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The Honorable Janet Yellen
Chair, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: “Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies”; Docket No. R-1505/RIN 7100 AE-16

To Whom it May Concern:

Americans for Financial Reform (“AFR”) appreciates this opportunity to comment on the above-referenced notice of proposed rulemaking (the “Proposal”) by the Federal Reserve Board (the ‘Board’). AFR is a coalition of over 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups. A list of AFR member groups is available at <http://ourfinancialsecurity.org/about/our-coalition/>.

AFR strongly supports the decision taken in this Proposed Rule to impose capital surcharges for the largest Global Systemically Important (GSIB) U.S. banks that potentially exceed the Basel minimum surcharges by several percentage points. We strongly support increasing the capital held by the largest U.S. banks to a level that exceeds the implausibly low minimum capital surcharges set by the Basel Committee. As further discussed below, we believe that the increased level of capital for globally systemic banks in this proposal is clearly justified by the extensive cost-benefit analyses already undertaken by the international regulatory community, and indeed a higher level should be required on cost-benefit grounds. Furthermore, the additional capital requirements in this proposal clearly align with the explicit Congressional directive in Section 165 of the Dodd-Frank Act required the Board to impose prudential standards that increase in stringency with the size, complexity, and activities of large bank holding companies.

AFR also supports the Board’s decision to make increased GSIB surcharges heavily dependent on a bank’s level of short-term wholesale funding. The significance of short-term wholesale funding as an indicator of bank run risk is supported by common sense. Since this funding is short term, creditors can withdraw their funding at short notice based on any indication that a bank may be in danger of failure. This clearly poses run risk. The relationship between reliance

on short-term wholesale funding and prudential risk is also supported by a large amount of empirical research undertaken since the financial crisis. Numerous studies and books have documented the significance of disruptions in short-term wholesale funding markets in the origins and spread of the 2008 financial crisis, as well as the strong statistical relationship between dependence on short-term wholesale funding and the likelihood of bank failure.¹

While we support the general direction of the Board's proposal, AFR is concerned that the levels of capital required in this proposal remain inadequate. We are also concerned that the indicators used in the proposal may not fully capture all indicators of systemic significance, or properly weight those that are captured. We are particularly concerned in relation to the treatment of short-term wholesale funding, which we believe is not properly weighted in the metric recommended in this proposal. We also have several recommendations with respect to the measurement of firm complexity.

The Costs And Benefits of Additional GSIB Capital

Over the past five years, international regulators have conducted extensive cost-benefit analyses of additional capital requirements. We understand that the Board has played a central role in this analysis. As part of this analysis, at least three different major impact assessments were published, each of which drew on dozens of different academic and regulatory economic analyses.² These comprehensive analyses examine the optimal tradeoff between the benefits of additional capital in reducing the probability of a costly financial crisis, and any costs of additional capital requirements created through increasing lending spreads. The central case results for this analysis found that the optimal level of risk-weighted Basel III common equity capital for an ordinary (non-GSIB) bank was 10.5%, or 3.5 percentage points in excess of the minimum Basel requirement of 7%.³

¹ For recent research, see Blundell-Wignall, Adrian, Paul Atkinson and Caroline Roulet, "[Bank Business Models and the Basel System](#)". OECD Journal: Financial Market Trends, Volume 2013/2, OECD 2014. This paper finds a very large impact of wholesale funding on bank risks after controlling for other factors. There is also a very large literature finding that runs on short term wholesale funding were crucial to the 2008-2009 global financial crisis. For useful summaries, see Gorton, Gary B. and Metrick, Andrew, "[Getting up to Speed on the Financial Crisis: A One-Weekend-Reader's Guide](#)". January 11, 2012; and Brunnermeier, Markus K. and Oehmke, Martin, "[Bubbles, Financial Crises, and Systemic Risk](#)". June 6, 2012 in Handbook of the Economics of Finance, Volume 2, George Constantinides, Milton Harris and Rene Stulz, eds., North Holland, October 2012.

² Basel Committee on Banking Supervision, "[An Assessment of the Long-Term Economic Impacts of Stronger Capital and Liquidity Requirements](#)". Bank of International Settlements, August, 2010; Macroeconomic Assessment Group, "[Final Report: Assessing the Impact of the Transition to Stronger Capital and Liquidity Requirements](#)". Bank of International Settlements, December, 2010; Macroeconomic Assessment Group, "[Assessment of the Macroeconomic Impact of Higher Loss Absorbency For Global Systemically Important Banks](#)". Bank of International Settlements, October 10, 2011.

³ The minimum Basel requirement is 4.5% of base CET capital plus a 2.5% capital buffer. For the comparison to the optimal level, see the summary discussion at p. 25, Basel Committee on Banking Supervision, "[Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement Rules Text](#)". Bank of International Settlements, November, 2011, as well as the sources in footnote 2 above.

