January 16, 2024

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15) (Docket No. R-1814, RIN 7100-AG65)

Dear Ms. Misback:

We are pleased to submit this letter in support of the Board of Governors' proposal to strengthen the risk-based capital surcharge for global systemically important bank holding companies (GSIBs). By way of background, we are scholars of banking and finance whose research focuses on bank regulation, systemic risk, and financial stability, among other topics. The proposal (Proposed Rule) will improve the calibration of the GSIB surcharge and better align GSIBs' capital levels with the firms' systemic importance. We urge the Board to adopt the Proposed Rule with minor enhancements discussed below.

Robust GSIB capital surcharges are essential for two reasons. First, this extra capital cushion helps mitigate the outsized threats that GSIBs pose to financial stability. The U.S. GSIBs are among the most systemically important financial institutions in the world, and the risks they pose to the global economy have only continued to grow. By adding a capital cushion on top of the baseline requirements that apply to less systemically important banking organizations, the GSIB surcharge reduces the likelihood that a GSIB will collapse and seriously damage the economy. In addition, the GSIB surcharge discourages these firms from expanding even faster and intensifying risks to the financial system. Ensuring that GSIBs maintain capital levels commensurate with their systemic importance is especially critical in light of questions that have arisen about authorities' ability to resolve systemic banking organizations following the disorderly collapse of Credit Suisse and three U.S. domestic systemically important banks in 2023. The case of Credit Suisse, where policymakers chose not to invoke the resolution mechanism, is particularly troubling.[1]

Second, the GSIB surcharge helps to promote competition in the banking sector. Reducing the competitive advantages enjoyed by the small number of U.S. GSIBs is a widely shared regulatory

[1] The distortions associated with too-big-to-fail institutions and the importance of capital requirements in addressing these problem are discussed extensively in the new and expanded edition of ANAT ADMATI AND MARTIN HELLWIG THE BANKERS NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (Princeton University Press 2024) (see especially chapters 9, 14, 16 and 17). On Credit Suisse, see Anat Admati, Martin Hellwig & Richard Porter, *Credit Suisse: Too Big to Manage, Too Big to Resolve, or Simply Too Big?*, VoxEU (May 8, 2023), https://cepr.org/voxeu/columns/credit-suisse-too-big-manage-too-big-resolve-or-simply-too-big.

objective.[2] Implicit and explicit government subsidies ensconce the GSIBs' dominance and harm smaller banks. For example, the GSIBs receive a "too-big-to-fail" funding subsidy because creditors expect that the government would bail out a distressed GSIB rather than let it collapse.[3] The GSIB surcharge helps offset, at least in part, these competitive advantages. In doing so, the GSIB surcharge begins to level the playing field for small and mid-sized banks.

Although the GSIB surcharge has worked reasonably well in the decade since it was first implemented, experience has shown that it needs to be modified in several ways to better achieve its objectives. The Proposed Rule will introduce several necessary enhancements to the GSIB surcharge. These enhancements will generally increase GSIB surcharges, which is important since Federal Reserve Board research has shown that the international GSIB surcharge framework is under-calibrated to account for macroprudential risks.[4] We discuss the most critical of these reforms below and explain why they are essential to mitigating financial stability risks and promoting competition in the banking system.

1. <u>Preventing "Window Dressing"</u>

The Proposed Rule would limit a banking organization's ability to engage in "window dressing," or strategic balance sheet manipulation before the end of a reporting period, to artificially reduce its GSIB surcharge. Window dressing has become widespread in the decade since the GSIB surcharge's enactment.[5] Indeed, one empirical study concluded that GSIBs strategically reduce their scores by 11 basis points at year-end, on average.[6] This behavior can impair financial stability in two ways. First, when a banking organization engages in window dressing, it understates its actual systemic importance and may become subject to a lower GSIB surcharge than is warranted. Second, window dressing may impair financial market functioning at the end of reporting periods, as GSIBs retreat from critical markets and leave few alternative providers of critical financial services. For example, one study found that European GSIBs strategically reduce their balance sheet repo volumes by up to 25 percent immediately prior to year-end, potentially impairing repo market functioning.[7]

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[2] *See* Michelle W. Bowman, Member, Bd. of Governors of the Fed. Rsrv. Sys., Responsive and Responsible Bank Regulation and Supervision 12 (June 25, 2023), https://www.bis.org/review/r230627b.pdf (expressing concern that G-SIBs are "insulated from competition" and "ensconc[ed] … atop the banking system").

