timing of U.S. government support programs during the financial crisis and the experience of several banks that failed during the crisis before most government support programs were in place provides a partial answer. Moreover, calibrating the LCR to a standard that truly eliminates all governmental support -- again, actual or potential -- tends toward the "no bank ever fails due to liquidity risk" goal discussed in the introductory paragraphs of Section II. We believe such a goal is impractical.

As shown in the Liquidity Study, government liquidity support from the Federal Reserve Board, Treasury and FDIC reached its peak in December of 2008 at nearly \$1.2 trillion of net liquidity. However, it is important to recognize that these facilities were not all established in a single instance. Many of these facilities were intermittently deployed between the fourth quarter of 2007 and the fourth quarter of 2008 as the full extent of the crisis became apparent. Further, many of the emergency liquidity facilities were used to support non-banking organizations (e.g., money-market funds) and/or financial institutions (investment banks, foreign institutions) not included in this study. Thus, the actual existence of massive government liquidity-support programs -- which of course were put in place in the crisis -- does not support a simple conclusion that bank calibrations in this study are far less severe than those in the Basel III standard solely due to use of emergency-support programs.

The Liquidity Study, in contrast to the assumptions incorporated in the Basel rules, presents calibration data that reflects actual worst-case/worst-period scenarios, though perhaps not the worst case possible, for two U.S. banks that failed during the financial crisis: Wachovia Bank and Washington Mutual. Importantly, Wachovia and Washington Mutual failed and were acquired by other banks on October 3, 2008 and September 25, 2008, respectively, before the majority of government liquidity facilities had been established. Indeed, on October 3, 2008, when Wachovia Bank was sold to Wells Fargo, the only government liquidity facility directed towards banks then in operation was the Term Auction Facility (TAF), which was established by the Federal Reserve Board on December 12, 2007. While Wachovia and Washington Mutual both made use of this facility, they collectively accessed only \$20 billion before their eventual sales. Therefore, calibrations derived from these two institutions can serve as appropriate benchmarks for stress in the absence of government support. Initial conclusions that can be drawn from these acquired institutions demonstrate that:

- The worst 30-day run-off for retail deposits at insured depositories was in-line with the LCR, but uninsured deposits experienced a significantly more severe run-off factor.
- The worst run-offs in demand deposit accounts and negotiable order of withdrawal accounts were less severe than the LCR factor for operational wholesale deposit accounts, and run-offs in money market demand accounts and non-core deposits was less severe than the non-operational account factor.

B. Conflicting Capital and Liquidity Regulation

A key prudential concern is the manner in which the LCR works in tandem with the capital requirements applicable to large U.S. banks. Even if the Basel III capital and liquidity rules were wholly justified as finalized, the two standards intersect to result in unintended and adverse consequences.

First, the Basel III rules require capital adjustments based on unrealized gains and losses, increasing earnings and capital volatility related to holdings of obligations marked to market under applicable accounting standards. This creates an incentive for some banks to move away from fixed-income and other assets favored under the liquidity rules even though these assets may pose little long-term credit risk – the reason they are selected for favorable treatment in the liquidity rules. While the fixed-income assets favored in the liquidity rules are generally granted favorable risk-based capital treatment, U.S. banks are under significant pressure to increase capital against these risk weightings which affects their ability to hold all assets and may even create incentives to hold higher-risk ones. Further, the U.S. is the only nation with a leverage capital requirement that forces significant amounts of capital to be held even against assets such as U.S. Treasury obligations that are granted a zero under the risk-weighting scheme. Pressures here are clearly evident, as recent market events have led to unprecedented amounts of these holdings and further leverage-related capital stress.

Second, the LCR forces U.S. banks to shift out of certain asset classes – e.g., holdings of agency MBS and debentures – to U.S. Treasuries and other sovereign debt. This will have a significant and adverse impact on the U.S. mortgage market, but it also has a surprising impact on the structure of the U.S. banking industry: it will force big U.S. banks to grow their balance sheets even larger so that they can hold enough capital to offset the cost of the LCR’s forced asset shift. However, deposit products present their own risks – e.g., interest-rate mismatches. Thus, to be prudent, a bank will need to “gross-up” its balance sheet with hedging instruments to match its liability profile, essentially ballooning its balance sheet for non-business reasons created by an ill-designed liquidity measure that forces uneconomic liability strategies that, in turn, require new hedging strategies for continued safe-and-sound operation.

C. Research Assessment

Since the onset of the financial crisis, there has been a relative dearth of research focused on the assumptions on which the Basel III liquidity framework’s rules are based and macroprudential and macroeconomic effects of enhanced liquidity-risk standards as compared to the attention accorded capital requirements. And the limited research published to date is inconclusive. Academic and regulatory research discussed further below makes clear that even the Basel Committee and its parent organization, the Bank for International Settlements (BIS), have significant qualms about the assumptions on which these rules are premised. The International Monetary Fund (IMF) has sounded a clear, cautionary note, stating that “[P]olicymakers will need to be conscious of the interactive effects of

multiple approaches to mitigate systemic risks. Capital surcharges or other tools to control systemic solvency risk could help mitigate systemic liquidity risk.”⁵³ The Clearing House does not support a capital surcharge and has elsewhere conducted extensive research on it to demonstrate its adverse implications,⁵⁴ but these problematic results are compounded when a surcharge is imposed in tandem with a new, costly liquidity requirement that is implemented at the same time numerous other new rules are being put in place with unknown implications when all are taken into full account. Even the Chairman of the Federal Reserve Board, Ben Bernanke, has noted that the total cost of all of these rules is still unknown to the regulators.⁵⁵

1. Concerns with a Bank-Centric Approach

As the IMF paper cited above addresses, the current approach to governing liquidity risk is bank-centric.⁵⁶ As a result, it may encourage a transfer of liquidity risk from regulated banks to unregulated, or less regulated, “shadow” organizations, doing little thereby to prevent future financial crises. The FSB has begun to consider how various bank-centric rules may encourage the transfer of financial activities from regulated providers of credit intermediation (e.g., traditional banking) to shadow firms,⁵⁷ but has taken no concrete action yet to address this major risk. It is vital that the liquidity rules, like all the others now being demanded of banking organizations, be carefully calibrated to prevent risk migration outside of regulated institutions and from nations with meaningful regulatory regimes to “haven” states.

2. Studies Evaluating the LCR’s and NSFR’s Impact Are Inconclusive

The studies that have sought to evaluate the impact of the LCR and NSFR have been inconclusive at best. As many of the studies have noted, accurately measuring liquidity data and modelling challenges make the pending standards particularly difficult to analyze.⁵⁸ For example, two BCBS reports published in

⁵³ Jeanne Gobat et al., *International Monetary Fund: How to Address the Systemic Part of Liquidity Risk: Global Financial Stability Report* (April 2011), available at <http://www.imf.org/external/pubs/ft/gfsr/2011/01/pdf/press2.pdf>.

⁵⁴ Letter from The Clearing House to Timothy Geithner, Secretary, U.S. Department of Treasury, Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Sheila Bair, Chairman, FDIC, and John Walsh, Acting Comptroller of the Currency, OCC (June 15, 2011) available at <http://www.theclearinghouse.org/index.html?f=072373>.

⁵⁵ Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke’s Speech on the U.S. Economic Outlook (June 7, 2011) (transcript available at <http://video.cnbc.com/gallery/?video=3000026289>) (stating: “Has anybody done a comprehensive analysis of the impact on credit? I can’t pretend that anybody really has. It’s just too complicated. We don’t really have the quantitative tools to do that.”).

⁵⁶ Gobat, *supra* note 54.

⁵⁷ Financial Stability Board, *Shadow Banking: Scoping the Issues*, (Apr. 12, 2011), available at http://www.financialstabilityboard.org/publications/r_110412a.pdf.

⁵⁸ BCBS, *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements* (Aug. 18, 2010) at 14, available at <http://www.bis.org/publ/bcbs173.pdf>.

August 2010 assess the transition to the LCR and NSFR⁵⁹ and the long-term economic impact of these standards.⁶⁰ Both studies acknowledge that a number of assumptions need to be made in order to model the effects of the liquidity rules, noting further that these assumptions are subject to debate. An assessment of the status of recent research, focusing principally on these BCBS and related studies, is helpful to understanding the quantitative and qualitative analytics presented elsewhere in this white paper.

The BCBS study on long-term effects does not advocate particular calibration levels, but it does estimate that, in order for banks to meet the NSFR, lending spreads will increase by fourteen basis points after synergies with increased capital requirements are taken into account.⁶¹ While the report suggests there are net economic benefits for enhancing capital and liquidity requirements, it concedes that, in measuring the impact of liquidity, “there is a range of uncertainty around estimates of central tendencies, reflecting data limitations and the need for various modeling assumptions.”⁶² Indeed, the report does not specifically evaluate the LCR because “based on the information available...it was only possible to model the December 2009 proposal for the NSFR, albeit imperfectly.”⁶³

Similarly, the BCBS study on the transition phase to enhanced prudential standards states that “a 25% increase in liquid asset holdings is estimated to lower GDP by a maximum of 0.13% of GDP” but concedes that many of the models used to arrive at this number were more “uncertain about these results than those for capital, noting that the statistical relationship between liquidity ratios and lending spreads tended to be weak. Given data limitations, not all member nations were able to model the potential impact of the NSFR.”⁶⁴

Similarly problematic, a BIS working paper offers a map for bank compliance with the NSFR and estimates the corresponding increase in lending spreads to be twelve basis points after accounting for the fall in risk-weighted assets due to capital synergies, but the methodology is admittedly “based on a series of assumptions” and the “estimates are sensitive to changes in the balance sheet structure.”⁶⁵

The results of a more recent study performed by the BIS Monetary and Economic Department were in line with these BCBS findings.⁶⁶ Using a number of widely accepted macroeconomic models to

⁵⁹ BCBS, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements – Interim Report* (Aug. 18, 2010), available at <http://www.bis.org/publ/othp10.pdf>.

⁶⁰ BCBS, *Long-Term Economic Impact*, *supra* note 59.

⁶¹ *Id.* at 24.

⁶² *Id.* at 31.

⁶³ *Id.* at 23.

⁶⁴ BCBS, *Macroeconomic Impact*, *supra* note 60, at 18.

⁶⁵ BIS, *Working Paper No. 324: Mapping Capital and Liquidity Requirements to Bank Lending Spreads* (Nov. 2010) at 27-28, available at <http://www.bis.org/publ/work324.pdf>.

⁶⁶ P. Angelini et al., *BIS Working Paper No. 338, BASEL III: Long-Term Impact on Economic Performance and Fluctuations* (Feb. 2011), available at <http://www.bis.org/publ/work338.pdf>.

analyze the impact of various combinations of higher capital ratios and liquidity targets on long-term economic performance, this paper found that a 25% increase in the liquidity ratio (as defined in these models) results in an eight basis point reduction in baseline output projections, and a 50% increase results in a fifteen basis point reduction.⁶⁷ In addition to economic performance, this study also examined the long-term effect of higher liquidity requirements on economic fluctuations and found that a 25% increase in the liquidity ratio results in a 1% reduction in the standard deviation of output.⁶⁸ While the results of this study were, in the opinion of the authors, consistent with those of the BCBS findings presented above, they acknowledge limitations of the approach that introduce uncertainty to their conclusions. Specifically, the study acknowledges that current macroeconomic models are not well suited to forecasting the impact of the Basel III liquidity standards because they either do not account for bank liquidity entirely or they rely upon “very simple [liquidity] definitions (e.g. [sic] the ratio of cash and government bonds to total assets), quite distant from the complex measures introduced by the new rules.”⁶⁹ In addition, the study points out that data gaps and modelling uncertainty did not allow for an account of national heterogeneities.⁷⁰

While BIS economists have been unable to confidently quantify the impact of the liquidity rules, the BCBS has prescribed these rules using assumptions of uncertain validity. For example, the Basel III liquidity rules evidence a strong preference for banks to use sovereign securities to meet the LCR requirements. The underlying rationale for this preference would seem to be that sovereign securities that meet certain liquidity benchmarks may be just as good as cash during a stress scenario.⁷¹ The support for this argument is questionable and discounted by a new supervisory study and recommendations on sovereign credit risk published by the BIS Committee on the Global Financial System (CGFS).⁷² This paper demonstrates that downgrades in sovereign credit reduce the ability of banks to cost-effectively access important funding channels such as the market for wholesale funds.⁷³ The CGFS notes that the advanced economies, specifically the U.S. and EU members, may be entering a period of heightened sovereign risk due to the extraordinary measures undertaken by these countries during the financial crisis and their ongoing fiscal struggles with debt and rising government obligation costs.⁷⁴ While the Basel III liquidity rules are not specifically mentioned in this paper, the CGFS does conclude that the financial crisis has shown that sovereign debt may not be liquid or riskless in all

⁶⁷ *Id.* at 20.

⁶⁸ *Id.*

⁶⁹ *Id.* at 5.

⁷⁰ *Id.* at 1.

⁷¹ BCBS, *Basel III liquidity framework*, *supra* note 2, at ¶¶ 38-40.

⁷² BIS, *The Impact of Sovereign Credit Risk on Bank Funding Conditions* (July 11, 2011), available at <http://www.bis.org/publ/cgfs43.pdf>.

⁷³ *Id.* at 1.

⁷⁴ *Id.*

instances, and it advises national authorities to proceed with caution when implementing policies which incentivize banks to hold large amounts of government securities.⁷⁵

3. Only One Study Attempts to Assess the Basel III Liquidity Framework's Impact on the Banking Industry Per Se

Only one final study to date attempts to assess the impact of the liquidity rules on the banking industry per se, though the authors to our knowledge conduct this examination in combination with the new capital rules. In a recent paper, Bill Allen et al. conclude that Basel III will force banks to change their current business model from one of asset-driven liability management, which is predicated on easy access to the short-term wholesale markets, to one of asset management, where asset volumes are constrained by the availability of long-term funding.⁷⁶ Otherwise stated, bank balance sheet size will be limited by the ability to attract funding and not the ability to find assets.⁷⁷ According to the authors, this constraint will inevitably result in higher lending rates to compensate banks for the increase in their funding costs.⁷⁸ However, this paper finds that “in the long run (once there is a full adjustment) the costs of credit to most bank borrowers will be only moderately affected ...,”⁷⁹ citing as an example corporate loan portfolio increases of no more than 60 basis points.⁸⁰ The authors support this conclusion by asserting that policymakers will adjust fiscal and monetary policies to mitigate the impact of the Basel III rules on bank lending rates.⁸¹ In addition, the authors argue that banks will absorb some measure of the Basel III costs through efficiency gains and cost reductions rather than pass along the full cost impact to their customers.⁸² This positive result is, however, tempered by a more negative assessment in this study of the rules’ effects at the riskier end of the credit spectrum. There, high credit risk borrowers such as small businesses will bear the brunt of the rules’ impact as Basel III punishes bank assets with higher risk weightings or those more likely to be impaired during a major economic downturn.⁸³ This is a significant factor since these companies often do not have access to funding through capital markets. The resultant tightening of credit at this end of the spectrum could, therefore, move these “borrowers to more expensive forms of credit (or den[y] them credit altogether).”⁸⁴ The

⁷⁵ *Id.* at 2.

⁷⁶ Bill Allen et al., *Basel III: is the cure worse than the disease?* (Sept. 2010) at 3, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1688594.

⁷⁷ *Id.* at 4.

⁷⁸ *Id.* at 13.

⁷⁹ *Id.* at 4.

⁸⁰ *Id.* at 26.

⁸¹ *Id.* at 13.

⁸² *Id.* at 17.

⁸³ *Id.* at 28.

⁸⁴ *Id.* at 28 (quoting Ben Bernanke, *Credit in the Macroeconomy*, Federal Reserve Bank of New York Quarterly Review (Spr. 1993) at 56).

authors suggest that the exclusion of these types of borrowers from the credit market may have long-term negative effects on economic output as small businesses are important engines of employment and business innovation.⁸⁵

⁸⁵ *Id.* at 29.