Since the final GSIB surcharge suggested by the Basel committee ranged from 1 to 2.5%, the Basel recommendation for the GSIB surcharge still leaves even the very largest and most critical global banks with risk-adjusted capital below the optimal level calculated for a typical non-GSIB bank. This is despite the fact that the social benefits of capital for GSIBs are clearly greater than for non GSIBs, since a financial crisis featuring the failure of major GSIBs would likely be far more damaging than a financial crisis involving only the failure of smaller banks. Furthermore, the social costs of capital requirements limited to GSIBs would be lower than a requirement extended to all non-GSIB banks, since non-GSIBs can increase lending to substitute for any increased lending costs induced among GSIBs by higher capital requirements. Correction for either of these issues would lead to a GSIB surcharge larger, not smaller, than the 3.5% level of additional capital necessary to reach the optimal level of capital for an ordinary bank.

In 2011, AFR provided comment to the Basel Committee that made these points in detail.⁴ The AFR comment also pointed out that even after adjusting for the greater significance of GSIB banks, the LEI Committee's estimate of a 10.5% optimal level of risk-adjusted capital was based on unrealistic assumptions. For example the LEI Committee analysis assumed a 15 percent required return on equity for bank capital and a complete pass-through of all costs of increased capital directly to lending rates, both of which are unrealistic. Furthermore, the LEI analysis, while it did incorporate the very significant benefits resulting from a lower probability of bank failure due to better bank capitalization, did not appear to include other positive economic benefits from higher bank capitalization that might occur short of bank failure. Such benefits would include the counter-cyclical lending benefits of having better capitalized banks during the contraction period of a financial cycle.

In combination, these issues make a strong case that the Basel Committee's GSIB capital surcharge is a substantial underestimate of the socially optimal capital level for the largest global banks. For this reason, we believe that the higher levels of additional capital called for in this proposal, which range up to 4.5% of risk-adjusted capital for the largest and most complex U.S. banks, would be well justified on a cost-benefit basis.

Indeed, given that the extensive cost-benefit analyses cited above implied that a 3.5% surcharge would be necessary to raise even a typical bank to the socially optimal level of loss absorbency, a 4.5% surcharge still appears low. We believe that appropriate analysis would support an even higher level of capital surcharge than is recommended in this Proposal, especially for the largest and most complex banks that remain heavily dependent on short-term funding. The Board states in the Proposed Rule that "nearly all of the eight firms would already meet their GSIB surcharges on a fully phased in basis and all firms are on their way to meeting their surcharges over the proposed three-year phase in period" (CFR 75480). We are concerned that this statement

⁴ Americans for Financial Reform, "[Letter to the Basel Committee Regarding G-SIB Surcharges](#)", August 26, 2011. This comment was on the Basel Committee's proposed GSIB surcharges but the actual surcharges that were approved did not change from the proposed level.

suggests that the surcharges in the rule may have been selected not based on the best estimate of the capital charges that would maximize potential societal benefits, but instead reverse engineered to match the current capital levels at U.S. GSIB firms. We believe that the Board should set capital levels at our largest and most complex firms that optimally address the negative externalities created by excessive leverage at such firms.

In order to do this, we recommend performing an analysis similar to the one performed by the Basel LEI committee, except using more reasonable assumptions in the following areas:

- Some level of substitutability between GSIB and non-GSIB lending should be assumed.
- There should be an assumption of greater negative externalities created by under-capitalization at GSIB banks vs. smaller banks.
- Pass-through of any additional capital costs to end user loans should be significantly less than 100%, due to the ability of banks to reduce operating costs and compensation.
- Assumed returns on equity for bank capital should be set to a more sustainable level than 15% and should reflect investor response to lessened bank risks.
- Counter-cyclical benefits of better capitalized banks should be included, beyond simply the lower probability of bank failure.
- The additional failure likelihood of banks that are heavily dependent on short-term funding should be directly modeled.

We believe that such an analysis would support a higher level of GSIB surcharge than is called for in this proposal, and would also demonstrate that the levels of additional capital called for here are very moderate compared to the social costs of undercapitalization at large banks heavily dependent on short-term funding. Such an analysis would provide an effective response to the issues raised in Question 9 of the proposal.

Treatment of Short Term Wholesale Funding

In seeking to incorporate dependence on short-term wholesale funding into the metric used to determine the G-SIB surcharge, the Board has chosen an additive metric in which the impact of short-term wholesale funding is apparently limited to roughly one-fifth of the total summary metric. We feel this is inappropriate. The liability structure of the bank affects the risk posed by all of the bank's activities. That is, almost any activity of the bank becomes riskier and more dangerous if it is funded with short-term and unstable funding. The marginal effect of additional short-term and unstable funding is thus quite different than the marginal effect of, for example, size. A very large, complex, and interconnected bank which was funded with short-term and unstable funding would be riskier along every dimension of its activities than an otherwise similar bank funded with long-term stable funding sources. We believe it would therefore be more sensible to incorporate short-term funding in a multiplicative and not an additive fashion. Dependence on short-term funding should serve as a multiplier on other measured risks and not

an addition, as laid out in the alternative metric suggested by the Board in Part 4 (CFR 75481) of the Proposal, which we discuss further below.