[3] Following the 2008 crisis and ensuing regulatory reforms, typical estimates of the "too-big-to-fail" subsidy have ranged from roughly twenty-two to one hundred basis points. *See* Nicola Cetorelli & James Traina, *Resolving "Too Big to Fail"* 1-2, (Fed. Rsrv. Bank of N.Y., Staff Rep. No. 859, 2018), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr859.pdf.

[4] *See* Wayne Passmore & Alexander H. von Hafften, *Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?*, 15 INT'L J. CENTRAL BANKING 107, 107 (2010) (estimating that appropriately calibrated G-SIB surcharges would be 3 to 8.25 percentage points higher).

[5] *See, e.g.*, Markus Behn, Giacomo Mangiante, Laura Parisi & Michael Wedow, *Behind the Scenes of the Beauty Contest—Window Dressing and the G-SIB Framework*, 18 INT'L J. CENTRAL BANKING 301 (2022); Luis Garcia, Ulf Lewrick & Taja Secnik, *Is Window Dressing By Banks Systemically Important?* (Bank for Int'l Settlements, Working Paper No. 960, 2021), https://www.bis.org/publ/work960.pdf; Jared Berry, Akber Khan & Marcelo Rezende, *How Do U.S. Global Systemically Important Banks Lower Their Capital Surcharges?*, FEDS NOTES (Jan. 31, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/how-do-us-global-systemically-important-banks-lower-their-capital-surcharges-20200131.html.

[6] *See* Behn et al., *supra* note 5, at 303.

[7] *See* Claudio Bassi, Markus Behn, Michael Grill & Martin Waibel, *Window Dressing of Regulatory Metrics: Evidence from Repo Markets* (Eur. Ctr. Bank., Working Paper No. 2771, 2023), https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2771~fc55bab0d6.en.pdf.

The Proposed Rule will limit window dressing by requiring banking organizations to report certain systemic indicators as the average of daily values over a reporting quarter, rather than a quarter-end point-in-time. In addition, the Proposed Rule will base a banking organization's GSIB score on the average of its reported values over four quarters of a calendar year, rather than only its fourth quarter value. These reforms will reduce banking organizations' incentives to strategically manipulate their balance sheets at the end of a reporting period. In doing so, these changes will ensure that GSIB scores more accurately reflect banking organizations' actual systemic risk and mitigate the likelihood of financial market disruptions at the end of reporting quarters.

As proposed, the Proposed Rule would require daily averaging for many on-balance sheet systemic indicators. However, the Proposed Rule would allow banking organizations to report the average of month-end values instead of daily values for certain off-balance sheet items, such as intra-financial system assets and liabilities, as well as over-the-counter (OTC) derivatives. We are concerned that permitting banking organizations to report the average of month-end values for these indicators will incentivize banking organizations to continue window dressing. Indeed, since the Proposed Rule limits banks' ability to window dress with respect to on-balance sheet systemic indicators, banking organizations may have even more incentive to strategically manipulate their month-end averages for off-balance sheet indicators in order to minimize their GSIB scores. Although calculating the daily averages of these indicators may impose a modest reporting burden on covered banking organizations, the strategic manipulation of intra-financial system assets, intra-financial system liabilities, and OTC derivatives would perpetuate the dangers of window dressing inherent in the existing GSIB surcharge framework. We therefore urge the Board to require daily averaging for these systemic indicators, as well.

