



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

January 16, 2024

Subject: Notice of Proposed Rulemaking (NPR) for the Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y–15) (Docket R–1814, RIN 7100–AG65)

Dear Ms. Misback:

Americans for Financial Reform Education Fund (AFREF) appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System’s (Board) notice of proposed rulemaking for the “Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y–15).”<sup>1</sup> AFREF is a nonpartisan and nonprofit coalition of more than 200 civil rights, consumer, labor, business, investor, faith-based, civic and community groups dedicated to advocating for policies that shape a financial sector that serves workers, communities, and the real economy, and provides a foundation for advancing economic and racial justice.

The Board issued this proposal in July 2023 together with the banking agencies’ notice of proposed rulemaking for the regulatory capital rule for large banks and those with significant trading activity (commonly known as Basel III Endgame)<sup>2</sup> for which AFREF has submitted a separate comment letter. This proposal would strengthen the Board’s risk-based capital surcharge rules for global systemically important bank holding companies (GSIBs) to improve the measurement of systemic risk indicators and enhance the sensitivity of the surcharge to changes in a bank holding company’s risk profile. These proposals are

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<sup>1</sup> Notice of Proposed Rulemaking. [“Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report \(FR Y–15\).”](#) 88 Fed. Reg. 169. September 1, 2023, at 60385 et seq.

<sup>2</sup> Notice of Proposed Rulemaking. [“Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity.”](#) Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the FDIC. 88 Fed. Reg. 179. September 18, 2023 at 64028 et seq.

important to increase large banks' safety and soundness, strengthen financial system stability, and preserve people's access to financial services, particularly in underserved communities.

AFREF supports these changes, together with the changes in the large bank capital proposal, to remedy the longstanding undercapitalization of America's largest banks. The changes would increase the stability of the financial system by better aligning firms' applicable capital surcharges with the intended functioning of the GSIB framework.

### **The background of the current GSIB capital surcharge rules**

In the wake of the 2008 financial crisis, banking regulators began to address how deeply interconnected banks, securities firms, and insurance companies could transmit economic volatility throughout the global financial system. The Board adopted a final rule in 2015 that established a methodology for identifying U.S. GSIBs and assigning a risk-based capital surcharge (in addition to other capital requirements) for the largest, most interconnected U.S.-based bank holding companies. The GSIB surcharge framework requires a GSIB to maintain additional capital to strengthen the firm's resiliency, reduce the probability of its failure, and lower the risks that the firm's failure or distress could pose to the U.S. financial system.

Some U.S.-headquartered and foreign domiciled financial institutions had a historic over-reliance on U.S. short term wholesale funding markets, including tri-party repo, asset-backed commercial paper, and other short term funding markets. This over-reliance contributed to the collapse of the major independent investment bank business model in 2008 and challenged a number of domestic and foreign banking organizations that were dependent on short-term wholesale funding markets to support their U.S. operations.<sup>3</sup>

The events of 2007 to 2009 demonstrated the large-scale vulnerabilities of firms with business models that are heavily dependent on uninterrupted access to these kinds of secured financings and the systemic impacts of a loss of funding in these markets. Many firms relied on excessive short-term wholesale financing of long-term illiquid assets, in many cases on a cross border basis—a practice that made it difficult for the firms to withstand market stresses absent a stable deposit base and / or sovereign and central bank support. Large investment and commercial banks took advantage of the opportunity the market afforded to obtain short-term (often overnight) financing for assets that should more appropriately have been funded with long-term, stable funding. Faced with uncertainty about the values of higher-risk assets and mindful of the higher volatility of assets more generally, lenders demanded substantial cushions, or "haircuts," on the assets they were willing to finance.<sup>4</sup>

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<sup>3</sup> Baklanova, Viktoria, Adam Copeland, Rebecca McCaughrin. Federal Reserve Bank of New York. "[Reference Guide to U.S. Repo and Securities Lending Markets](#)." Staff Report No. 740. September 2015. Revised December 2015.