Glossary

ABS – Asset Backed Securities
Basel Committee or BCBS – Basel Committee on Banking Supervision
BHC – Bank Holding Company
BIS – Bank for International Settlements
BIS CGFS – Bank for International Settlements Committee on the Global Financial System
CBRC – China Banking Regulatory Commission
CCAR – Comprehensive Capital Analysis and Review
CFP – Contingency Funding Plans
CGFS – BIS Committee on the Global Financial System
CMM – Constant Maturity Mortgage
CP – Commercial Paper
CRAs – Credit Rating Agencies
CRD IV – Capital Requirements Directive IV
DDAs – Demand Deposit Accounts
EBA – European Banking Authority
EC – European Commission
ECB – European Central Bank
EU – European Union
FHLBs – Federal Home Loan Banks
FHLB System – Federal Home Loan Bank System
FI – financial institution
FI Liquidity Lines – Financial Institution Liquidity Lines
FSB – Financial Stability Board
FTP – Funds Transfer Pricing
GAAP – Generally Accepted Accounting Principles
GSE – Government Sponsored Enterprise
HKMA – Hong Kong Monetary Authority
IFRS – International Financial Reporting Standards
IMF – International Monetary Fund
JGBs – Japanese Government Bonds
L1 Assets – Level 1 Assets
L2 Assets – Level 2 Assets
LC – Letter of Credit
LCR – Liquidity Coverage Ratio
The Liquidity Study – the study attached as Appendix 1
LTD Ratio – Loan-to-Deposit Ratio
MBS – Mortgage-Backed Securities
McKinsey & Company, Inc. – McKinsey
MMDA – Money Market Deposit Accounts
MMMFs – Money Market Mutual Funds
NSFR – Net Stable Funding Ratio
OBS Assets – Off-Balance Sheet Assets
QIS – Quantitative Impact Study
RWAs – Risk Weighted Assets

SBPA – Standby Bond Purchase Agreements
September Clearing House Study – the study attached as Appendix 2
SME – Small and Medium Enterprises
USG – United States Government
VRDN – Variable Rate Demand Notes
Wells Fargo – Wells Fargo and Company

Appendix

Background

As noted in the Introduction to this white paper, the Basel III liquidity framework is the cornerstone of the regulatory community's response to inadequacies in liquidity-risk management that became apparent during the financial crisis. Liquidity risk is the risk that a bank or other entity will be caught short – that is, while it has the capital and other assets to meet its obligations over time, it cannot honor immediate claims because the funds to do so are inaccessible, previously committed or simply not in place. In this Appendix 2, we have summarized the Basel III liquidity framework and highlighted liquidity-risk regulatory developments in the United States apart from pending implementation of the Basel III standards.

A. Global Regulatory Action

The liquidity rules in Basel III reflect lessons learned during the financial crisis. Liquidity stress in the crisis began in 2007 and, in some cases, occurred at financial institutions that, while in full compliance with applicable capital standards or even well above Basel II requirements, still experienced acute stress or even failed. Markets evaluated the capital position of firms in real time and assessed the amount and composition of capital. As a result, the evaluation of a firm's viability may have differed from the definition of solvency in the regulatory capital rules and in certain instances resulted in denial of market funding. Because markets before the crisis were in boom mode, institutions (especially non-banks like Lehman Brothers) were easily able to obtain funding and often sought to maximize returns by moving to shorter-term instruments that cost less even though the assets being funded had considerably longer tenors. Often, off-balance sheet (OBS) assets, especially non-contractual ones, went wholly unfunded even though firms under pressure needed to fund these assets to honor their explicit or implicit commitments under stress to avert still more extreme stress in what they feared would be a downward spiral of systemic risk. When markets froze and short- and long-term funding markets evaporated, many firms were threatened because they simply could not meet their immediate obligations. In response, hundreds of billions of dollars in government facilities were rapidly constructed to support financial markets in turmoil due to the liquidity strains and the solvency crisis brewing as a result of rapidly deteriorating asset quality and insufficient capital.

It is vital to note the inter-relationship between liquidity and capital regulation, as well as the impact of these two critical regulatory issues with another important pending reform: new resolution practices for very large financial institutions, including cross-border ones, to ensure that they can be resolved under stress and that none is too big to fail. Liquidity and capital stress reverberate in ways clearly seen during the financial crisis that could likely have been handled at the time had effective resolution protocols been in place in concert with improved capital and liquidity resilience. For example, when firms scramble to meet claims from counterparties for which they lack ready funds, they will often seek to sell assets to raise these funds. Doing so under stress market conditions creates "fire sales" – that is, downward spirals of market prices as investors seek to unload assets before prices drop still farther as more panicky sellers seek to do the same. Downward asset pricing creates "cliff effects," situations in which a single action like stress on one systemic institution leads to dramatic reductions in asset valuations that, in turn, undermine capital adequacy, precipitating another round of market and regulatory actions that exacerbate stress and provoke still more systemic risk. The absence of proven

orderly-resolution protocols for systemic institutions during the crisis made the drop off these cliffs still more pronounced and quick because investors feared unbridled market chaos as even the soundest systemic firms struggled to handle the catastrophic stress of a financial market seemingly in free-fall.

To address the liquidity-risk issues experienced during the crisis, the final Basel III liquidity standards were issued in December 2010 following principles-based global guidance in this area in 2008⁸⁶ and a proposal for a more prescriptive set of quantitative requirements released in 2009.⁸⁷ The final standards build on the earlier requirements, but go well beyond them by stipulating two minimum quantitative requirements: a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR), along with numerous supplementary requirements.

When the Basel Committee released the final standards, the United States, through the regulators that sit on the Basel Committee, made clear that it intended to implement the rules. National regulators do, however, have discretion not only with regard to certain aspects of these ratios, but also are able to vary certain parameters to reflect national conditions and/or to set higher minimums. As with the capital rules, the Basel Committee plans “rigorous” evaluation to ensure that nations meet at least the minimum liquidity rules and apply them in a fair, transparent fashion. However, the complexity of the standards and the significant scope of national discretion could still result in wide variation among implementing nations. Indeed, variance is already emerging, with the European Union (see Section III.A.) initially deciding not only to liberalize the LCR (essentially making it a goal, not a binding rule), but also to defer implementation of the NSFR. The fate of the Basel III standards in major Asian markets is also, at best, unclear (see Section III.B.).

The final Basel III standards are to be implemented through rules nations must finalize by year-end 2012, but numerous transitions to them are provided. Bank reporting to supervisors on the LCR and NSFR is to begin on January 1, 2012, for the observation periods,⁸⁸ although the degree to which this can occur is at best uncertain given the absence of final implementing standards in the U.S. and other key nations. “Unintended consequences” will be addressed as they are identified through these transitions, based in part on findings through an observation period that was to begin in 2011 for the LCR. The LCR will then be “introduced” on January 1, 2015, with any changes to it made by mid-2013. The NSFR, including any revisions, will move to a minimum standard by January 1, 2018, with changes to it following the observation period made by mid-2016.⁸⁹ However, this entire schedule is uncertain due to the lack of final implementing rules, differing national regimes related to liquidity and, most importantly, the uncertain results of the observation periods. The degree to which banks, including those in the U.S., will be held to the LCR and NSFR during the implementation period is also uncertain, as is the market impact of any reporting related to the rules as they are tested.

⁸⁶ BCBS, *Principles for Sound Liquidity Risk Management and Supervision* (Sept. 25, 2008), available at <http://www.bis.org/publ/bcbs144.pdf>.

⁸⁷ BCBS, *Consultative Document: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 17, 2009), available at <http://www.bis.org/publ/bcbs165.pdf>.

⁸⁸ BCBS, *Basel III liquidity standards*, *supra*, note 2, at 197.

⁸⁹ *Id.*

B. Basel III Liquidity-Risk Standards: Key Provisions

The Basel III standards are complex, imposing significant operational and supervisory challenges for covered banking organizations and their regulators. The global rules are to apply at the parent, legal entity and branch/subsidiary level, taking into account an array of complexities (e.g., varying currencies in which obligations are held, legal impediments to fund transfer, and operational requirements to report liquidity under stress as quickly as daily).

1. Liquidity Coverage Ratio

This standard aims to ensure that a bank maintains a sufficient level of cash and other unencumbered, high-quality liquid assets that can be converted into cash to meet liquidity needs for a thirty calendar day time horizon under a significantly severe liquidity stress scenario specified by supervisors. The stock of liquid assets at a minimum should enable the bank to survive until Day 30 of the stress scenario, by which time it is assumed that appropriate corrective actions will be taken by management and/or regulators, and/or the bank can be resolved in an orderly fashion.⁹⁰ The rules include numerous ways to stress-test liquidity, including mandatory consideration of stresses such as a ratings downgrade, market volatility, and rapid drawdown of liquidity facilities.

The standard requires that the value of the ratio be no lower than 100% (i.e., the stock of high-quality liquid assets should at least equal total net cash outflows). Banks and supervisors are also expected to be aware of any potential mismatches within the 30-day period and to ensure that sufficient liquid assets are available to meet any cash flow gaps.⁹¹

Critical to the LCR (as well as to the NSFR, as shall be discussed below) are the definitions underlying key terms. In order to qualify as a “high-quality liquid asset,” assets should be liquid under stress and, ideally, be central-bank eligible. The standards detail the characteristics and operational requirements that meet these criteria, with liquidity judged according to the stress scenarios discussed above.⁹²

Eligible assets are divided into Level 1 (L1) assets (which may be held without limit) and Level 2 (L2) ones, which may comprise up to 40% of the stock (taking into account the unwind of certain secured-funding transactions). National supervisors may also apply haircuts to L1 assets based on factors such as duration or risk. Ratings are among the criteria determining these levels, a provision in Basel III that will complicate implementation in the U.S., where the Dodd-Frank Act bars reliance on ratings determinations in all federal regulation.⁹³ Quantitative and qualitative criteria for L2 assets are among the factors up for review during the observation period, along with strategies for nations with scant supplies of otherwise eligible L2 assets.

⁹⁰ BCBS, *Basel III liquidity standards*, *supra* note 2, at ¶ 15.

⁹¹ *Id.* at ¶¶ 16-19.

⁹² *Id.* at ¶¶ 12-13.

⁹³ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Section 939A (2010).

Total net cash outflows are defined as the total expected cash outflows minus the total expected cash inflows in the specified stress scenario for the subsequent thirty calendar days. Total expected cash outflows are calculated by multiplying the outstanding balances of various categories or types of liabilities and OBS commitments by their expected runoff or drawdown rates. Total expected cash inflows are calculated by multiplying the outstanding balances of various categories of contractual receivables by the rates at which they are expected to flow in under the scenario up to an aggregate cap of 75% of total expected cash outflows,⁹⁴ with one of the most critical factors here being the expected outflows of deposits and other funding sources under stress (minimum rates are included in the rule). A set of limits on other contractual inflows is also established, with a 0% inflow assumed for “operational” deposits with other financial institutions.

The rules, in one of the more stringent provisions, require banks to assume zero inflow from their own liquidity facilities from other institutions – that is, banks are to assume that they receive no liquidity from third parties to handle outflow demands. Conversely, banks providing liquidity facilities are to assume that these are fully drawn down.⁹⁵

2. Net Stable Funding Ratio

This standard establishes a minimum acceptable amount of stable funding based on the liquidity characteristics of a firm’s assets and OBS activities over a one year horizon under stress (defined for the NSFR to include a broader range of events than under the LCR). This metric is designed to act as a minimum enforcement mechanism to complement the LCR and reinforce other supervisory efforts by promoting structural changes in banks’ liquidity-risk profiles away from short-term funding mismatches toward more stable, longer-term funding of assets and OBS business activities. The NSFR is defined as the ratio of the amount of available stable funding compared with the amount of required stable funding. This ratio must be above 100%.⁹⁶

“Stable funding” is the portion of those types and amounts of equity and liability financing expected to be reliable sources of funds under extended stress over a one year horizon. The amount of required funding is a function of the liquidity characteristics of various types of assets held, OBS contingent exposures incurred and/or the activities pursued by the institution. The rule defines available stable funds, including in this the bank’s capital, long-term liabilities, and some wholesale-funding sources.⁹⁷ Different run off factors are assigned to various forms of deposit liabilities.

3. Additional Requirements – Monitoring Tools

The Basel III standards include not only these ratios, but also additional prudential requirements. These include reporting of contractual maturity mismatches, concentration reporting, reporting related to

⁹⁴ BCBS, *Basel III liquidity standards*, *supra* note 2, at ¶ 50.

⁹⁵ *Id.* at ¶ 111.

⁹⁶ *Id.* at ¶ 120-121.

⁹⁷ *Id.* at 122-128.

available unencumbered assets (which might be needed under stress), and market-risk monitoring standards.⁹⁸

C. U.S. Regulatory Action Related to Liquidity Risk

Apart from the progress of international regulators on liquidity risk, the U.S. has established its own framework of robust standards that do not rely on the untested and questionable LCR and NSFR ratios. The U.S. began this process with an interagency proposal in 2009⁹⁹ that led to final liquidity-risk management standards in 2010.¹⁰⁰ This guidance was followed up in 2011 with a proposal for still tougher stress-testing for bank holding companies (“BHCs”) with assets over \$10 billion¹⁰¹ and an even more stringent proposed rule from the Federal Reserve covering BHCs with assets over \$50 billion.¹⁰² Although both of these more recent proposals are in large part focused on capital, each also addresses liquidity, considering it in connection with forward-looking capital resilience and the array of other risks (e.g., operational and market risk) that may at times be even more important than capital adequacy and liquidity.

While the U.S. has tried to adopt a comprehensive rulemaking approach, the Basel III rules treat capital, liquidity, operational and market risk – the only ones covered to date with formal standards – in “silo” fashion. That is, each of these rules is freestanding and mandated as if none of the others were in place or as if any of the other risks covered in these rules have inter-related effects that require a synoptic approach to effective enterprise-wide risk management.

Another key difference between the U.S. liquidity rules to date and the global approach is that many U.S. liquidity-risk standards apply to all insured depositories, not just to internationally active ones (although tougher standards are reserved for the biggest BHCs). As a result, they provide greater protection not just to financial markets, but also to the FDIC’s Deposit Insurance Fund and broader regulatory considerations, rightly addressing the fact that, under stress, even seemingly small institutions can create systemic risk.

⁹⁸ *Id.* at ¶¶ 137-183.

⁹⁹ Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration, *Proposed Guidance on Funding and Liquidity Risk Management*, 74 Fed. Reg. 127 (July 6, 2009), available at <http://edocket.access.gpo.gov/2009/pdf/E9-15800.pdf>.

¹⁰⁰ Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration, *Final Policy Statement on Funding and Liquidity Risk Management*, 75 Fed. Reg. 54 (Mar. 22, 2010), available at <http://edocket.access.gpo.gov/2010/pdf/2010-6137.pdf>.

¹⁰¹ Office of the Comptroller of the Currency, Federal Reserve System, FDIC, *Proposed Guidance on Stress Testing for Banking Organizations With More Than \$10 Billion in Total Consolidated Assets* 76 Fed Reg. 115 (June 15, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-06-15/pdf/2011-14777.pdf>.

¹⁰² Federal Reserve System, *Proposed Rule to Require Large Bank Holding Companies to Submit Capital Plans to the FRB on an Annual Basis* 76 Fed Reg. 117 (June 17, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-06-17/pdf/2011-14831.pdf>.

In addition, the U.S. rules incorporate a strong mandate for corporate governance, directing boards of directors and senior management to take a hands-on role in this area through actions such as approving risk tolerances, ensuring that liquidity-risk standards meet these tolerances, validating performance and holding senior management accountable for it. The 2010 guidance incorporates in clear-binding form a recommendation from senior supervisors around the world that boards of directors set the “risk appetite,”¹⁰³ requiring boards of directors to establish risk tolerances and other parameters related to liquidity risk, with senior management then charged with implementing and reporting on these board-directed limits and policies. As emphasized in an array of recent global statements, the U.S. guidance also stipulates internal controls through independent risk management, with line management also given a far greater role both in budgeting for liquidity risk (e.g., through pricing) and in being held responsible for compliance with board and management standards.

Finally, it is important to note that the U.S. standards do not disadvantage obligations of government-sponsored enterprises (GSEs), granting recognition of the ready market value of agency securities that is not, as shall be discussed in more detail in Section III, appropriately reflected in the Basel III standards.

¹⁰³ Senior Supervisors Group (“SSG”), *Observations on Developments in Risk Appetite Frameworks and IT Infrastructure* (Dec. 23, 2010), available at <http://www.newyorkfed.org/newsevents/news/banking/2010/an101223.pdf>.

Studies – Tab 4

Understanding the Economics of Large Banks



November 7, 2011

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Introduction

Supervision of large financial institutions is arguably the central issue in the ongoing debate on bank regulatory reform. Many observers see large banks as prime contributors to the 2007-2009 global economic crisis. Laws and proposals in various stages of adoption or evaluation aim to reduce or avoid such crises. These include Basel III and the Dodd-Frank Act, both of which constrain some large bank activities, increase their capital and liquidity requirements, and subject them to greater oversight.

In aggregate, such measures could compel large banks to shrink, either by reducing the size of their components, or by breaking up into separate lines of business. Some argue that large banks provide minimal benefits to society, and that smaller institutions could provide any benefits they do offer, and it is therefore appropriate to focus on reducing the size of large banks, without significant concern about potential economic costs from size reductions.

In an effort to test the validity of such assertions and to better understand the benefits that large banks provide, we examined their role and contributions to the economy. Four dimensions of size are particularly relevant to analyzing the benefits of large banks: scale in an individual business, scope across multiple businesses, scale in an individual geography, or presence in multiple geographies. The 26 largest U.S. banks, each with more than \$50 billion in assets, are large in at least one of these dimensions.