As a practical matter, if the recommended additive method of incorporating short-term funding in the Proposal is used, additional use of short-term funding will only have a limited impact on the G-SIFI capital charge. For example, suppose Bank A funds 75 percent of risk weighted assets using the forms of short-term wholesale funding most disfavored in this proposal, while Bank B funds 25 percent of risk-weighted assets in that manner. The maximum differential between Bank A and Bank B on the Method 2 G-SIFI score in this proposal would be 175 points (50 percent multiplied by the two weighting factors of 175 and 2), corresponding to roughly one additional percentage point of risk-adjusted capital. We believe one additional percentage point of risk-adjusted capital is an inappropriately low differential given that Bank A has triple the dependence on unstable short-term funding compared to Bank B, and also has a very high absolute level of dependence on short-term funding compared to Bank B.

The impact of short-term funding on the absolute capital requirement is further lessened by the fact that the short-term funding metric in Method 2 replaces the ‘substitutability’ metric in Method 1. This means that the marginal impact of short-term funding dependence is not determined by the full absolute measure of short-term funding calculated under Method 2, but only the difference between the Method 1 ‘substitutability’ measure and the short-term funding metric in Method 2. The Proposal does note at several points that the surcharge calculated under Method 2 will generally be higher than the Method 1 surcharge. However, from our comparisons of the two methods, it appears that the increase in the surcharge under Method 2 is more driven by the general doubling of all the metrics in the Method 2 calculation than it is by responsiveness to the additional measures of dependence on short-term wholesale funding incorporated in Method 2.

Given the weaknesses in the additive methodology suggested in the proposed rule, we recommend that the Board instead use some version of the alternative multiplicative metric suggested on CFR 75481 of the Proposal. This method would keep the metrics used in Method 1 but would scale them multiplicatively according to the ratio of short-term wholesale funding divided by total risk weighted assets. We believe that, given the choice of an appropriate scaling factor, this method would increase the marginal impact of an additional unit of short term funding on the firm’s capital buffer as compared to the additive method. Furthermore, the marginal impact would increase depending on the other factors that increase the firm’s systemic risk, which we believe is appropriate. This would mean that the largest and most complex firms also had the largest disincentive to rely on unstable short-term funding. We believe that the scaling factors used in this method should be calibrated using empirical correlations on the relationship between short-term funding and bank distance to default during the financial crisis.

Measurement of Financial Firm Complexity

The measurement of firm complexity in this proposal relies on notional value of OTC derivatives exposures, size of the trading book/AFS securities, and the amount of level 3 assets. We believe that it is entirely appropriate to weight derivatives exposures heavily in the complexity metric, as research on bank distance to default shows that derivatives exposures have a powerful impact on bank risk, indeed roughly equivalent to the impact of wholesale funding.⁵ This is not surprising given that derivatives margin calls can have a short-term liquidity impact that is in many ways comparable to the effect of the withdrawal of short-term funding by creditors.

However, we do have two recommendations regarding these metrics. First, the division between level 2 and level 3 assets can be blurry and easily manipulated, particularly during relatively stable market periods. Banks tend to hold very large amounts of level 2 assets compared to level 3 assets, perhaps from a desire to avoid signaling valuation issues to investors.⁶ Making the complexity metric depend so heavily on level 3 assets alone will only increase this incentive. We suggest adding some fraction of level 2 assets to the metric, although at a lower weighting than level 3 assets.

Second, we believe that there is valuable information concerning the structural complexity of financial firms that is contained in the bank resolution plans or ‘living wills’ required under Title I of Dodd-Frank. Particularly significant is whether the bank has achieved any effective separation or firewalls between different business lines (e.g. its more complex dealer and derivatives activities vs. its more conventional commercial banking activities) such that operating subsidiaries in one business line could be placed into a bankruptcy proceeding separately from the rest of the bank. Current regulatory reviews of bank resolution plans indicate that major global G-SIBs have not yet achieved structural simplification through this process, and resolution plans are marked by numerous inadequacies, so at this point it may be premature to differentiate G-SIB surcharges using information from resolution plans. However, as banks do progress toward more effective simplification through the resolution planning process, we believe it would be appropriate to reflect such progress (or lack of it) through different G-SIB surcharges based on bank structural complexity.

Thank you for the opportunity to comment on these Proposed Rules. Should you have any questions, please contact Marcus Stanley, AFR’s Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

⁵ Blundell-Wignall, Adrian, Paul Atkinson and Caroline Roulet, “[Bank Business Models and the Basel System](#)”, OECD Journal: Financial Market Trends, Volume 2013/2, OECD 2014.

⁶ <https://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/chap3.pdf>