<sup>4</sup> Senior Supervisors Group. "Risk Management Lessons from the Global Banking Crisis of 2008." October 12, 2009.

The 2015 GSIB surcharge rule requires banks to adopt a capital surcharge amount based on the more conservative (known as “binding”) of two systemic risk measures, method 1 (Basel) and method 2 (U.S. tailoring):

- Method 1, applies the Basel Committee on Banking Supervision (BCBS) capital surcharge methodology and determines the institution’s systemic risk profile based on five equally-weighted categories (size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity) that estimate the potential impacts on the financial system.
- Method 2, the U.S. tailored method, determines a systemic risk profile that takes into consideration the history of over-reliance on short-term wholesale funding markets and requires banking organizations to establish capital surcharges that constrain short-term wholesale funding reliance, including on a secured basis through repo markets. The method 2 risk profile is based on reporting on intra-financial system assets, intra-financial system liabilities, securities outstanding, assets under custody, OTC derivatives, trading and available for sale securities, Level 3 assets, cross-jurisdictional claims, and cross-jurisdictional liabilities. The current systemic risk scoring bands for method 2 are overly broad, which makes the metrics imperfect for assessing actual systemic risk and makes it easier for firms to manipulate their reporting to achieve lower risk profiles and thus lower GSIB capital surcharge levels.

Generally, a bank holding company subject to category I, II, or III capital standards must calculate its method 1 score annually under the current framework. The GSIB-determined systemic risk measure is also used for purposes of the Board’s regulatory tailoring framework for determining prudential standards for large banking organizations.<sup>5,6</sup> Banks must determine their global systemic risk under both methods and adopt the capital requirements from the method that establishes the higher, or more stringent, capital requirement.

AFREF supports the proposed GSIB capital surcharge rule that improves systemic risk reporting to more accurately assess a firm’s risk profile to determine the necessary level of GSIB capital surcharge and makes suggestions to further improve the proposal. Measurement of firms’ systemic indicator values should align properly with firms’ actual systemic footprint. The proposed rule improves the risk reporting, narrows the risk scoring bands, requires more continuous risk assessment through daily average reporting (instead of quarterly or year-end reporting, depending on the risk metric), and updates the cross-jurisdictional activity systemic risk indicator by requiring reporting of cross-border derivative risk exposures. The proposal would update the related FR Y-15 systemic risk report (the regulatory form institutions use to report system risk data) to address the measurement challenges and increase the sensitivity of the

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<sup>5</sup> Board of Governors of the Federal Reserve System. [Tailoring Rule Visual](#). October 10, 2019.

<sup>6</sup> The proposal would require a firm subject to Category II or III standards to calculate its method 1 and method 2 GSIB scores by using the average of its four quarterly reported values for the year. Firms that are subject to Category II, III, or IV standards to newly report FR Y–15 data as averages of daily or monthly values, in order to limit operational burdens for firms that are not yet identified as GSIBs.



surcharge to changes in firms' risk profile. These changes require more accurate systemic risk reporting and assessment and make it harder for banks to game the system by manipulating their operational risk profile for a specific reporting period.

***The proposal should include derivatives in the GSIB surcharge cross-jurisdictional activity indicator, also used to determine a large bank's tailored supervision category; current framework exclusion of derivatives understates cross-jurisdictional activity, especially for foreign owned banks.***

The proposal would revise the cross-jurisdictional activity indicator in the GSIB surcharge framework to include cross border derivatives exposures not captured currently. The absence of derivatives exposures in the current framework substantially understates the systemic risk in cross jurisdictional activity, since derivatives are a substantial source of cross border jurisdictional exposure, especially for foreign owned U.S. banking organizations. The inclusion of derivatives in the cross-jurisdictional activity indicators and in the FR Y-15 would have the greatest impacts on category III and IV foreign banking organizations because the cross jurisdictional activity measure is also an indicator for determining the large banks' tailored supervision category. Thus, some category III and IV firms, with the added derivatives exposure, would be required to advance to the next tailoring category, which would result in the application of more stringent capital and liquidity requirements (e.g., daily liquidity reporting rather than monthly or no reporting); monthly (rather than quarterly) liquidity stress testing; and full (rather than reduced) liquidity risk management.