In this report, we make the following major points:

- Due to their size, large banks in some products and markets are able to generate unique benefits, which fall into three categories: they exhibit economies of scale that reduce unit costs, they offer a broad scope of products and services that smaller institutions do not, and they spread innovations throughout the industry.
- Our best estimates for each of these unique benefits indicate that large U.S. banks (as previously defined) provide benefits to companies, consumers, and governments totaling an estimated \$50 billion to \$110 billion annually.¹
- Banks larger than \$500 billion provide over half of the total benefit amount.
- Only banks larger than \$50 billion can provide an estimated 50 to 70 percent of these benefits. Reducing the size of these large banks could have negative economic implications beyond the loss of benefits, ranging from a loss of diversification to reduced global competitiveness of U.S. banks.

We do not imply that smaller banks do not play an important role in the financial system and broader economy. They certainly do. Rather, we contend that large banks play a specific role and add value in ways that would be hard to replicate at a smaller scale.

This study is the first to our knowledge that attempts to look comprehensively at the potential economies of scale, the impact of the breadth of products, and the impact of large banks on innovation, and to do so on a line-of-business-by-line-of-business basis. The

¹ While the benefits from scope of product and services offerings and from the spread of innovation are estimating the value received by customers, economies of scale are reductions in unit cost that may be passed to customers or may be captured as additional profits to shareholders.

analysis draws upon three kinds of evidence: individual case studies (e.g., the historical role of large banks in spreading innovations), internal bank data (e.g., scale curves), and market-conduct data (e.g., market share). We rely on proprietary data from 10 institutions as well as on publicly available data. Our access to proprietary bank data on unit costs and volumes enables us to estimate directly the empirical economies of scale, an analysis that, we believe, is unique in the current literature. We conducted a thorough review of policy and academic literature to understand the current state of knowledge. *(See sidebar (“Review of Literature on Large Banks”) and Section A of the appendix for sources.)*

This report contains three sections. Section 1 provides context, discussing large banks and their activities. Section 2 examines the benefits of large banks. Section 3 considers what benefits would be lost in the absence of large banks.

REVIEW OF LITERATURE ON LARGE BANKS

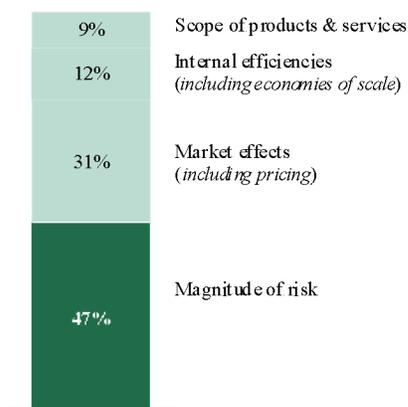
Our survey of policy and academic literature covered the benefits and risks associated with larger banks. We reviewed more than 200 academic articles, most published in peer-reviewed journals. Our review included those articles cited in Financial Stability Oversight Council reports and the Vickers Commission Report on Banking as well as relevant articles from the past three years published in a selection of top economics and finance journals.* Discussion of large banks falls into four general categories: scope of products and services offered, market effects, internal efficiencies, and magnitude of risk. (Exhibit 1 summarizes articles reviewed.)

- **Scope of products and services offered** refers to the potential for large banks to offer products that are unique or have unique features.
- **Internal efficiencies** are the potential decrease in unit cost associated with a bank growing in size, either in terms of producing more units of a given product (economies of scale) or more units of different products (economies of scope).
- **Market effects** are the potential effects that larger banks have on the markets in which they participate—for example, their impact on product availability and pricing and their impact on the allocation of capital—which may affect the efficiency of the broader economy.
- **Magnitude of risk** is the potential that large banks have different risk profiles than do smaller banks, including diversification of risks across businesses and geographies, potential increased risk-taking, and increased complexity.

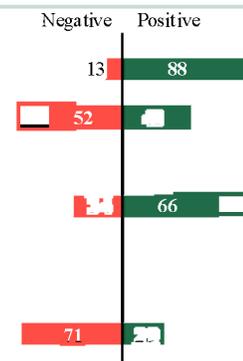
EXHIBIT 1

Much of the academic literature discussing large banks focuses on risk, while evidence on benefits is inconclusive.

Breakdown of literature discussing large banks
Percent; 100% = 220 articles



Views toward benefits
Percent



SOURCE: FSOC Study of the Effects of Size and Complexity of Financial Institutions on Capital Market Efficiency and Economic Growth, ICB Interim report and references therein

Much of the work we examined focused on discrete topics rather than a holistic view of the role of large banks in the banking system. Thus, while these articles are instructive, they are limited in purview. In summary, we find:

- **More articles focus on the magnitude of risk than on other aspects of large banks.** Nearly half of the literature that we reviewed focused on risk. Of that portion, approximately 70 percent conclude that large banks are riskier than smaller institutions.
- **However, many papers on topics other than risk find that large banks provide benefits.**
 - While just a few studies examine the effects of the scope of products and services offered by large banks, most studies find benefits.

- Work using the latest methodologies and data find that economies of scale persist even above \$100 billion. Older papers tend to find little or no economies of scale.
- Papers on market effects find that the presence of large banks aids spread of innovation, capital allocation, and increased efficiency in other banks. Some papers find that having more large banks decreases competition, but there was no consensus.

Section A of the appendix provides more detail on the literature reviewed.

* American Economic Review; Econometrica; Journal of Banking and Finance; Journal of Econometrics; Journal of Finance; Journal of Financial Economics; Journal of Money, Credit and Banking; Journal of Political Economy; Quarterly Journal of Economics, and Review of Financial Studies.

1. Large banks and their activities

Banks can be defined as large according to various criteria, and these various kinds of large banks play different roles in the banking system. To understand the benefits that large banks provide requires knowledge of the activities and services they perform as well as the role that size plays in their ability to do these things. This study analyzes to what extent, if any, there are unique benefits that are attributable to large size. In instances where there are unique benefits, large banks are able to add value differentially, relative to the next best option (whether a small bank or a non-bank). In instances where there are not unique benefits, large banks may still benefit customers and markets, but the benefit is approximately the same as that provided by a smaller bank or a non-bank.

BANKING ACTIVITIES

The banking system, with banks large and small—is like the circulatory system of the U.S. and global economies—performing a number of critical activities. These include lending or intermediating to allow businesses and individuals to invest and consume, matching those with savings with those who are worthy borrowers, transferring money among individuals and businesses to enable commerce to function, providing stores of liquidity, and facilitating the longer-term savings and investment of individuals and institutions. Banks are thus rarely more than one or two steps removed from all vital economic activities.

Banking activities fall into four product areas: retail banking, payments & clearing, commercial banking, and capital markets. Retail banking serves both consumers and small businesses, holding deposits of savers and matching them with credit needs of borrowers. Payments and clearing functions are used by all players in the financial system—including consumers, middle-market companies, multinational corporations, pension funds, and governments—to move cash, settle transactions, and register and hold securities. Commercial banking includes cash management, lending, and trade finance, particularly for middle-market and larger companies. Finally, banks are the foundation of the capital markets, underwriting the debt and equity offerings of corporations and governments and enabling funds to be raised from markets.

MEASURES OF BANK SIZE

Bank size can be quantified in multiple ways. Three widely used measures are total balance-sheet size, assets as a fraction of GDP, and assets as a fraction of a country’s banking assets.² We consider banks with more than \$50 billion in assets to be “large” for the purposes of these analyses. We follow Dodd-Frank in this regard but recognize substantial limitations in this definition, which we address in this report.

Over 70 percent of the banking activity in the U.S. is conducted by the 26 banks that each have balance sheets over \$50 billion (*Exhibit 2 shows a breakdown*). They serve more than

² There are also variants of these basic measures, adjusting assets to account for risk (e.g., risk-weighted assets) or accounting differences among countries (e.g., applying U.S. GAAP rules to assets of non-U.S. banks). Recently, bank “interconnectedness,” the degree to which a bank is linked to others, has been the subject of much discussion, but no simple means of quantifying this attribute yet exists.

70 million households, 85,000 small businesses, and more than 1,000 large corporate customers. Among U.S. banks, the share of activity of banks larger than \$50 billion is higher than their asset share in investment banking, international lending, trade finance, and corporate cash management and lower in commercial-real-estate lending, small-business loans, and ATM and branch share. Banks with more than \$50 billion in assets employ nearly 2 million people in the U.S.

EXHIBIT 2

The 26 US banks with more than \$50 billion in assets comprise 74% of total industry assets.

As of 4Q 2010

	Size range \$ Billions	Number of institutions	Total assets ² \$ Trillions	Share of assets ³ Percent	
U.S.- based parent ¹	> \$500	6	\$9.3	57%	} 26 banks and 74% of assets
	\$100-500	11	\$2.1	13%	
	\$50-100	9	\$0.6	4%	
	< \$50	5,201	\$2.8	17%	
Foreign- based parent	> \$500	11	\$1.3	8%	
	\$100-500	3	\$0.3	2%	

1 Includes only institutions with US parent companies.

2 Excluding MetLife assets of \$730 billion.

3 May not equal 100% due to rounding.

SOURCE: SNL Financial

However, the U.S. banking sector is less concentrated and smaller compared to GDP than are the banking sectors of other countries. For example, as a fraction of GDP, the assets of the largest three U.S. banks are 41 percent, whereas the largest three banks in each of France, Germany, the U.K., Canada, and Australia hold assets that exceed 130 to 180 percent of their respective home country's GDP. Similarly, the largest three U.S. banks hold 36 percent of industry assets, compared to the 44 to 61 percent of industry assets held by the largest three banks in Germany, France, Canada, and Australia.

TYPES OF LARGE BANKS

Using total assets to examine the consequences of size can be misleading and unsatisfactory for three reasons. First, what counts as "large" may vary over time and by country. What was large in the U.S. in 2001 is not equally large in 2011 after the effects of inflation and the growth and globalization of the companies that banks serve. "Large" may not have the same meaning in a more concentrated market, such as Canada. Second, institutions with similar asset size may have different business mixes. For example, a monoline credit-card bank and a traditional retail bank might each hold \$50 billion in assets. The third reason relates most

significantly to the purpose of our study: *asset size is not, in and of itself, directly linked to the benefits that large banks provide.*

We need a framework that captures the aspects of size that are most relevant to the benefits that banks provide customers. Consequently, we focus on four aspects of bank size: scale in an individual business, scope across multiple businesses, scale in an individual geography, and presence in multiple geographies, either in the U.S. or abroad. Being big in varying combinations of these dimensions may provide different potential benefits to customers. Growing along any of these dimensions would likely increase total assets. All 26 U.S. banks with over \$50 billion in assets, the size threshold set by Dodd-Frank, are large in at least one of these ways.

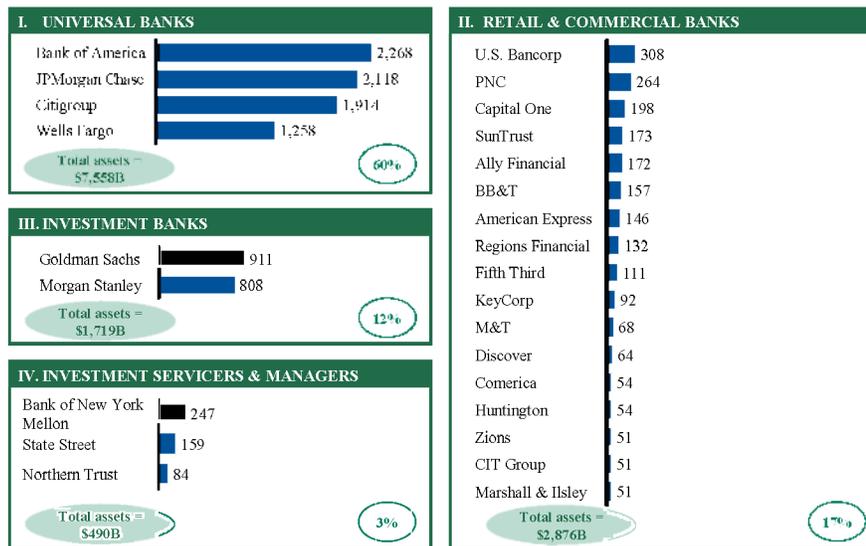
In aggregate, U.S. banks with over \$50 billion in assets hold \$12 trillion in assets. Each of these banks is one of four predominant types: universal bank-holding companies (referred to here as “universal banks”), retail & commercial banks, investment banks, and investment servicers and managers. (*Exhibit 3 lists these banks.*) Each such type of bank is large in a characteristic set of dimensions.

EXHIBIT 3

There are 4 types of U.S. banks with more than \$50 billion in assets.

Assets by bank, \$ Billions as of 4Q 2010

(x%) % of assets held by banks over \$50 billion



Note: Excludes Met Life BHC, which has \$731 billion in assets. Includes only those banks with US parent companies.
SOURCE: SNL Financial

- Universal banks.** Universal banks are large along all dimensions of bank size, operating in multiple regions, often across many countries. Four U.S.-based banks with over \$50 billion are in this category: Bank of America, Citibank, JPMorgan Chase, and Wells Fargo. They hold \$7.6 trillion in assets, or 60 percent of the total assets of U.S. banks with over \$50 billion.

- **Retail & commercial banks.** Large retail & commercial banks typically have a sizable presence in retail banking, commercial banking, and portions of the payments & clearing spaces. In the U.S. they also typically are well penetrated in at least one or more metropolitan areas or regions. Twenty U.S.-based banks with over \$50 billion in assets fall in this category and hold an aggregate of \$2.9 trillion in assets, representing 17 percent of asset of banks over \$50 billion. Examples include U.S. Bank, PNC, BB&T, and KeyBank.
- **Investment banks.** Large investment banks have a sizable presence in the capital-markets space. U.S. investment banks' business also spans multiple geographies. Two banks with over \$50 billion in assets are in this category: Morgan Stanley and Goldman Sachs. Together they hold \$1.7 trillion in assets, 12 percent of assets held by banks over \$50 billion.
- **Investment servicers and managers.** Large banks that act as investment servicers and managers are uniquely at scale in the payments & clearing space. In the U.S. they are also typically sizable across international borders. Three banks with over \$50 billion in assets fall in this category: Bank of New York Mellon, State Street and Northern Trust. Together they total \$500 billion in assets, or 3 percent of the \$12 trillion in assets held by banks over \$50 billion.

Banks with non-U.S. parents also play a significant role in the U.S. banking industry, holding \$1.5 trillion in U.S.-based assets. In addition, they have more than a 40 percent share of debt-capital-markets transactions, and 3 percent of equity capital markets. Bank holding companies with non-U.S. parents include Taunus, HSBC North America Holdings, TD Bank US, Citizens, ING, RBC US Holdco, Union Bank, BancWest, BMO Financial Corp, and BBVA USA Bancshares.

2. Benefits of large banks

We examine three categories of potential unique benefits from large banks: economies of scale, scope of products and services, and the large banks' role in the spread of innovation across the industry. We further examine each type of benefit across the various lines of business, including retail, commercial, payments and clearing, and capital markets.

For each benefit category and product area of banking, we analyzed areas where large banks provide benefits that others do not. (*Exhibit 4 shows an overview.*)³ There are areas where large banks do not provide unique benefit. For example, in small-business or commercial-real-estate lending, smaller banks have a relatively higher share of assets; large size is not essential to providing value in these areas.

EXHIBIT 4

Each type of large bank provides different types and sizes of benefits.

Product categories	Types of large banks			
	I. Universal banks	II. Retail & commercial banks	III. Investment banks	IV. Investment servicers & managers
1. Retail banking	<ul style="list-style-type: none"> ✓ National product footprint ✓ Economies of scale ✓ Spread of innovation 	<ul style="list-style-type: none"> ✓ Regional product footprint ✓ Economies of scale ✓ Spread of innovation 		
2. Payments & clearing	<ul style="list-style-type: none"> ✓ Broad product scope ✓ Economies of scale ✓ Spread of innovation 	<ul style="list-style-type: none"> ✓ Economies of scale ✓ Spread of innovation 		<ul style="list-style-type: none"> ✓ Broad product scope ✓ Economies of scale
3. Commercial banking	<ul style="list-style-type: none"> ✓ International product scope ✓ Economies of scale ✓ Spread of innovation 	<ul style="list-style-type: none"> ✓ Regional product scale and scope (with international correspondents) 		
4. Capital markets	<ul style="list-style-type: none"> ✓ Broad and international product scope ✓ Economies of scale ✓ Spread of innovation 		<ul style="list-style-type: none"> ✓ Broad and international product scale ✓ Economies of scale ✓ Spread of innovation 	

SOURCE: TCH large-bank study-participant data.