2. Reducing Cliff Effects

The Proposed Rule will also reduce "cliff effects" inherent in the existing GSIB surcharge framework. The current method 2 framework features relatively wide 100-basis point score bands. Thus, for example, a banking organization with a method 2 score of 230 is subject to the same GSIB surcharge as a firm with a score of 329.[8] Experience has shown that under this system, banking organizations cluster at the top end of score band ranges in an effort to maximize their systemic footprints without moving up to the next score band and triggering the associated 0.5 percentage point GSIB surcharge increase.[9] This clustering behavior is problematic because it exploits the risk insensitivity of the regulatory framework and results in lower GSIB surcharges than are warranted.

The Proposed Rule will deter clustering behavior by narrowing the method 2 score bands and thereby reducing cliff effects. Instead of 100-basis point score bands that correspond to 0.5 percentage point surcharges, the Proposed Rule introduces 20-basis bands that correspond to 0.1 percentage point surcharges. These narrower bands will make the method 2 surcharge framework more continuous and risk sensitive without changing its overall calibration. This reform will soften the regulatory impact when a banking organization moves up to the next score band and, in doing so, will reduce firms' incentives to manipulate their method 2 scores to remain in a lower score band. The Board should adopt this aspect of the Proposed Rule to enhance the method 2

[8] *See* 12 C.F.R. § 217.403(c).

[9] *See, e.g.*, Alexander Jiron, Wayne Passmore & Aurite Werman, *An Empirical Foundation for Calibrating the G-SIB Surcharge* (Bank for Int'l Settlements, Working Paper No. 935, 2021), https://www.bis.org/publ/work935.pdf.

framework's risk sensitivity and prevent banking organizations from clustering in a way that artificially depresses surcharge amounts.

3. Measuring Interconnectedness

In addition to preventing window dressing and reducing cliff effects, the Proposed Rule will enhance the measurement of a banking organization's interconnectedness with the rest of the financial system. A banking organization's interconnectedness is an important determinant of its systemic importance because financial distress may propagate from one institution to others through networks of linkages. Thus, the Board includes measures of a banking organization's interconnectedness with other financial institutions—including certain nonbank financial companies—among the indicators that are used to calculate its GSIB surcharge.

Over time, GSIBs' interconnectedness with nonbank financial companies has increased substantially. Indeed, large banking organizations' credit commitments to nonbank financial institutions have grown from approximately $600 billion in 2013 to more than $2 trillion in 2023, according to Federal Reserve data.[10] Critically, however, the existing GSIB surcharge framework ignores banking organizations' interconnections with some types of nonbank financial companies. As a result, the existing framework understates many firms' systemic importance.

The Proposed Rule would improve the accuracy of a banking organization's interconnectedness indicators by expanding the definition of "financial institution" to include more nonbank financial companies. Under the proposal, companies such as private equity funds, asset managers, exchange-traded funds, and savings and loan holding companies that are not currently considered when assessing a banking organization's interconnectedness would be included going forward. Each of these types of nonbank financial companies may transmit distress to a GSIB in much the same way as other types of financial institutions. Thus, the GSIB surcharge framework should take into account banking organizations' exposures to these nonbank financial companies to provide a more comprehensive assessment of a GSIB's interconnectedness with the broader financial system.

The Proposed Rule would also enhance the accuracy of the interconnectedness and complexity indicators by including a firm's guarantees of client performance to a central counterparty (CCP) with respect to client cleared derivatives. Currently, the interconnectedness and complexity indicators omit such exposures. However, such guarantees could destabilize a CCP and its members if a GSIB were to experience distress. They are therefore properly included in the interconnectedness and complexity indicators. Moreover, the GSIB surcharge framework currently treats the agency model of derivatives clearing differently than the principal model, even though the agency model is economically similar when backed by the clearing member's guarantee. Including a firm's guarantee of client performance on cleared derivative positions in the interconnectedness and complexity indicators would eliminate this unwarranted anomaly in the GSIB surcharge framework.

[10] *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., FINANCIAL STABILITY REPORT 29 (2018); BD. OF GOVERNORS OF THE FED. RSRV. SYS., FINANCIAL STABILITY REPORT 34 (October 2023).