***The proposal would prudently require GSIBs to report systemic indicators on an average daily basis by quarter rather than a single period end for method 2 (Questions 1 and 2)***

The proposal replaces end of period reporting with average daily reporting to prevent filers from manipulating their reporting by clustering their business activities just below thresholds for higher risk bands at the end of the period. The proposal would also introduce more frequent and in-depth reporting and analysis of systemic risk indicators. The current once-a-year period end reporting for these indicators has incentivized some banks to present a favorable picture of their risk management practices and downplay the risks they face. These banks have manipulated their balance sheet data to show lower exposures for the once-a-year reporting date than are typically the case the rest of the year.<sup>7</sup> This enables institutions to artificially reduce their apparent systemic risk and lower their required GSIB capital surcharge.

This proposal requires the calculation of GSIB surcharge risk measures on daily averages for both methods and introduces smaller increments for systemic risk indicators (see question 5) and corresponding increases in the surcharge amount for method 2.<sup>8</sup> These changes would remove many of the incentives firms have to game the system.

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<sup>7</sup> Berry, Jared, Akber Khan, and Marcelo Rezende. "[How Do Global Systemically Important Banks Lower Capital Surcharges?](#)" May 21, 2021.

<sup>8</sup> Unless otherwise noted, references to averaging of "daily" values refer to averaging of values for each business day. For certain off-balance sheet items, a GSIB would report the average of month-end values over the reporting

The proposal's average daily values provide more reliable reporting of a banking organization's true systemic risk exposure and reduce the ability to game the system. The proposed rule would require some firms to improve their risk monitoring and processing capacities; these firms *should* in fact have more robust risk systems and infrastructure to control risk exposures. The benefits of more accurate risk scoring, that hinders firms' efforts to game the system to reduce their GSIB capital surcharge levels, exceed any costs to implement better risk monitoring infrastructure.

***The proposal should base score calculation for risk indicators on the average of reported values over all four quarters, not just the reported values for the fourth quarter (Question 4)***

The proposal would require firms that are calculating their method 1 and method 2 GSIB scores to use the average of their four quarterly reported values for the year. Four quarter reporting would eliminate seasonal distortions and reduce any benefits from keeping a lower systemic risk profile during a single quarter. The proposal recognizes that seasonal changes in risk exposures of a GSIB can be significant and can create an unrepresentative depiction of the GSIB's risk exposures during the rest of the year.

***The proposal's enhanced method 2's measurement would reduce cliff effects and better align GSIB capital surcharge with their systemic risk profile (Question 5)***

The proposal's narrower risk scoring bands and better risk metrics would prevent the pattern of GSIBs' risk reporting that clusters around the upper limit of risk score bands under method 2. This creates cliff effects when firms can manipulate their scoring to achieve a lower risk rating and a relatively large reduction in their applicable capital surcharges. The broad risk scoring bands exacerbate the problems with firms gaming their risk scores under end-of-year and single-quarter reporting. The proposal's narrower risk bands reduce the tendency of firms to tweak their operations to stay below risk thresholds that would incur higher GSIB capital surcharge requirements.

The proposed rule significantly tightens the score bands. Instead of 100 basis point score band ranges corresponding to 0.5 percent increments in the surcharge, the proposal would assign 20 basis point bands corresponding to 0.1 percent increments in the surcharge. This does not change the current calibration but provides more granular measurements of the risk bands to better represent the actual risk exposures and capital surcharge levels.