- **Economies of scale.** Large banks reduce unit costs by spreading fixed costs, particularly for infrastructure and technology, over a large customer base. Economies of scale in large banks provide an estimated \$25 billion to \$45 billion of annual value. We estimate this benefit by comparing actual costs to what costs would be in a system with no banks larger than \$50 billion. While estimating the amount passed to customers is difficult, we believe that part of this value translates into lower prices for customers or investments in technologies benefiting customers and smaller banks.

³ To avoid double-counting, when scale allows large banks to provide offerings that small banks cannot, we list the associated product areas under either scale or scope. For example, custody falls under scope and funds transfer under scale.

- **Scope of products and services.** Large banks provide a broad set of products and services that others cannot provide at all, or at least cannot provide in an equally integrated and comprehensive manner.⁴ The size of large banks may increase the value of certain products to customers, in terms of improved convenience, distinct product features or geographic portability. These benefits are worth an estimated \$15 billion to \$35 billion in annual direct value to customers, including companies of all sizes, retail consumers, and governments. We reach these numbers by estimating incremental benefits that large banks provide to customers, product by product, compared to the best non-large-bank solution (either non-bank or bank with less than \$50 billion in assets). This is an estimate of the value that a large bank provides over and above the value of the next best option. Identifying the portion of the benefit solely attributable to large banks is difficult and subject to ambiguity. We do not estimate potential indirect benefits to the economy, which may also be significant.
- **Spread of innovation.** While often not the initial innovator, large banks help spread innovations industry-wide. Having a large existing customer base may help to create network effects and to expedite new technologies to achieving critical mass of adoption. We estimate that, historically, large banks have contributed as much as \$15 billion to \$30 billion in annual savings, particularly benefiting retail customers, as well as smaller banks who adopt these innovations.

2.1 ECONOMIES OF SCALE

Economies of scale generally arise in businesses that serve many customers and that require expensive technology or infrastructure because high fixed costs spread over many customers reduces unit cost. We use internal bank data to analyze economies of scale for a selection of products and then to estimate overall economies of scale, including costs for which we do not have data. We estimate overall benefit from economies of scale by comparing actual costs to what they could be in a system with no banks larger than \$50 billion.

Internal bank data indicate cost savings of 40 percent to more than 80 percent in each of multiple areas, equivalent to \$10 billion to \$25 billion annually. Benefits are largest in payments and capital markets. To estimate total economies of scale, we assume that a fraction of costs that we did not analyze directly have economies of scale similar in magnitude to those that we did. This yields total estimated annual benefits of \$20 billion to \$45 billion, of which 50 percent to 75 percent comes from banks larger than \$500 billion. While we have attempted to identify systematically all areas associated with significant economies of scale and to conduct as rigorous an analysis as possible, our total benefit numbers represent only the best estimate we could obtain. (*Exhibit 5 shows a breakdown.*)

It is difficult to estimate how much benefit from economies of scale is passed on to customers in the form of lower prices, as opposed to accruing to shareholders in the form of additional profits. However, scale economies are real value that accrues somewhere and that could be lost in the event that banks are shrunk below efficient scale levels.

⁴ Note that this category of benefit is different from the microeconomic concept of “economies of scope,” which refers to the reduction in cost due to the sharing of fixed costs across multiple product areas.

EXHIBIT 5

Economies of scale benefits are largest in payments and capital markets.

Product examined directly
Approximated indirectly

benefits from economies of scale from U.S. banks with over \$50 billion in assets¹

Product Area	Estimated Benefits (\$ Billions)
1. Retail banking	
2. Payments	\$3 - 5
3. Commercial banking	\$2 - 5
4. Capital markets	\$5 - 15
Total	\$20 - 45

Online bill payment	\$0 - 1
Other retail (e.g., ATM, mobile banking, mortgage servicing)	\$3 - 4
Subtotal	\$3 - 5
Credit	\$2 - 3
Debit	\$1 - 2
Check	\$1 - 2
ACH	\$0 - 1
Wire transfer	\$0 - 1
Other payments (e.g., custody-related, acquiring)	\$6 - 10
Subtotal	\$10 - 20
Other commercial banking (e.g., treasury services platforms)	\$2 - 5
Subtotal	\$2 - 5
Trade processing	\$5 - 15
Subtotal	\$5 - 15
	\$20 - 45

¹ Benefits due to banks over \$50B; numbers may not sum due to rounding.
SOURCE: TCH large-bank study-participant data.

2.1.1 Product-level economies of scale

Using bank data, we estimate product-specific economies of scale in seven areas: online bill payment, debit cards, credit cards, wire transfers, automated clearing house, check processing, and trade processing. Together these account for approximately 7 percent to 10 percent of total net interest earnings (“NIE”) of banks over \$50 billion. We estimate that associated economies of scale account for \$10 billion to \$25 billion in annual benefit, or 3 percent to 6 percent of NIE.⁵

Our analysis proceeds as follows. First, in each area analyzed, we fit a scale curve—a curve indicating dependence of unit cost on production volume—to data points for volume and unit cost.⁶ In all cases, we find a clean curve demonstrating unit costs decreasing with increased volume (Exhibit 6 shows example scale curves.⁷)

⁵ This number includes an estimate of costs not examined in each of the product areas considered.

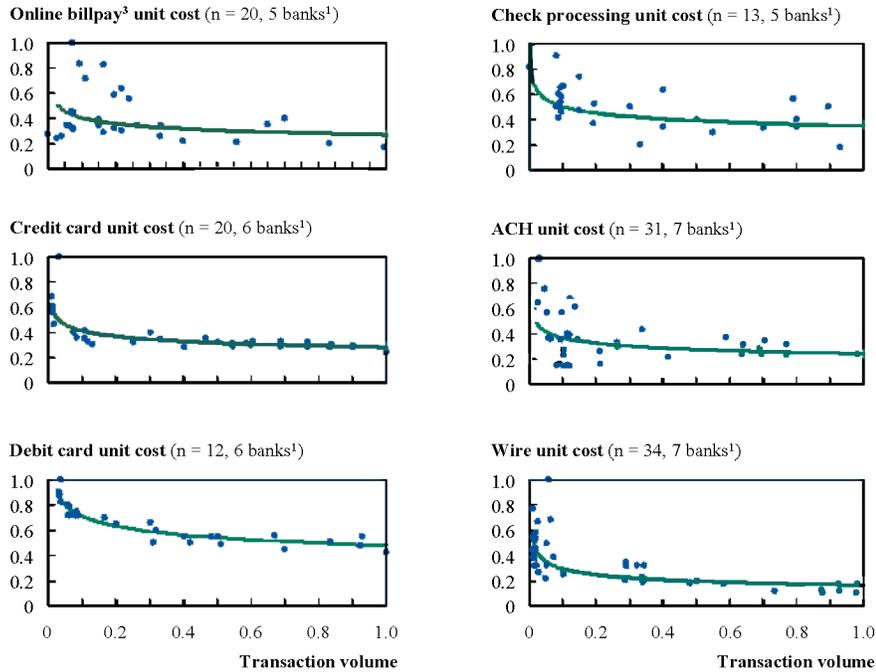
⁶ We fit curves of the form (unit cost) = b*(volume)^α, where b and α are fit parameters.

⁷ Data are fit using data from six banks spanning the years 2007 through 2011 (n = 22). Points shown include actual data plus ‘dummy’ observations in order to disguise the identity of any individual bank’s information.

EXHIBIT 6

Each product we examined in detail exhibits a scale curve.

Product-specific example scale curves², assorted points from 2007-2011



¹ Dummy points are randomly generated along curve to disguise participant data.
² Unit costs and transaction values are normalized to 1.
³ Online-bill-pay unit costs are measured per active user.
SOURCE: TCH large-bank-study participants.

Next, for each product we use the scale curve to estimate the increase in cost in the absence of banks larger than the asset threshold (i.e., \$50 billion). In particular, we look at the effect on unit cost of decreasing each bank's production (transaction) volumes by the percent difference between its assets today and the asset threshold.⁸ For example, a \$300 billion bank would need to reduce assets by 83 percent to reach \$50 billion, so we shrink its production volumes by 83 percent.⁹ (*Exhibit 7 illustrates this process schematically.*) For each product the estimated percentage cost increase is a weighted average over banks.¹⁰

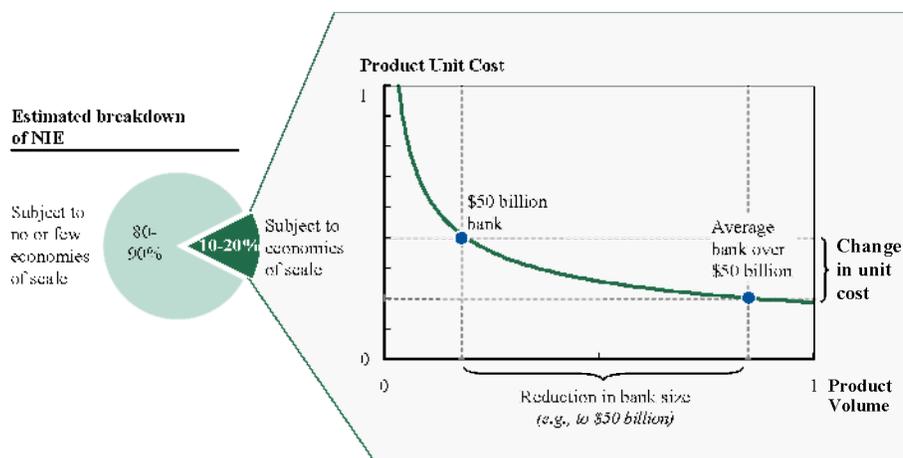
⁸ Where a bank's cost today is greater than the value associated with the fit scale curve, we evaluate unit cost at the reduced volume associated with the asset threshold. Where a bank's cost today is less than the value associated with the fit scale curve, we increase unit cost by the same percentage by which the fit curve changes under the given percentage reduction in volume. (*See Section C of the appendix for details.*)

⁹ We have verified this assumption across products for which we have bank-specific data. For ACH, check processing, and debit cards, transaction volume grows linearly with asset size with R^2 values greater than 0.9. For other products we have examined, the linear fit is also strong: credit cards, 0.7; wire transfers, 0.6; online bill payment, 0.42.

¹⁰ We do not have data for all banks larger than the asset threshold (e.g., \$50 billion). Thus, for each product, to estimate total cost across banks larger than the asset threshold, we (1) fit transaction volume as a linear function of asset size, using data from the banks for which we do have data, (2) use this curve fit to extrapolate an estimated transaction volume for each bank and (3) sum these transactions volumes to get an estimate of total cost to all banks above the asset threshold.

EXHIBIT 7

To estimate benefits from economies of scale, for each product we calculate increase in unit costs associated with a maximum bank size.



SOURCE: SNL Financial; TCH large-bank study-participant data.

Below we outline estimated benefits in the product areas we examine.¹¹ In some areas data collected from banks did not include all costs. For example, the data for online bill payment did not contain its share of the maintenance cost to support internet-banking platforms. We estimate that, in total, costs not directly examined make up 20 percent to 30 percent of product costs. In our estimates for product-specific economies of scale, we incorporate those costs that are not included in data collected from banks.¹²

Retail

- **Online bill payment.** The scale curve (*Exhibit 6*) indicates that costs would be 45 percent to 55 percent higher in a scenario in which no bank was larger than \$50 billion.¹³ This translates into an estimated annual benefit of \$50 million to \$70 million from the associated cost areas we examined directly. Cost data examined may exclude as much as 90 percent of the costs associated with online bill payment, such as, most importantly, its share of the maintenance cost to support internet-banking platforms. Thus we estimate the total annual benefit from online bill pay to be up to \$1 billion. This aggregate cost number is small because direct costs for online banking are relatively small. Based on limited data, we also anticipate that online banking more broadly and

¹¹ Due to uncertainty in quantifying the exact fraction of costs examined for each product area, we estimate benefits from each product area examined to the nearest \$1 billion.

¹² For these indirectly estimated costs, we assume a percentage increase in unit cost that is in line with the minimum percentage increase across all areas we examined; namely, 45 percent, as found for each of online-bill payment, debit cards, credit cards, and check processing. We chose this minimum percentage increase to give a conservative estimate because of the uncertainty in estimating costs for which we do not have complete direct data.

¹³ This change corresponds to an 11 percent decrease in unit cost associated with a doubling of number of active users.

mobile banking both show similar economies of scale. We discuss the role that large banks have played in spreading online banking in the section on innovation.

Payments & clearing

- **Credit cards.** The scale curve (*Exhibit 6*) indicates that costs would be 45 percent to 60 percent higher in a scenario in which no bank was larger than \$50 billion.¹⁴ This translates into an estimated annual benefit of \$1 billion to \$2 billion from the associated cost areas we examined directly. Cost data examined may exclude approximately 40 percent of banks' costs associated with credit cards, including costs for the supporting technology platform and customer service. Thus we estimate the total annual benefit from credit cards to be between \$2 billion and \$3 billion.
- **Debit cards.** The scale curve (*Exhibit 6*) indicates that costs would be 45 percent to 55 percent higher in a scenario in which no bank was larger than \$50 billion.¹⁵ This translates into an estimated annual benefit of \$1 billion to \$1.5 billion from the associated cost areas we examined directly. Cost data examined may exclude approximately 30 percent of banks' costs associated with debit cards, including costs associated with supporting technology platforms. Thus we estimate the total annual benefit from debit cards to be between \$1 billion and \$2 billion.
- **Check processing.** Today banks process most check transactions by exchanging electronic images of checks. However, for approximately 5 percent of transactions, banks still exchange physical paper checks. The scale curve we examine (*Exhibit 6*) accounts for some costs from both sorts of check processing and indicates that costs would be 45 percent to 50 percent higher in a scenario in which no bank was larger than \$50 billion.¹⁶ This translates into an estimated annual benefit of \$200 million to \$300 million from the associated cost areas we examined directly. Cost data examined may exclude as much as 85 percent of the costs associated with check processing, most importantly for image-infrastructure investment. Thus we estimate the total annual benefit from check processing to be between \$1 billion and \$2 billion. As banks continue to phase out paper check processing, the resulting purely electronic process will likely have greater economies of scale and lower unit costs.
- **Wire transfers.** Wire transfers are a means of transmitting high-value payments securely between institutions. The scale curve (*Exhibit 6*) indicates that costs would be 80 percent to 90 percent higher in a scenario in which no bank was larger than \$50 billion.¹⁷ This translates into an estimated total annual benefit of \$300 million to \$400 million. To account for additional costs associated with wire but potentially excluded from the data we examined, we estimate the total annual benefits from wire

¹⁴ This change corresponds to an 11 percent decrease in unit cost associated with a doubling of the number of purchase transactions.

¹⁵ This change corresponds to an 11 percent decrease in unit costs associated with a doubling of the number of purchase transactions.

¹⁶ This change corresponds to a 10 percent decrease in unit cost associated with a doubling of the checks processed.

¹⁷ This change corresponds to a 17 percent decrease in unit cost associated with a doubling of the number of wire transactions.

transfers to be up to \$1 billion. In the section on innovation, we discuss the role that large banks have played in spreading wire transfer.

- **Automated Clearing House.** ACH speeds the delivery of credits and debits to account-holders and automates payments and deposits. The scale curve (*Exhibit 6*) indicates that costs would be 60 percent to 70 percent higher in a scenario in which no bank was larger than \$50 billion.¹⁸ This translates into an estimated annual benefit of \$80 million to \$100 million from the associated cost areas we examined directly. Cost data examined may exclude approximately 50 percent of the costs associated with ACH, most importantly for security and IT security. Thus we estimate the total annual benefit from ACH to be up to \$1 billion and likely between \$100 million and \$200 million. In the section on innovation, we discuss the role that large banks have played in spreading ACH.

Capital markets

- **Trade processing.** Trade processors approve the sale of securities, change records of ownership, and arrange for the transfer of the securities and payment. The scale curve indicates that costs would be 100 percent to 150 percent higher in a scenario in which no bank was larger than \$50 billion.¹⁹ This translates into an estimated annual benefit of \$5 billion to 15 billion.

¹⁸ This change corresponds to a 14 percent decrease in unit cost associated with a doubling of the number of ACH transactions.

¹⁹ This change corresponds to a 29 percent decrease in unit cost associated with a doubling of trades processed.