4. Measuring Cross-Jurisdictional Activity

Like the interconnectedness indicators, the Proposed Rule also facilitates a more comprehensive and accurate measurement of a banking organization's cross-jurisdictional activity. A banking organization's cross-jurisdictional activity is a key aspect of its systemic importance because cross-border exposures may complicate or prevent a firm's orderly resolution in the event it experiences financial distress. As currently structured, the GSIB surcharge framework understates a banking organization's cross-border activity because it omits derivative exposures. Derivatives, however, create obligations to or from a banking organization's counterparties in much the same way as other instruments that are included in cross-jurisdictional indicators. Derivative positions can transmit distress in many of the same ways, as well. Further, omitting derivatives from cross-jurisdictional indicators may incentivize banking organizations to transact with overseas counterparties using derivatives in a form of regulatory arbitrage. Conceptually, therefore, derivatives should be included in measures cross-border activity, just like other cross-border claims and liabilities.

The Proposed Rule corrects this shortcoming by including derivative exposures in the systemic indicators for cross-jurisdictional claims and cross-jurisdictional liabilities. The Board should finalize this reform to more comprehensively and accurately measure a banking organization's cross-jurisdictional activity and to reduce regulatory incentives for firms to transact using derivatives instead of more transparent, on balance sheet exposures.

5. Reducing Lag Time in Effective Date of GSIB Surcharges

Finally, in the Proposed Rule, the Board asks whether it should adjust the effective date of an increase in a banking organization's GSIB surcharge. Under the current framework, there is a long lag between when a firm calculates its GSIB surcharge and when any associated increase becomes effective. In many cases, this lag may be as long as 21 months.[11] As recent experience has shown, however, lengthy transition periods to higher regulatory standards to account for increases in a bank's systemic importance can be problematic. For example, the Board cited the lengthy transition period for Silicon Valley Bank to become subject to enhanced prudential standards after it surpassed the $100 billion asset threshold as a contributing factor in its collapse.[12] As this experience demonstrates, the bank regulatory system must adapt quickly to account for changes in a bank's systemic footprint.

We suggest that the Board should set the effective date of a firm's method 2 GSIB surcharge, if binding, as October 1 of the year in which the increased GSIB surcharge is calculated. Setting October 1 as the effective date would reduce the lag time in the implementation of any increase by up to 15 months.[13] Further, an October 1 effective date is sensible because it coincides with the

[11] As the Board notes in the proposal, a banking organization typically calculates its method 2 score for Year 1 during April of Year 2. An increase in its GSIB surcharge does not become effective until January 1 of Year 3. *See* 88 Fed. Reg. at 60390 n.21.

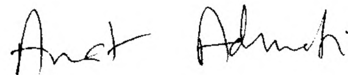
[12] BD. OF GOVERNORS OF THE FED. RSRV. SYS., REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK 91 (2023) ("[T]he long transition periods provided by the rules that did apply further delayed the implementation of requirements such as stress testing that may have contributed to the resiliency of the firm.").

[13] As a practical matter, a bank's method 2 surcharge is almost always binding.

effective date for the banking organization's stress capital buffer (SCB).[14] Thus, setting October 1 as the effective date would streamline banks' capital planning processes. Notably, an October 1 effective date would not be overly burdensome for banks. As the Proposed Rule notes, GSIBs will have better ability to anticipate their method 2 surcharges farther in advance in light of the proposed change to measure certain indicators based on average values over a four-quarter period, rather than at year-end. Thus, shifting to an October 1 effective date will meaningfully reduce lag time and simplify banking organizations' capital planning processes without significant downsides.

In conclusion, we urge the Board to adopt the Proposed Rule to strengthen the GSIB surcharge and better align GSIBs' capital levels with the firms' systemic importance. The reforms contained in the Proposed Rule will help mitigate the risks that large banking organizations pose to the broader financial system and the global economy, and it will promote competition with the GSIBs by beginning to level the playing field for small- and mid-sized banks. These reforms are overdue and urgently needed. We encourage the Board to adopt them without delay.

Sincerely,



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[14] 12 C.F.R. § 225.8(h)(4).