The proposed narrowing of the score bands would reduce the cliff effects because the incremental increases in the capital surcharge would be smaller between risk scores. Narrow score bands would also tie the applicable capital surcharges more closely to firms' method 2 systemic footprints and assign similar

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quarter, rather than an average of daily values. Category II or III firms would calculate its method 1 and method 2 GSIB risk scores by using quarterly rather than daily averages. The proposal would not require Category II, III, or IV firms to newly report FR Y-15 data as averages of daily or monthly values except for the total exposures risk indicator to limit operational burdens for firms that are not yet identified as GSIBs.

capital surcharges to firms with similar systemic footprints, resulting in less variability in scores across GSIBs for similar risk profiles.

***The proposal must maintain the reduced implementation timeline for increases in GSIB scores from two years to six months (Question 7)***

The proposed rule would appropriately impose a six-month period for firms to achieve higher GSIB capital surcharges or potentially shrink their systemic risk profile as an alternative to satisfying a higher GSIB surcharge. A change in GSIB's systemic footprint and risk score should result in a higher GSIB capital surcharge quickly enough to provide capital surcharge levels that reflect the institutions' systemic risk profile. The current rule allows firms up to two years to comply with a higher GSIB surcharge. Such a long transition is likely to lead to a dangerous delay in requiring supervised firms to increase their capital and comply with other enhanced supervisory requirements.

***The proposal should change the effective date of firm's GSIB surcharge requirement to coincide with the stress capital buffer requirement to gain efficiency and synchronize the exercises (Question 8)***

The proposal should change the effective date for an increase in the GSIB surcharge under method 2 to align with the effective date of the stressed capital buffer (October 1 of the year in which the increased GSIB surcharge was calculated). This approach would more closely match the systemic risk as of the date of the change in the GSIB surcharge, but also provide some flexibility for method 1 (which has an April or October effective date) as method 1 data from the Board comes out later in the year.

***The proposal should include private funds in the definition of "financial institutions" and include major family offices with risk profiles similar to large private equity and hedge funds (Question 11)***

The proposal would appropriately clarify the types of entities included in the term "financial institution" for purposes of the interconnectedness indicators. AFREF agrees that the proposal should expand the definition of "financial institution" to include additional entities, notably the private equity funds that transmitted systemic risks during the 2008 financial crisis and presented potential systemic risks during the 2020 pandemic. As Axios noted recently, "[p]rivate equity has become ubiquitous in almost every sector of the U.S. economy, investing trillions of dollars. It's also become a pillar of the capital markets and is seeking to engage with more individual investors."<sup>9</sup> The proposal should be expanded to include family offices. The collapse of family office Archegos Capital severely impacted markets in 2021 that resulted in more than \$10 billion of losses to large financial institutions, including Credit Suisse' \$5 billion loss that contributed to its failure in March 2023.

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<sup>9</sup> Primack, Dan. "[Federal regulators take new aim at private equity and hedge funds.](#)" Axios. November 8, 2023.

***The proposal would appropriately clarify instructions for the interconnectedness and complexity indicators to better align a banking organization’s risk metric from client-cleared derivatives positions with the actual risk (Question 12 and 14)***

The proposal would update the interconnectedness and complexity categories for client-cleared derivatives to include guarantees of a client’s performance. Currently, the interconnectedness and complexity indicators only reflect derivatives positions in which the banking organization acts as an intermediary between clients and central counterparties.<sup>10</sup> The more accurate representation of notional amount would improve the Board’s ability to assess systemic risk.

The proposal would clarify in the instructions for the interconnectedness and complexity indicators that an ‘agency’ (or guarantor role) clearing relationship holds different risks for a GSIB than a ‘principal’ clearing relationship. These technical changes would better align the risk scoring in the GSIB broker dealer’s agency role to the true counterparty. Inclusion of guarantees would provide a more accurate assessment of the firm’s complexity and interconnectedness resulting from derivatives exposures and treat the differing derivative clearing models consistently.