2.1.2 Estimates of total economies of scale

We estimate that the aggregate annual benefit from economies of scale is between \$20 billion and \$45 billion. We do so by extending our product-level analysis in two steps. First, we estimate that 10 to 20 percent of total NIE is subject to economies of scale of a similar magnitude to those in areas we examined directly. Second, we estimate that on average these costs would be 45 to 55 percent higher in a scenario in which no bank was larger than \$50 billion. We obtain our benefit estimate by multiplying these percentages by \$397 billion, which is the total NIE for all banks over \$50 billion.²⁰ (*See Exhibit 7.*)

We use high-level, industry-reported cost buckets to estimate that 10 percent to 20 percent of total NIE is subject to economies of scale of the magnitude found in our product-specific analysis. Consistent with our product-level analysis, we assume that economies of scale are highest in areas involving processing and technology as well as other forms of equipment. These represent approximately 10 percent of total costs.²¹ Other areas—such as marketing, occupancy, documentation, and compliance—will see more modest scale economies. If approximately a quarter of these costs are also scalable, 20 percent of NIE sees economies of scale.²²

Our product-level analysis covers 35 percent to 70 percent of these estimated total scalable costs. Additional products in which economies of scale likely exist include ATMs, branch costs, the payments function in mortgage servicing, and cash management. Costs associated with such products will be spread over the high-level cost buckets. While we have attempted to identify the fraction of NIE seeing economies of scale systematically, our estimate remains subject to uncertainty. (*See Section C of the appendix for further details of the estimate.*)

We then estimate that these costs would be 45 percent to 55 percent higher if no bank were larger than \$50 billion. Forty-five percent is the minimum percentage cost increase across all product areas that we examine directly. Fifty-five percent is the average percentage cost increase across all product areas that we examine directly.²³ To be conservative, we use the average rather than the maximum percentage cost increase across products in setting the upper end of the range.

²⁰ We estimate benefits to the nearest increment of \$5 billion. Some academics and regulators have suggested that diseconomies of scale might exist due to organizational complexity. We do not quantify potential diseconomies, as we did not investigate the issue directly.

²¹ Bank annual reports; SNI.. Processing & technology and equipment costs each represent approximately 5 percent of NIE.

²² Bank annual reports; SNI.. Of total NIE, marketing, occupancy and other expenses account for approximately 3 percent, 8 percent, and 20 percent to 25 percent, respectively. Other expenses include both partially scalable expenses (e.g., general operating expenses) and non-scalable expenses (e.g., goodwill impairment and restructuring)

²³ Average is cost-weighted by product area.

2.2 SCOPE OF PRODUCTS AND SERVICES

The scope of large banks across multiple businesses, their geographic penetration and reach, and their balance-sheet size allow large banks to offer products and services that are central to the banking system but that smaller players cannot provide. Large-bank offerings are particularly vital in helping companies and asset managers operate internationally as well as in helping companies finance their activities through the capital markets. By our estimation, the scope of large banks' product and services provides \$15 billion to \$35 billion in direct value to customers annually. (*Exhibit 8 breaks down the components of this estimate across the four product areas of banking.*) We estimate that banks with assets over \$500 billion are responsible for \$10 billion to \$20 billion of the total. These numbers do not include indirect benefits to the economy at large, which may also be significant.

EXHIBIT 8

Benefits from scope of products and services are largest in securities servicing and in capital markets.

Estimated benefits from scope of products and services from banks larger than \$50 billion¹
\$ Billions

1. Retail banking	Local branch and ATM density	\$1 - 2
	Cross-regional presence	\$0 - 1
	Subtotal	\$1 - 3
2. Payments ²	Custody	\$4 - 8
	Subtotal	\$4 - 8
3. Commercial banking	Cash management	\$2 - 5
	International lending	\$1 - 2
	Trade finance	\$1 - 3
	Subtotal	\$3 - 10
4. Capital markets	HCM	\$1 - 3
	DCM	\$1 - 2
	M&A	\$1 - 2
	Syndicated lending	\$3 - 4
	Subtotal	\$7 - 11
Total²		\$15 - 35

¹ Benefits due to banks over \$50B; numbers may not sum due to rounding.

² Benefits associated with ACH, wire and check imaging are accounted for under economies of scale.

SOURCE: TCH large-bank study-participant data.

We reach our estimates by looking at the products and services in which large banks provide a unique benefit, estimating the number of customers using the product, the benefit that each customer receives, and the fraction of this benefit that is uniquely provided by large banks.²⁴ We acknowledge, however, that identifying the portion of the benefit due to large banks is difficult and subject to interpretation.

The remainder of this section discusses both the importance of the areas in which large banks provide differential products and services as well as the benefits that large banks confer in these areas.

²⁴ We include only the fraction of total benefit to the consumer that, we estimate, only a large bank could provide.

2.2.1 Retail banking

Large banks provide minimal product-scope benefits in most areas of retail banking. However, large banks do provide two primary convenience benefits to their retail consumers: easier access to a branch or to no-fee ATMs at home, and branch and ATM availability when customers move or travel. These benefits result from geographic penetration and geographic reach, respectively. In total, we estimate that banks with over \$50 billion in assets provide \$1 billion to \$3 billion in annual benefits in retail banking.

Customers are more likely to find branches or ATMs of national or large regional banks near their homes or work. Both national and large regional banks can provide this benefit because they can establish meaningful branch and ATM presence in the markets in which they participate.²⁵ Indeed, national and large regional banks are at scale in 80 percent of the markets in which they play, while smaller regional banks are at scale in only about 60 percent of the counties where they are present. In metropolitan areas in which they are present, banks of over \$100 billion in assets have networks that are about three times as dense as those of their smaller counterparts. This greater outlet density translates to reduced travel time for customers, equivalent to an estimated \$1 billion to \$2 billion in total annual savings.²⁶

Furthermore, larger banks have greater reach across geographies, saving money and time for many of the 13 million U.S. taxpayers who move each year.²⁷ This equates to an estimated \$0.5 billion to \$1 billion in annual savings to large-bank consumers.²⁸ The greater reach across geographies of large banks' ATM networks also saves money for people traveling. We do not include this benefit in our quantification, however, since small banks are increasingly reimbursing customers for fees paid at foreign ATMs.

2.2.2 Payments & clearing

Within payments & clearing, securities servicing is the primary area of benefit in product scope provided by large banks. Such banks are the near-exclusive provider of securities servicing to large institutional investors, supporting the estimated \$40 trillion of assets under custody on behalf of U.S. investors. Their role depends on their uniquely broad international presence and sophisticated analytic capabilities. We estimate that related annual benefits are \$4 billion to \$8 billion. These benefits generally require either specialist banks of approximately \$100 billion or more or larger universal banks.

²⁵ Empirically, the minimum requirement to capture fair share of deposits is approximately 5 percent, with some variation across markets. Deposit share begins to saturate once branch share reaches around 12 percent, so no further gain comes from the ability to grow beyond that in a given market. This dynamic is consistent with the premise that banks with over \$50 billion in assets provide this benefit to customers across all markets in their footprint.

²⁶ We assume eight branch visits per year, which is the average that those retail-banking study participants with available data report, and an average hourly wage of \$20, based on IRS individual tax statistics (available at <http://www.irs.gov/taxstats/indtaxstats>).

²⁷ IRS U.S. population migration data, available at <http://www.irs.gov/taxstats/indtaxstats>.

²⁸ We estimate that beginning a new banking relationship costs \$50-\$80, accounting for both direct costs and time spent. We based this estimate on average fees of \$10-\$20 to open a new account, a typical time of two hours (an average reported from participating retail banks) and an hourly wage of \$20 per hour (IRS). The total cost estimate then accounts for the fact that about 60 percent of deposits are held by banks with over \$50 billion in assets.

Large banks also hold a disproportionate share of the market in other payments areas, including credit card and wire transfers. We believe that this prevalence is largely due to substantial economies of scale. We discuss these payments areas in Section 2.1, on economies of scale.

Securities servicing

Institutional investors, including pension funds and money-market funds, as well as broker-dealers, rely on providers of securities servicing to support their estimated \$100 trillion of global assets under custody. Securities servicing includes settling and holding securities and providing analytics and reporting. Through sub-custodians and connections with local securities depositories across the world, custodian banks help institutional investors register and safely keep their assets in different regions, while ensuring that they comply with regulations across all jurisdictions. Furthermore, custodian banks can generate aggregated analytics on portfolio positions across multiple asset classes and geographies, helping clients optimize returns on their portfolios.

Large banks' geographic scope, scale in custody, and scope in related products enable them to provide unique benefits to customers in securities services. Thus the top four U.S. banks by assets hold approximately 60 percent of global assets under custody.²⁹ Furthermore, many institutional-investor clients will work only with large custodians with established reputations because they must answer to shareholders and often are contractually required to choose from among already well-established providers.

The primary benefits in securities servicing provided by large banks include the range of domestic securities processed, cross-border settlement and holding, administration, reporting and compliance, and complementary product and service offerings.

- **Range of domestic securities processed.** Only large custodians process certain types of domestic assets, such as U.S. Treasury securities. Thus, using a large custodian bank improves customers' investment flexibility.
- **Cross-border settlement and holding.** The ability to invest in cross-border as well as domestic assets helps investors optimize their portfolios. Domestic U.S. clients can settle and hold securities abroad, through a global custodian bank's links to foreign securities depositories where these securities are registered. Links may be either via relationships with local custodians or through the bank's own foreign custody offices. However, custody is an extremely low-margin business, so developing and making use of foreign links makes sense only for players with substantial scale.
- **Administration, reporting and compliance.** Sophisticated and costly IT platforms allow large banks to provide global reporting and compliance, helping investors monitor and analyze their positions. Smaller banks could not generate the volumes needed to make worthwhile the investment necessary to develop such reporting systems and global compliance expertise. Dedicated platforms and broad regulatory experience allow large custodians to undertake these activities much more efficiently and expertly than even large customers might on their own.

²⁹ Available at globalcustody.net, visited July 2011.

- **Complementary offerings.** Large custodians also have scope across related products, such as cash-management products, allowing them to cross-subsidize the low-margin custody business. Lower-volume players or those without related businesses would not be economically viable. Consistent with this claim, securities-servicing activity is highly concentrated in larger banks.

Of the aggregate annual benefits of \$4 billion to \$8 billion that large banks provide in securities servicing, we estimate the share related to foreign assets at \$3 billion to \$6 billion annually. Benefits related to domestic assets are somewhat smaller, at an estimated \$1 billion to \$2 billion annually.³⁰

2.2.3 Commercial banking

In commercial banking, large banks play a vital enabling role in international trade and commerce. We estimate the aggregate annual benefit uniquely provided by large banks at \$3 billion to \$10 billion, over half of which is provided by banks with more than \$500 billion in assets. For both large corporations and middle-market companies, large banks provide customized products in cash management, international lending, and trade finance, integrated across countries. They also offer similar white-label services for smaller banks.

Cash management

Cash-management products are fundamental to companies of all sizes, whether operating domestically or internationally. All companies must collect, pool, and manage payments from customers, report on and forecast cash balances, as well as manage their own payrolls. When payments come from many sources, at many varying times, cash management becomes a complex undertaking. Efficient cash management can save companies money by minimizing idle cash and providing smooth process automation, both of which reduce discrepancy rates and lower overhead. Companies operating internationally face particular cash-management challenges: they must accept and disburse payments in different currencies and across multiple countries while conforming to local regulations and predominant payment formats. Correspondingly, their needs are sophisticated: many require a robust platform to manage receivables, payables and cash balances globally. In 2010 the U.S. cash-management market size by volume was approximately \$1.6 trillion.

Large banks' geographic scope, scale in cash management, product scope, and large balance sheets enable them to provide benefits to middle-market companies and large corporations in cash management. Furthermore, large banks' provide white-label cash-management systems for smaller banks and other financial institutions. (*See sidebar: "Commercial-Banking Case Studies."*) Case studies indicate that the largest banks—which, for this purpose, we define as those with more than \$500 billion in assets—provide the largest benefit in international cash management, while banks with over \$50 billion in assets can begin to provide effective regional cash-management products. (*See Section B of the appendix.*) Consistent with large banks' ability to offer products and services that others cannot, the top

³⁰ We arrive at this range by estimating the number of customers (2,500 to 5,000 large investors with significant foreign assets, and 5,000 to 10,000 with large domestic assets), the benefit per customer (\$750,000 to \$2 million for investors with foreign assets and \$200,000 to \$400,000 for large domestic investors), the market share (80 to 100 percent) and the fraction of benefit allocated to large banks (80 to 100 percent for investors with foreign assets and 70 to 90 percent for large domestic investors).

four U.S. banks by assets hold approximately 50 percent of the U.S. cash-management market by revenue.

Primary benefits are automated processes and high visibility into currency and credit positions, international services, complementary product and service offerings, and liquidity provision.

- **Automated processes and high visibility.** Larger banks have more and larger clients, leading to higher cash-management volumes. As a result they have been able to invest in sophisticated and flexible cash management that automates many time-consuming processes, reduces discrepancy rates, increases visibility of the cash position, and improves liquidity and risk management. These translate to lower overhead for customers. For example, technology that replaces paper documentation of exceptions saves many hours of employee time processing and cataloging these items.
- **International services.** Because they have a broad international footprint, large banks can provide cash management across countries and currencies that an individual small bank cannot. Large banks' broad-reaching, integrated IT platforms enhance this capability by helping customers monitor balances and transact payments globally. Companies would need to cobble together services from multiple small banks across countries and provide their own IT solutions if they wanted to see an integrated view. For large corporations this would be inefficient. For middle-market companies it could prevent them from broadening their international activity.
- **Complementary offerings.** Their product scope allows large banks to provide a suite of complementary products. For example, large banks can offer payment hubs that interface with the corporate customer's systems and provide a consolidated package of cash-management services through a single system, integrating legacy systems into a complementary solution for customers. Furthermore, large banks can provide integrated services across product areas, such as trade finance coupled with cash management. *(See case studies in Section B of the appendix.)*
- **Liquidity provision.** Large banks' balance sheets allow them to meet the short-term liquidity needs of multiple companies at once and on short notice, both in the U.S. and abroad. Their ability to enter into overnight repo transactions provides one example.

We estimate aggregate annual benefits in cash management from banks over \$50 billion in assets to be \$2 billion to \$5 billion. This estimate includes large banks' ability to meet more sophisticated needs, such as cross-border cash-concentration structures, and large-scale automation of payables and receivables.³¹ These abilities reduce financing costs (e.g., by reducing idle cash balances or lowering foreign loans needed) and reduce overhead through labor-saving solutions. *(See Section B of the appendix for details.)* Estimated annual benefits are \$1 billion to \$1.5 billion to large corporations and \$1 billion to \$4 billion to middle-market companies.³² Nearly half of the estimated benefit to middle-market

³¹ We exclude estimations of less-complex cash-management services but note that such services confer more limited additional benefit.

³² We arrive at these ranges by estimating the number of customers (1,000 large corporations and 20,000 to 40,000 middle-market companies), the benefit per customer (\$1.2 million to \$2 million for large corporations and \$120,000 to \$240,000 for middle-market companies), the market share (90 to 100 percent for large corporations and 70 to 90 percent

companies comes indirectly, through cash-management systems white-labeled to smaller banks.

for middle-market companies), and the fraction of benefit allocated to large banks (70 to 90 percent for both sizes of company).

COMMERCIAL-BANKING CASE STUDIES

Working with 10 large banks, we have collected case studies illustrating products and services uniquely provided by large banks in commercial banking. This sidebar highlights examples in cash management and trade finance.

1. Large banks provide white-label cash-management systems for smaller institutions.

Situation and needs	Products and services provided	Outcome and results
<p>Client D, a financial institution, needed a customized platform to meet its customers' complex cash management needs.</p> <ul style="list-style-type: none"> ▪ The platform would help Client D earn fee revenue and retain customers by providing them with necessary services. ▪ Client D did not have sufficient capital or customer demand to justify building its own cash-management platform. 	<p>Bank A provided a customized white-labeled integrated cash-management platform together with trade solutions.</p> <ul style="list-style-type: none"> ▪ Displayed Client D's brand ▪ Combined functions at a single interface, including payments and receivables management (e.g., lockbox and check deposit), information-reporting services, and global payments (e.g., international funds transfer and remittances) ▪ Offered trade solutions (e.g., letters of credit, global collections) through a global network of affiliates and representatives, and regional trade-processing centers in multiple major foreign cities 	<p>Client D maintained customer relationships while expanding its range of offerings.</p> <ul style="list-style-type: none"> ▪ Provided services under its own brand ▪ Reduced direct operating expenses in some cost categories by outsourcing

2. Large banks offer cross-border supply-chain finance products across many countries to multinational corporations.

Situation and needs	Products and services provided	Outcome and results
<p>Client A, a major US industrial manufacturer, anticipated that increased demand following the economic recovery would stress the financing abilities of its global supply chain.</p> <ul style="list-style-type: none"> ▪ Needed to support the working-capital position and liquidity of suppliers across the world ▪ Wanted to standardize payment terms 	<p>Bank B provided an online supply-chain management solution, purchasing supplier receivables, and then distributing them to financial institutions and its own credit-trading desk.</p> <ul style="list-style-type: none"> ▪ Solution relies on systems requiring significant capital investment. ▪ Credit can be extended to hundreds of suppliers simultaneously, as a result of Bank B's large balance sheet. ▪ System can accept payments and extend credit in 8 different currencies, as well as perform foreign-exchange transactions, relying on Bank B's broad geographic reach. ▪ Multiple departments within Bank B can work on a given transaction, leveraging product scope 	<p>Client A ensured financing for suppliers while standardizing payment terms and is scaling the solution through a global rollout.</p> <ul style="list-style-type: none"> ▪ Suppliers obtained cheaper financing sufficient for production ramp-up. ▪ Client A standardized payment terms to 60 days. ▪ Client A is rolling out this program to subsidiaries around the world, expecting to add suppliers in China, India, Brazil, and Mexico.

International lending

Nearly all American companies with international operations and aspirations use international lending products. This pattern holds true for both large corporates and middle-market companies that have expanded their sales or production to markets outside the U.S. To obtain foreign-currency-denominated loans and in-market lines of credit, such companies can either assemble relationships with a combination of foreign banks in many countries or turn to a domestic U.S. bank with international operations or relationships. Loans to non-U.S. addresses, including foreign subsidiaries of U.S. companies, reached more than \$180 billion in 2010. Based on share of international revenue for select large corporations, we estimate that nearly 50 percent of these loans financed U.S. expansion and operations abroad, facilitating crucial activities such as building bricks-and-mortar presence in a foreign market, paying in-market suppliers, and hiring employees to begin operations. Furthermore, such activities create interest-rate risk and working-capital challenges for companies. Large banks help resolve these issues through cross-border lending, integrated with other products, such as cash-management and trade-finance products.

Large banks' geographic reach and balance-sheet heft, complemented by their broader scope of products, allow them to offer international loans and accompanying services to both middle-market companies and large corporations. Case studies indicate that those banks that hold over \$100 billion in assets can provide effective international lending, particularly in a limited range of countries. Banks that provide truly global international lending products have over \$500 billion in assets. Consistent with large banks' differential ability to offer international lending products in a way that others cannot, banks over \$50 billion are responsible for 97 percent of international lending from the U.S. Banks over \$500 billion are responsible for 88 percent of the total.

Primary benefits from large banks include consolidated banking relationships, reduced financing cost, and a range of complementary offerings.

- **Consolidated banking relationships.** U.S. banks can deliver international loans and lines of credit to clients, through either a global banking model or correspondent banks. Both options require either significant geographic reach to establish in-market offices and branches or a breadth of relationships to ensure that correspondent banks are prepared to serve the large bank's clients abroad. Large banks can help organize and maintain the necessary correspondent relationships for access to services in different regions, both domestically and abroad. Furthermore, working with a single bank allows customers increased visibility into their cash and debt position across their footprint, enabling better risk management.
- **Reduced financing cost.** Sizable balance sheets allow large banks to deliver multicurrency loans or to inspire confidence from correspondent banks, which offer companies credit based upon the domestic bank's guarantee. As a result the cost of foreign credit for the customer is reduced.
- **Complementary offerings.** Finally, global banks in particular can combine their product scope with their geographic reach to serve as one-stop shops for companies abroad, providing a range of products and loans. Large banks also offer advisory services to companies going abroad for the first time or entering an unfamiliar market.

We estimate that customers enjoy \$1 billion to \$2 billion in annual benefit from large banks through international lending products.³³ These numbers account for estimated interest-rate improvements on foreign-currency loans made through a domestic U.S. bank compared to a foreign institution. Estimated annual benefits to large corporations are \$0.6 billion to \$1 billion and they are \$0.2 billion to \$1 billion to middle-market companies. While we only estimate benefits to U.S. businesses, large U.S. banks can also help foreign businesses invest in the U.S. and thereby provide potential benefit to the U.S. economy.

Trade finance

Standard trade-finance instruments provide a guarantee of payment to suppliers through letters of credit. More complex instruments involve buyer-organized deals that keep entire supply chains provisioned with sufficient liquidity and credit in a form of structured supply-chain finance. The U.S. structured-trade-finance market is relatively small. It has most recently been reported as \$10 billion in annual deal volume, as compared to approximately \$800 billion to \$900 billion of trade-finance volume in letters of credit and factoring/receivables. However, this market is essential for many large corporations. Many U.S. multinationals and some middle-market companies maintain global supply chains with tens to hundreds of suppliers across dozens of countries. Suppliers can deliver goods on time only if they have enough liquidity to finance their inputs before receiving payment for the delivered output. Through structured trade finance, a bank can extend credit to a company's suppliers at rates based on the company's cost of funding, rather than that of individual suppliers. At the same time, the company can make its own payment cycle to suppliers more regular and potentially longer.

As in international lending, large banks can offer integrated structured trade-finance solutions that others cannot because of their geographic reach and balance-sheet heft, complemented by product scope. Case studies indicate that banks with over \$100 billion in assets provide limited offerings and that banks over \$500 billion are able to offer comprehensive structured trade financing to multinational companies with complex, global supply chains. (See sidebar ("*Commercial-Banking Case Studies*") and Section B of the appendix.)

Primary benefits derived from large bank size in structured trade finance include improved working-capital management, the potential for large deal size, complementary product offerings, and improved and automated processing.

- **Improved working-capital management.** Banks with broad geographic reach can provide working capital to suppliers across the full global footprint of a multinational corporation. This improves working-capital management by making delivery of supplies to the corporation³⁴ more regular and by smoothing and potentially lengthening the payment cycle for these supplies. Furthermore, suppliers can benefit from lower borrowing costs.

³³ We arrive at this range by estimating the number of customers (250-500 large corporations and 2,500 to 5,000 middle-market companies), the benefit per customer (\$2 million to \$4 million for large corporations and \$100,000 to \$200,000 for middle-market companies), the market share (90 to 100 percent for large corporations and 80 to 100 percent for middle-market companies), and the fraction of benefit allocated to large banks (70 to 90 percent for large corporations and 60 to 80 percent for middle-market companies).

³⁴ Delivery of goods will actually be to the buying entities of the corporation in question.

- **Large deal size.** Large banks have sufficient balance-sheet heft to underwrite large facilities for supply chains, in some cases advancing more than \$600 million to a supply chain, backed by \$1 billion of supplier receivables. The breadth of large banks' relationships also aids distribution capabilities for spreading outstandings over syndicates of partner banks.
- **Complementary offerings.** Large banks also have the product scope to mitigate risks associated with maintaining a global supply chain by offering appropriately tailored derivatives. For example, they can help companies hedge associated foreign-exchange or interest-rate risk.
- **Automated processes.** Since larger banks have more and larger clients operating globally, they have been able to invest in flexible, integrated IT platforms for trade-finance management. Such systems can be configured to a client's particular needs and facilitate trade-document processing. This facilitation can be a significant benefit, especially when dealing with thousands of documents in transit between countries with idiosyncratic customs and regulations. Furthermore, flexible platforms allow easy on-boarding and off-boarding of suppliers, improving vendor relationships, and strengthening buyers' negotiating positions.

We estimate that large banks provide aggregate benefits in trade finance of \$1 billion to \$3 billion annually.³⁵ This estimate reflects lower costs of working capital and lower overhead thanks to customized systems for processing trade documentation. Estimated annual benefits to large corporations are \$0.5 billion to \$1 billion and to middle-market companies \$0.3 billion to \$1 billion. While we do not explicitly account for the capacity for large deal sizes or complementary product offerings, these factors are included in our estimate of the portion of the benefit consumers receive that comes uniquely from large banks. We exclude an estimate of more common trade-finance products, such as letters of credit and open accounts, since, with the right set of foreign correspondent bank relationships, smaller banks can offer letters of credit. Open accounts are generally used in secure markets, where goods are shipped and delivered before payment, and do not generally require heavy bank intermediation. Thus, while large banks play a dominant role in providing these services as well, alternative solutions are potentially easier to find.

2.2.4 Capital markets

In capital markets, large banks play a central role in allowing companies and governments to raise capital and companies to undertake mergers and acquisitions. In this product area, we estimate that large banks provide from \$7 billion to \$11 billion annually in benefit to customers. Banks providing these benefits tend to hold more than \$500 billion in assets.

To break down these benefits, we consider the scope of products and services across investment banking, including in the debt capital markets ("DCM"), in the equity capital markets ("ECM"), in aiding mergers and acquisitions ("M&A"), and in participation in syndicated lending. Sizable investment-banking deals generally involve 3 to 5 participants.

³⁵ We arrive at this range by estimating the number of customers (250 to 500 large corporations and 2,500 to 5,000 middle-market companies), the benefit per customer (\$2.1 to \$4.3 million for large corporations and \$110,000 to \$320,000 for middle-market companies), the market share (90 to 100 percent for large corporations and 80 to 100 percent for middle-market companies), and the fraction of benefit allocated to large banks (70 to 90 percent for both sizes of company). The upper bound represents potential benefits for this product as the U.S. market matures.

More than half of the deals that are larger than \$500 million involve more than one bank, and multi-billion-dollar deals almost exclusively involve multiple players. Groups of more than five participants are rare.³⁶ Smaller deals will generally involve fewer participants.

- **Equity and debt capital markets.** In these markets new stocks and bonds are sold to investors. Governments and companies use these markets to finance operations or to make long-term investments, such as by building factories, investing in technologies, or financing research and development. A company that conducts an initial public offering (IPO), selling stock, uses the equity capital markets. A government that issues bonds to finance its activities uses the debt capital markets. There are multiple types of stocks and bonds as well as hybrid products, with both debt- and equity-like features. For example, a convertible bond can be converted into shares of common stock. When raising money on the capital markets, companies and governments rely on their banks to help tailor an optimal combination of equity and debt products.
- **Mergers and acquisitions.** M&A transactions bring smaller companies together to form a bigger one that is intended to be more valuable than the sum of the parts. Improved economies of scale, the combination of complementary resources, or increased market share can create value. Potential buyers and sellers may each need external advisory help in identifying acquisition opportunities, screening potential buyers or sellers, negotiating, and valuing and structuring the transactions. Both large investment banks and specialist advisory businesses offer such services. In bigger deals large banks tend to play the advisory role; this tendency is less pronounced in smaller deals.³⁷ In many cases the buyer also needs a bank to help finance the transaction, generally through an issuance of debt, equity, or some combination of both.³⁸
- **Syndicated lending.** In syndicated lending, one or several arranger banks form a larger syndicate of lenders to provide either a direct loan or a line of credit, in return for a fee from the borrower. Syndicated lending spreads risk of borrower default over lenders, and hence, such loans are generally much larger than standard bank loans. Lenders can include banks as well as institutional investors, such as pension funds and hedge funds. Borrowers range from large corporations, to specific large projects, to governments, or other sovereign concerns. When borrowers are little known or require close monitoring, syndicates tend to be smaller, and arrangers tend to choose as members those who already have a tie to the borrower—either through previous

³⁶ Of deals larger than \$500 million in 2010, the following percentages involved more than five banks: 8 percent in DCM, 10 percent in FCM, and 0 percent in M&A. Even in syndicated lending, only 25 percent of deals involved more than five advisor participants (DealLogic; SNL).

³⁷ For example, in 2010, 79 percent of M&A deals over \$500 million involved a bank with over \$500 billion in assets in an advisory role. On the other hand, large banks played an advisory role in only 16 percent of deals under \$100 million, and non-banks were the lead advisor in approximately 70 percent of such deals (DealLogic; SNL). In addition, the dominance of banks playing the advisory role has slipped somewhat over the past 5 years.

³⁸ The literature is mixed on the benefit to having a bank serve as both a lender and advisor in M&A transactions. Allen, Linda, Julapa Jagtiani, Stavros Peristiani and Anthony Saunders, "The role of bank advisors in mergers and acquisitions," *Journal of Money, Credit, and Banking* 36 (2004).

lending relationships or geographic proximity. Furthermore, lead arrangers with strong reputations can generally syndicate out a larger fraction of the loan.³⁹

³⁹ Sufi, Amir, "Information asymmetry and financing arrangements: Evidence from syndicated loans," *Journal of Finance* 62 (2010).

CAPITAL-MARKETS CASE STUDIES

Working with 10 large banks, we collected case studies illustrating products and services uniquely provided by large banks across ECM, DCM, M&A and syndicated lending. This sidebar highlights two examples.

1. Large banks can provide multiple investment-banking products to help finance large M&A transactions.

Situation and needs

Client C, a large US apparel and lifestyle company, sought a multi-billion-dollar acquisition and simultaneous refinancing of hundreds of millions of dollars in unsecured debt.

- Needed arrangement and underwriting of significant financing
- Required a bank with expertise in designing flexible capital structures to accommodate banking needs and market demand
- Required advisory services

Products and services provided

Bank B served as joint financial advisor to Client C, arranged financing for the transaction, and designed a customized capital structure to meet acquisition and refinancing needs, including:

- Cash on hand
- Secured debt issuance
- Unsecured notes issuance
- Perpetual convertible preferred stock issuance
- Common stock issuance

Outcome and results

Client C financed the acquisition through a favorable product structure without committed financing, resulting in a highly profitable merged entity.

2. Large banks can play multiple roles in delivering equity offerings on a global scale.

Situation and needs

Client E, a large supplier of commodities and raw materials, wanted to IPO to support growth.

Products and services provided

Bank A leveraged significant geographic reach and product scope to:

- **Arrange intermediate debt financing**, jointly advising and placing more than \$2 billion in convertible bonds for Client E and thereby providing liquidity to facilitate the next stage of growth
- **Generate global demand for the IPO** by meeting about 50 accounts, one-on-one, across Europe, Asia and North America, and launching a road show across 13 countries. Bank A's private-bank division provided more than \$2 billion in book orders.
- **Educate investors** through opinion-leading, highly rated deal research and by visiting more than 200 accounts across major investment centers (e.g., London, Hong Kong and Singapore).

Outcome and results

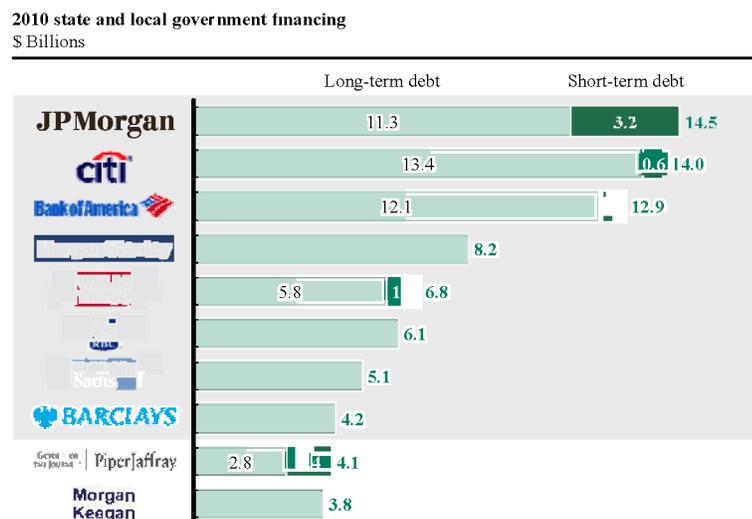
Client E's IPO was oversubscribed and improved the financial flexibility of the company.

- Able to fund future organic and acquisition growth opportunities
- Developed a permanent equity base

Large banks can offer particular benefit in ECM, DCM, M&A and syndicated lending because of their balance-sheet size, product scope, scale in capital markets, and geographic reach. Case studies indicate that banks must hold more than \$500 billion in assets to provide full benefits in such products, while banks larger than \$100 billion can provide benefits in smaller, less complicated deals. *See sidebar (“Capital-Markets Case Studies”) and Section B of the appendix.* This tendency is consistent with market-share data, which indicates that large banks hold over 90 percent share across investment-banking products originating in the U.S.⁴⁰ Furthermore, large banks underwrite the majority of U.S. state and local governments’ short- and long-term debt. In 2010 they were responsible for 87 percent of such financing,⁴¹ with the six U.S. banks with over \$500 billion in assets among the largest players. *(See Exhibit 9 for a breakdown.)*

EXHIBIT 9

Larger banks underwrite the majority of state and local governments’ short- and long-term debt.



SOURCE: Thomson

Primary benefits from large banks include performance of large issuances and deals, tailored product combinations, international options, and broad distribution capabilities.

- Large issuances and deals.** A larger balance sheet allows for underwriting larger deals. For DCM banks can keep sizable debt issuances on their balance sheets for the holding period before syndicating,⁴² or in case the market is disrupted and the sale postponed. For ECM banks must often commit to buying back any part of the offering not sold. Typically, a larger balance sheet also goes along with greater diversification, allowing higher concentration limits, as a proportion of balance-sheet size. Similarly,

⁴⁰ DealLogic and SNL Financial.

⁴¹ Thomson.