***The proposal would prudently include systemic indicators for trading volume as measures of a firm’s substitutability based on its contributions to efficient market functioning (Question 15)***

The proposed rule includes average daily trading volume in the substitutability category (in addition to underwriting activity) that would provide a clearer assessment of a banking organization’s activities’ contribution to liquidity in both primary markets (underwriting) and secondary markets (trading). The substitutability category used in method 1 measures the extent to which a banking organization provides critical financial services and infrastructure to third parties and the broader financial system that would be difficult to substitute in a period of financial stress or failure. Currently, there are three substitutability indicators: payments activity; assets under custody; and underwriting transactions in debt and equity markets. The proposal would amend the substitutability category by introducing two new trading volume systemic indicators (for fixed income and for equity) to complement the existing systemic indicator for underwriting transactions in debt and equity markets.

The inclusion of average daily trading volume in the measure of risks in a GSIB’s capital markets is appropriate to better reflect the range of risks associated with capital markets and trading. Excessive and operationally unsustainable trading volumes can contribute to financial distress and be difficult for regulators to resolve in the event of a GSIB’s failure. Federal agencies would face challenges in transferring the failed bank’s trading positions to other participants to prevent serious disruptions in the affected markets. The permitted trading activity of banking organizations, such as market making, can promote market liquidity, enhance price discovery, and permit market participants to manage financial risk but must also be fully accounted for in the firm’s GSIB systemic risk indicators.

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<sup>10</sup> Central Counterparty Clearing Federal Reserve Bank of New York. LCH.Clearnet. 2015 Payment System Policy and Oversight Course. [“What is a CCP?”](#) May 2015.

***The proposal's inclusion of cross-jurisdictional activity indicators would address substantial understatement of cross-border derivatives risk (Question 19)***

The proposal would revise the systemic indicators for cross-jurisdictional claims and cross-jurisdictional liabilities to include derivative exposures. These expanded indicators would provide a more accurate and comprehensive measure of a banking organization's cross-jurisdictional activity and the associated risks. Under the proposal, cross-jurisdictional derivative claims and cross-jurisdictional derivatives liabilities would be calculated gross of collateral to measure the underlying scale of a banking organization's cross-jurisdictional derivatives activity.

The current omission of derivatives from the systemic indicators for cross-jurisdictional activity can materially understate an institution's risks and create an incentive to use the currently unscored derivatives to reduce systemic risk indicators without reducing actual risks. The inclusion of derivatives in cross-border exposures is essential to achieve an accurate measure of cross border exposures, and the proposal must include derivative exposures in cross-jurisdictional activity systemic indicator by making appropriate revisions to FR Y-15, which currently only collects such cross-jurisdictional derivative exposures as memoranda items. The inclusion of derivatives would increase risk sensitivity and reduce incentives for banks to structure exposures in a manner that understates their actual risk.

***The Board should proceed with these GSIB surcharge refinements in conjunction with the inter-agency large bank capital proposal to bolster U.S. bank capital framework and add measures to assess merger-related risks (Question 22 to 23)***

The GSIB surcharge is a necessary complement to the large bank capital proposal, which also seeks greater sensitivity of risk-based capital measures to changes in a firm's risk profile. Revisions to the surcharge would prevent GSIBs from downplaying their systemic risk profile and manipulating their reporting to face lower GSIB capital surcharges.

The agencies should more explicitly address mergers and acquisitions in the methodology for calculating GSIB surcharges to reflect the consolidation-related risks created by mergers involving GSIBs. Federal banking agencies have not revised their merger guidelines more than two years after President Biden issued his executive order calling on the agencies to do so. AFREF agrees with President Biden that revised bank merger guidelines are urgently needed to address the dangers that bank consolidation poses to American consumers and Main Street businesses.

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AFREF applauds the federal banking agencies for the proposal and supports the proposed changes, together with the changes in the large bank capital proposal. The proposed changes are necessary to remedy the longstanding undercapitalization of America's largest banks and, consistent with the Dodd-



Frank Act, establish a more robust capital surcharge for GSIBs. Thank you for the opportunity to comment on the proposal and for the consideration of our recommendations in developing a final rule.

Sincerely,

Americans for Financial Reform Education Fund