⁴² A typical holding-period length ranges between 20 and 30 days.

in the case of syndicated lending, large banks are able to extend more credit and are likely to be more successful arranging for other creditors to do the same.

- **Tailored product combinations.** Large banks have expertise across multiple equity and debt products, as well as in syndicated lending, alone and in different combinations. Their sophisticated deal-structuring capabilities help optimize integrated financing options, accounting for cost, risk, and flexibility.
- **International options.** Large banks have a presence and experience in multiple geographic markets and a range of expert bankers at their disposal. Cross-market experience can help them find the lowest-cost financing, potentially by splitting a capital-markets issuance across multiple markets or by forming a syndicate with banks from multiple countries.
- **Distribution capabilities.** Finally, factors such as balance-sheet size, geographic reach and product scope combine to ensure that large banks see high deal-flow across a range of deal types in multiple markets. Broad relationships with institutional investors across geographies and markets may provide companies issuing debt or equity with faster execution and lower risk in volatile market conditions.

In principle, large syndicates of smaller banks might underwrite deals of the sort currently underwritten by several large banks. However, there are reasons to question whether this would be possible in practice because of the complexity introduced by the large number of participants that would need to be involved. For example, a cross-border, cross-product, \$1 billion deal would require approximately ten \$50 billion banks,⁴³ that together had experience across geographies and in multiple products, creating large coordination challenges. Therefore, for large or complex deals, even if such syndicates could replicate the benefits outlined above, they could do so only at substantial detriment to speed, execution risk, and reaching consensus on deal terms. Speed is important in helping customers to meet tight deadlines and to mitigate risk, and establishment of consensus is critical to helping ensure appropriate deal terms and full subscription to issuances.

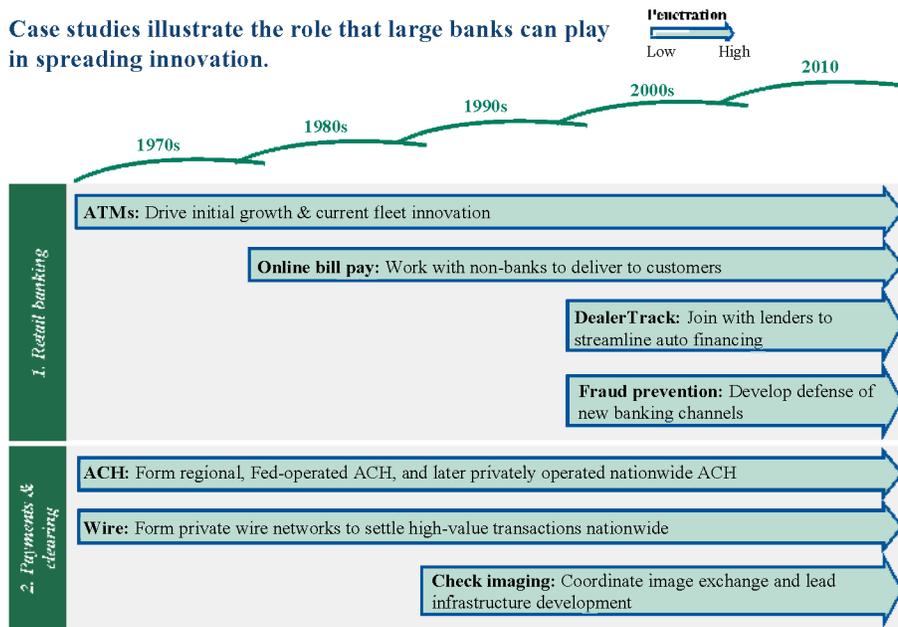
Breaking down our estimate of \$7 billion to \$11 billion in investment-banking benefits from large banks, we attribute \$2 billion to \$3 billion to DCM, \$1 billion to \$2 billion to ECM, \$1 billion to \$2 billion to M&A, and \$3 billion to \$5 billion through syndicated lending. We arrive at these numbers by estimating that large banks are uniquely positioned to perform approximately 30 percent of deals and confer more replaceable advantages in approximately an additional 45 percent. *(See Section B of the appendix for details.)*

⁴³ This calculation assumes a 20-basis-point concentration limit.

2.3 SPREAD OF INNOVATION

While often not the initial innovator, large banks have helped spread innovations industry-wide over the past three to four decades. (*Exhibit 10 illustrates this role for some important innovations in retail banking and payments & clearing.*) It is reasonable to expect that large banks will continue to spread innovation in the future, so long as they retain the characteristics that allowed them to do so in the past (for example, a large embedded customer base and physical footprint over which it is more economical to spread high fixed costs of investments in new products and technologies).

EXHIBIT 10



SOURCE: Hayashi, Sullivan, and Weiner (2003); FRB Philadelphia (2005); OnlineBankingReport (2009); annual reports.

We estimate that historical contributions of large banks in spreading innovation have led to as much as \$15 billion to \$30 billion in annual savings, particularly benefiting retail customers, as well as smaller banks that adopt these innovations. However, ours is a rough estimate because the contribution of larger banks to the spread of innovation does not submit easily to direct estimation for four reasons. First, banks' asset size today is not directly comparable to historical levels in part due to inflation, along with changes in interstate and other banking regulation. Second, multiple entities play a role in bringing technologies to market, so it is difficult to separate out the role of large banks. Third, it is impossible to know what would have developed without large banks. And fourth, benefits today come from the role of large banks in the past. We cannot measure what future benefits will come from the actions of large banks today. Therefore, we first focus on a qualitative examination of the role of large banks in spreading innovation. We turn to our estimates of benefits from large banks at the end of the section.

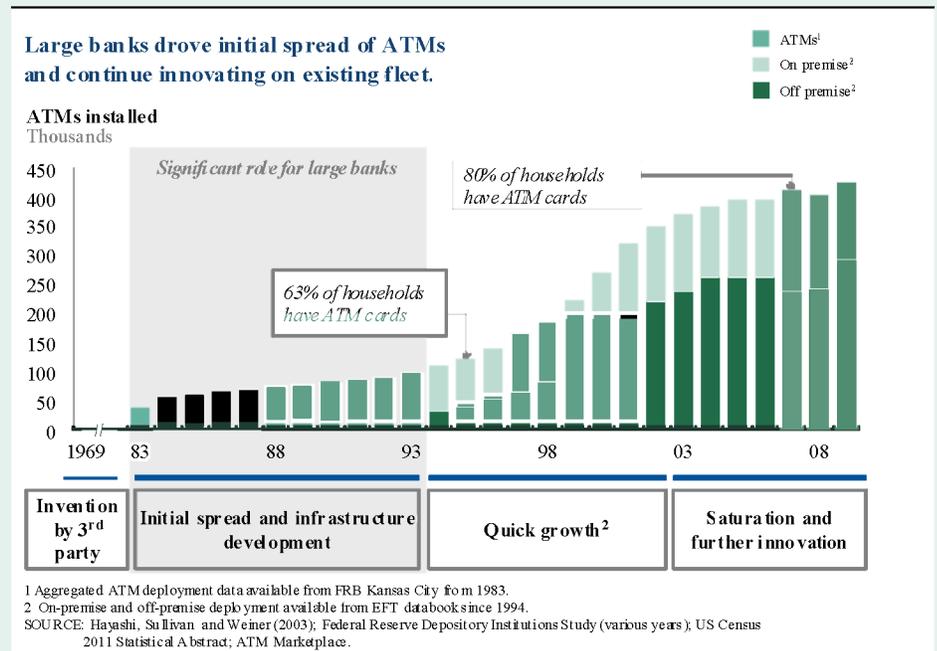
SELECT RETAIL AND PAYMENTS INNOVATIONS SPREAD BY LARGE BANKS

Large banks have played an instrumental role in spreading both retail and payments & clearing innovations over the past three decades. This sidebar highlights some such examples.

- Automatic teller machines.** In 1969 Docutel created the first automatic teller machine. It was installed at Chemical Bank, one of the largest banks at the time. Eight years later Citibank rolled out a fleet of ATMs across New York City. As ATMs proliferated, large banks of the time, such as Philadelphia National Bank, partnered to form shared networks that would serve customers reciprocally across different bank ATMs. In 1995, the two dominant national networks, Cirrus and Plus, allowed fee surcharges on ATMs, making the economics attractive for smaller banks and independent service providers. A period of quick growth followed but leveled off in the early 2000s. Even today, nearly one in every four ATMs in the U.S. is owned by a large bank. *(Exhibit 11 illustrates the evolution of ATMs.)*

- Online bill payment** lets consumers and small businesses send money from their bank account to whomever they specify. By the mid 1980s, technology companies such as Checkfree had developed a method of paying bills via personal computers. With the advent of the Internet in the 1990s, large banks started offering online bill payment through third-party providers. By 2001, 40 percent of households were paying some bills online. Bank of America's decision to abolish fees for online bill payment in 2002 caused many other large players to follow suit, causing online bill payment volume to rise significantly and become even more commonplace.

EXHIBIT 11



- DealerTrack** links customers, auto dealers and banks across the country via a Web-based loan platform that allows auto dealers and customers to get quotes instantly across a broad range of lenders. Previously, customers and dealers would spend days contacting banks by fax and phone to obtain financing. In 2001 Chase, Wells Fargo, and Americredit formed DealerTrack, providing software and bringing together a broad network of dealers and a large customer base. In response, captive financiers for GM, Ford and DaimlerChrysler set up their own version of automated auto-financing via RouteOne. Today DealerTrack processes more than 50 million auto-loan applications annually.
- Automated Clearing House (ACH).** Large banks established the first regional automated clearing houses then created a nationwide, private

ACH network in tandem with the Fed's network. ACH technology speeds up the processing of low-value recurring payments and allows customers to make and receive automatic payments conveniently. Today nearly 75 percent of all ACH originations and distributions pass through a large bank.

- Check imaging.** In check processing, large banks led the way in setting up an image exchange to replace the slow, costly paper presentation of checks that existed before 2004. Large banks built the necessary infrastructure and protocols needed to scan, transmit, and receive check images, which were later rolled out to smaller banks via the Fed. Today 95 percent of checks are cleared as images, lowering processing costs by a factor of more than three and improving clearing and settlement times by two days for consumers and businesses.

2.3.1 Benefits of innovations spread by large banks

Innovations that large banks have helped to spread tend to offer one of four benefits: serving individual customers better, improving transaction efficiency between already defined transactors, increasing product availability and price transparency, or aggregating and using data more effectively. (*Exhibit 12 breaks these benefits down by banking-product area.*)

EXHIBIT 12

Across all market areas, large banks have driven innovations that offer four distinct benefits.

✓ Profiled in detail

Product categories	Role of innovation			
	Serving individual customers better	Improving transaction efficiency	Increasing product availability and price transparency	Aggregating and using data more effectively
1. Retail banking	<ul style="list-style-type: none"> ✓ ATM ▪ Online banking ▪ Mobile banking 	<ul style="list-style-type: none"> ✓ Online billpay 	<ul style="list-style-type: none"> ✓ DealerTrack 	<ul style="list-style-type: none"> ✓ Fraud prevention ✓ Credit modeling and scoring
2. Payments & clearing	<ul style="list-style-type: none"> ▪ Securities servicing platforms 	<ul style="list-style-type: none"> ✓ Check imaging ✓ ACH ✓ Funds transfer (wire) 	<ul style="list-style-type: none"> ▪ Settlement systems 	<ul style="list-style-type: none"> ▪ Collateral management systems
3. Commercial banking	<ul style="list-style-type: none"> ▪ Cash management platforms ▪ Trade finance management platforms 			
4. Capital markets			<ul style="list-style-type: none"> ▪ Alternative trading systems; electronics communications networks 	

¹ Improvement of transaction efficiency when transactors are already set (e.g., a company and its employees, a consumer and the electric company).

SOURCE: TCH large-bank study-participant data.

- **Serving customers better.** Innovations spread by large banks that improve service are particularly common in retail banking, payments & clearing, and commercial banking. In retail banking and payments, examples include automatic teller machines (ATMs) and, more recently, both online and mobile banking. These advances all considerably improve convenience to customers. ATMs let them withdraw cash or make deposits and payments at any time. Online and mobile banking enable them to perform banking transactions anytime from anywhere, including making payments, viewing statements and reviewing information about deposits. In commercial banking, large banks also have played an important role in developing securities servicing, cash management and trade-finance-management platforms. These innovations provide companies large and small with considerable improvements in transparency, reductions in overhead, and advancements in financial and risk management.
- **Improving transaction efficiency.** Large banks have helped spread innovations improving transaction efficiency in the payments & clearing area. Examples include check imaging, ACH, and wire funds transfer. Check imaging simplifies, quickens, and improves the accuracy and security of check processing by replacing paper checks with electronically transmitted images. It allows consumers and businesses to view and sort checks online as soon as they clear. ACH connects banks and provides a reliable and

secure network for transferring funds. This network processes direct deposits, electronic payments, debit-card payments, business-to-business payments, and some local, state and federal tax transactions. Wire-transfer systems provide more individualized transactions than do check imaging or ACH. Banks use them to transfer money to one another, particularly large amounts of money. Companies and consumers can use them to send money directly from one bank account to another. Online bill payment improves transaction efficiency, allowing customers to pay their bills over the Internet rather than by mail or in person and often occurs nearly instantaneously.

- **Increasing product availability and price transparency.** Large banks, which span market areas, have helped spread innovations **that** increase product availability and price transparency. Examples include DealerTrack in retail banking and alternative trading systems (ATS) in capital markets. DealerTrack links auto dealers and banks across the country, allowing dealers and their customers to get instant quotes and shop for multiple types of financing across a broad range of lenders. An ATS is a non-exchange trading venue, approved by the SEC, that provides a platform for matching buy and sell orders. These systems tend to lower execution costs for institutional investors.
- **Aggregating and using data more effectively.** Large banks also have helped spread innovations that lead to more effective aggregation and use of data. These innovations include fraud prevention and credit modeling and scoring in retail banking and collateral-management systems in payments & clearing. Online banking brought many new opportunities for fraud. Large banks have played a central role in containing these risks through new technologies and pooling of data. Credit-scoring models for small businesses have automated and systematized many of the smaller-value loans offered to small businesses, allowing them greater credit access and lowering associated risk. Collateral-management systems allow banks to see in one place all outstanding activity that demands collateral.

2.3.2 Why large banks are able to spread innovation

Large banks have played a central role in spreading innovation due to their large customer base, the multiple types of customers they serve, their reputations for trust, and their balance-sheet size. These characteristics make it worthwhile for larger banks to spend money in spreading innovation and also mean that they are able to do so more quickly.

- **Large customer base.** A large customer base means that a bank can amortize its investment in a technology over more users, providing the service at a unit price that is lower than that of its competitors. Thus, even before a technology has been fully developed and its price lowered, it can save money for a larger bank. ATMs provide an example. In their early days, they were cost-efficient for those banks with sufficient customer density to justify the investment relative to the cost savings from servicing fewer customers at a branch. ATMs became cost-efficient for many smaller players only after transaction fees were allowed. Similarly, in commercial banking, a single large customer can make it worthwhile for a large bank to develop or enhance a technology that later can help middle-market consumers, either in the hands of banks themselves or as offered by third parties. Some cash-management systems in place today were spurred by the complex needs of large U.S. corporations.
- **Multiple types of customers served.** Having multiple types of customers, spread across multiple geographies, has also allowed large banks to spread technologies. Having customers of different types helps encourage development of products that bring these customers together. In the case of ACH, a network of several large banks had pre-existing relationships with a substantial proportion of both potential payers and payees, making initial development more efficient. Large banks' customer base in many locations also can speed the spread of new technologies. For example, DealerTrack caters to dealerships and consumers across the U.S. Its initial large-bank founders, Wells Fargo, Chase, and non-bank founder Americredit, already had relationships in many parts of the country and so were willing and able to form a system with nationwide reach.
- **Reputation for trust.** In addition, large banks' pre-established reputation and stability inspires trust in customers and a willingness to try something new. In the spread of online bill payment, for example, large banks were able to use relationships with both consumers and the companies they wished to pay. While non-bank payment processors introduced this innovation, they did not spread it successfully until large banks became actively involved. These banks had already established the trust of both payers and payees.

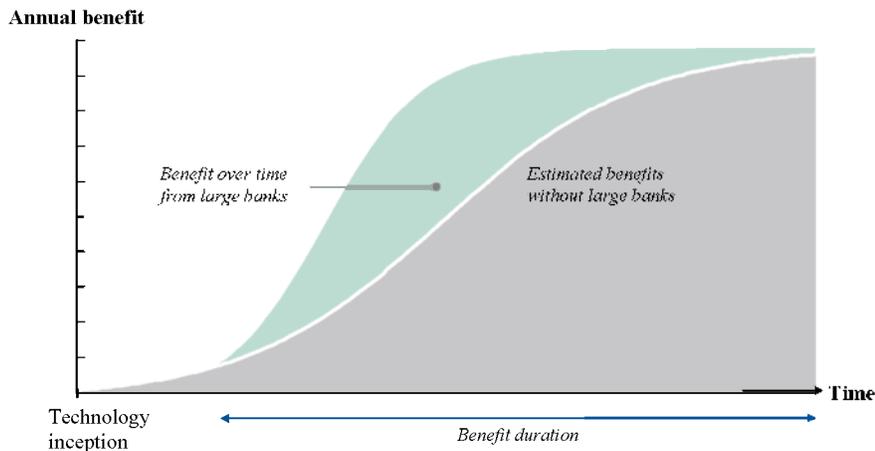
2.3.3 Quantification of innovation benefits

The benefit provided by large banks in spreading innovation is the sum of their contributions to each of the innovations in the process of proliferating them during a typical year. As we describe above, our rough aggregate estimate of this historical contribution of large banks is \$15 billion to \$30 billion annually. We calculate this estimate as the product of the average annual benefit per innovation times the average number of innovations spreading, with the help of large banks, in any given year.

First, to estimate the average annual contribution of large banks per innovation, we look at a collection of significant innovations over the past 30 years that large banks have helped to scale (ATMs, online bill payment, fraud-prevention, DealerTrack, ACH, check imaging, and wire transfer). For each, we build a hypothetical ‘no-large-bank’ growth curve based on the historical role of large banks, small banks, and non-banks at key historical inflection points in the innovation’s spread. The difference in innovation penetration between actual and hypothetical growth curves corresponds to the total benefit from large-bank participation. (*Exhibit 13 illustrates this concept.*)

EXHIBIT 13

Technologies spread faster with the participation of large banks.



For each innovation we translate a difference in penetration into a dollar amount based on the benefit that the innovation gives compared to the previous best alternative. For example, ATMs save people time compared to using a branch, which translates into a dollar amount based on average wages. (*See Section D of the appendix for calculation details.*) The rough average annual benefit is the total benefit divided by the number of years during which actual penetration exceeded the hypothetical penetration by a meaningful margin.

Second, to approximate the number of innovations spreading during a given year, we take the product of the typical number of new innovations each year, and the typical duration of difference between the actual penetration curve and the hypothetical curve assuming no large banks. We estimate these quantities based on the frequency and duration of significant innovations over the past 20 years, in aggregate and across the four banking-product areas. (Exhibit 14 breaks down our estimate. Section D of the appendix shows details of how we obtained these estimates.)

EXHIBIT 14

Spread of innovation benefits are largest in retail banking.

Estimated benefits from spread of innovation from U.S. banks with over \$50 billion in assets¹

\$ Billions

1. Retail banking ²	ATM	\$2 - 4
	Online billpay	\$1 - 2
	Other retail (e.g., online banking, mobile banking, DealerTrack, fraud prevention, credit modeling and scoring)	\$7 - 14
	Subtotal	\$10 - 20
2. Payments ²	ACII	\$0 - 0.5
	Check imaging	\$0 - 0.5
	Other payments (e.g., wire, securities-servicing platforms, settlement systems, collateral-management systems)	\$2 - 4
	Subtotal	\$2 - 5
3. Commercial banking ²	Other commercial banking (e.g., treasury-services platforms)	\$2 - 3
	Subtotal	\$2 - 3
4. Capital markets	Other capital markets (e.g., alternative trading systems)	\$1 - 2
	Subtotal	\$1 - 2
Total²		\$15 - 30

¹ Benefits due to banks over \$50B.

² Numbers may not sum due to rounding.

SOURCE: TCH large-bank study-participant data.

2.4 SUMMARY OF BENEFITS

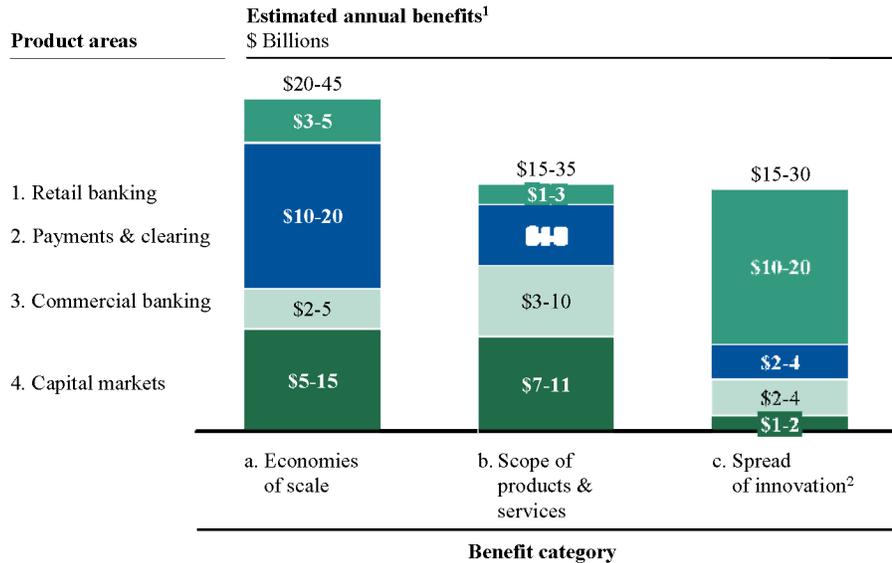
In aggregate, the 26 largest U.S. banks provide an estimated \$50 billion to \$110 billion worth of marginal value annually to the economy, as compared to banks with \$50 billion in assets or alternative non-bank solutions. Beneficiaries include consumers, companies, and governments.⁴⁴

These benefits are distributed across the four product areas of banking: retail banking, payments & clearing, commercial banking, and capital markets. The benefits are largest in payments & clearing, international commercial banking, and capital markets. Scope and scale benefits are relatively modest in retail banking. However, large banks have accelerated the spread of many retail innovations, which increase convenience and save time and money for consumers. (Exhibit 15 breaks down the value of these benefits.)

⁴⁴ The benefits of product scope and innovation measure only those benefits that are received by end-users. For economies of scale, these benefits are split between customers—in the form of reduced pricing and investment in new product innovation—and bank shareholders, in the form of higher profitability. For products with competitive markets, it is likely that portions of these scale economies are passed on to customers.

EXHIBIT 15

Benefits from large banks are distributed across product areas.



¹ Numbers may not sum due to rounding.

² Based on analysis of historical benefit from spread of innovations over the past 30 years.

SOURCE: TCH large-bank study-participant data.

Each of the four types of large bank—universal, retail & commercial, investment banks, and investment servicers and managers—provides different benefits, varying by their area of focus (*Exhibit 16*). From the point of view of assets alone, benefits continue growing as banks grow to \$500 billion or more (*Exhibit 17*).

EXHIBIT 16

Each type of large bank provides different types and sizes of benefits.

Relative size of benefit

✓ Larger ✓ Smaller

Product categories	Types of large banks			
	I. Universal banks	II. Retail & commercial banks	III. Investment banks	IV. Investment servicers & managers
1. Retail banking	<ul style="list-style-type: none"> ✓ National product footprint ✓ Economies of scale ✓ Spread of innovation 	<ul style="list-style-type: none"> ✓ Regional product footprint ✓ Economies of scale ✓ Spread of innovation 		
2. Payments & clearing	<ul style="list-style-type: none"> ✓ Broad product scope ✓ Economies of scale ✓ Spread of innovation 	<ul style="list-style-type: none"> ✓ Economies of scale ✓ Spread of innovation 		<ul style="list-style-type: none"> ✓ Broad product scope ✓ Economies of scale
3. Commercial banking	<ul style="list-style-type: none"> ✓ International product scope ✓ Economies of scale ✓ Spread of innovation 	<ul style="list-style-type: none"> ✓ Regional product scale and scope (with international correspondents) 		
4. Capital markets	<ul style="list-style-type: none"> ✓ Broad and international product scope ✓ Economies of scale ✓ Spread of innovation 		<ul style="list-style-type: none"> ✓ Broad and international product scale ✓ Economies of scale ✓ Spread of innovation 	

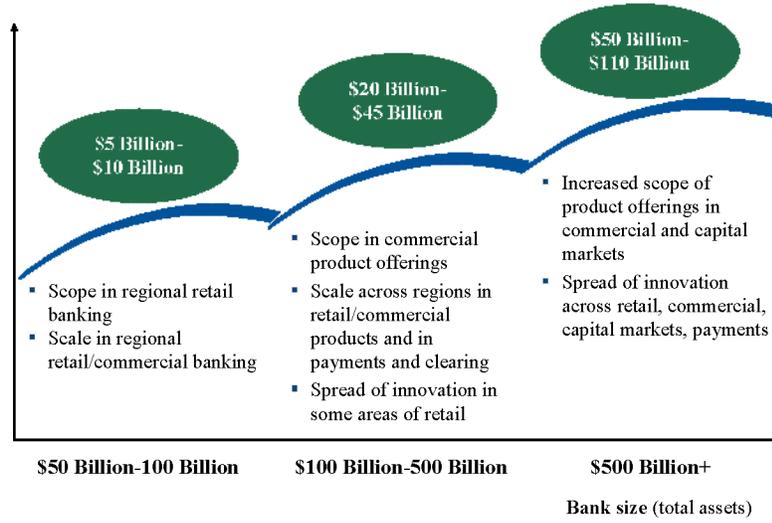
SOURCE: TCH large-bank study-participant data.

EXHIBIT 17

Benefits of large banks continue growing as the size of bank increases.

Estimated cumulative benefits of U.S. banks with \$50 billion+ in assets

 Cumulative benefit



3. Benefits lost in the absence of large banks

Do benefits from large banks *necessarily* mean that large banks are required in order to realize these benefits? Could some benefits be provided instead by a “large” non-bank entity, consortiums of small banks, or industry utilities? And what is the likely impact of reducing the size of large banks?

The answers to these questions depend on whether the benefits coming from economies of scale, scope of products, and spread of innovation can be decoupled from the core banking functions of credit provision, intermediation, and payments.

In some cases they clearly can, while in others it is challenging to replicate the economies of scale or product scope without having large banks. We estimate that 50 to 70 percent of the aggregate financial benefits found in this study do require the integration of core banking functions and size and hence could not be realized in the absence of large banks.

IMPACT OF REDUCING THE SIZE OF BANKS

There are several ways to reduce the size of banks. Each has a different impact on these benefits.

- **Reducing geographic scope.** Reductions in geographic scope limit the ability of banks to offer convenience benefits to customers based on the depth and breadth of ATM and branch networks and based on the ability to conduct transactions across borders. Moreover, limiting the geographic scope potentially increases banks’ exposure to the risks of specific regional economies or industries and reduces diversification of revenue sources.
- **Shrinking individual businesses.** Reductions of an individual business—either in penetration within geographies or breadth of geographies—would result in the loss of the economic benefits to customers identified here. Large individual businesses are, in many cases, necessary to provide the scope of product offerings and the convenience that customers require. Limiting individual businesses reduces the incentives of banks to invest in innovation because they can no longer realize a reasonable return on investment from a sufficiently large customer base.
- **Splitting multiple businesses into separate banks.** Proponents of “narrow banking” argue that individual businesses (e.g., capital markets, custody, commercial banking) be split into individual banks. Individual businesses could be large. This limitation would still allow banks to maintain a broad geographic scope and provide benefits of scale, product scope, skill, and innovation to their customers within each business. However, the consolidation of business units within a single bank provides diversification of revenue sources, portfolio risks (e.g., consumers, corporations, capital markets), and funding sources. Many of the weakest institutions in the last crisis were effectively monolines and thus overexposed to individual asset classes, or they lacked a diversity of funding sources. Both before and during the crisis, we saw the virtual death of a variety of monoline business models. Some of these companies lacked diversification of product (e.g., Indymac, WaMu, Countrywide). Others lacked diversification of risk,

geography, and funding sources (e.g., monoline credit cards, auto finance, and investment banks).

Many other benefits could not plausibly be offered in the absence of large banks because of the inherent link between credit provision and intermediation. Some examples follow.

- **Custody.** As a natural outgrowth of economies of scale, custodians naturally become larger. Because the service requires fiduciary responsibility, it requires the provider to be a bank.
- **Capital markets.** Large deals performed quickly could not be coordinated from syndicates of smaller institutions.
- **Scale in retail lending.** Credit-card lending, auto finance, and other national lending businesses benefit from benefits of scale and skill in risk management, marketing, and technology in back-office operations. Most of these benefits are directly linked to the provision of credit and hence would be very difficult to decouple from banks.
- **International lending, cash management, and trade finance.** The majority of benefits in these areas come from the scope of multiple product offerings across multiple geographies. These businesses rely upon an integrated view of the customer and provision of credit and transaction services. Large non-banks, syndicates of smaller banks, or industry utilities could not reasonably supply most such features.

BENEFITS THAT MIGHT BE REPLACED BY ALTERNATIVE MECHANISMS

We estimate that, of the annual benefits discussed in this report, those that may be available from other market mechanisms total approximately \$20 billion to \$40 billion. This portion is approximately 30 percent to 50 percent of the total estimated benefits from large banks today and includes the following.⁴⁵

- **Economies of scale in payments processing.** These could be realized by industry utilities or large non-bank players. For example, TSYS and Visa are non-banks that perform vital payment activities and realize significant economies of scale and network effects. These entities began as parts of large banks and were ultimately reorganized as independent companies. As we discuss above, estimated annual benefits from economies of scale in payments & clearing are \$10 billion to \$20 billion.
- **Product and convenience benefits in retail.** Some of the convenience benefits of larger banks to retail customers (e.g., distance to the nearest no-fee ATM) could be created through industry consortia of smaller banks (e.g., pooling ATM networks across geographies). We have estimated related annual benefits to be between \$1 billion and \$3 billion.

⁴⁵ We arrive at this percentage range by using, (1) for the lower bound, low-end estimates for all areas except scale in payments & clearing, retail convenience, and innovation, for each of which we assume high-end estimates (giving \$20 billion in benefits from non-large banks out of a total annual benefit number of approximately \$80 billion), and (2) for the upper bound, high-end estimates for all areas except scale in payments & clearing, retail convenience, and innovation, for each of which we assume low-end estimates (giving \$40 billion in benefits from non-large banks out of a total annual benefit number of approximately \$80 billion).

- **Innovations.** Many innovations require a large customer base to succeed. Non-bank innovators would need to have a significant customer base—of either many small banks or of several large banks—and a mechanism to capture the benefits of innovation; e.g., outsourcing relationships with many institutions. However, any such non-bank innovator likely would require an embedded customer base to promote initial adoption along with a way to monetize the benefits from the innovation.

Total estimated annual benefits from large banks in spreading innovation are \$15 billion to \$30 billion. We estimate that a non-bank might provide approximately half of this value, or \$10 billion to \$15 billion annually.⁴⁶

⁴⁶ The literature indicates that spread of innovation can be less efficient when it is not driven by individual banks. For example, Ferrari (2007) examined ATMs in Belgium, where all banks coordinated investment decisions so that there were no strategic reasons for investment. They find that banks substantially underinvested in this shared network. See Ferrari, Stijn, Frank Verboven and Hans Degryse, "Investment and usage of new technologies: Evidence from a shared ATM network," Katholieke Universiteit Leuven, Centrum voor Economische Studiën, Discussion Paper ces731 (2007).

Future research directions

To the best of our knowledge, this report represents the first systematic effort to examine and quantify the benefits that large banks provide to consumers, companies, and governments, as well as the U.S. economy as a whole. We believe that it establishes a preliminary fact base that could and should be further extended through additional work.

Continued research and discussion about the benefits of large banks is critically important to understanding the role that they play in the banking system and the economy at large. Measures that would compel large banks to shrink would affect the benefit profile as well as the risk profile of the industry and could have repercussions for the broader economy.

Potential future directions for research exist across all three areas of benefit discussed in this report. Some examples follow.

■ Economies of scale

- Continued and expanded investigation of product-level economies of scale across more product areas
- Investigation of the characteristics of products that are complementary or in conflict, producing either economies of scale or dis-economies of scale
- Examination and quantification of the distribution of the gain from economies of scale; e.g., among consumers, through reinvestment or to shareholders.

■ Scope of products and services

- Survey and quantification of customer views on benefits, both on the product-level and on the level of integrated cross-product services that are provided by a bank
- Identification, examination, and quantification of any indirect or knock-on benefits stemming from scope of products and services
- Further investigation of the potential for, and effects of, having small banks, non-banks or foreign banks provide products and services currently offered predominantly by large U.S. banks

■ Spread of innovation

- More exhaustive cataloguing of the successful and failed spread of banking innovations, understanding where large banks were essential, where they were inessential, and where, if anywhere, they were detrimental
- More detailed examination of direct and indirect benefits from past banking innovations
- Investigation into the potential future role of large banks in spreading innovation, based both on nascent innovations and the potential for other innovations across banking product areas