



April 2, 2015

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Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Notice of Proposed Rulemaking; Comment Request: Risk-Based Capital Guidelines – Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies (79 Fed. Reg. 75,473, December 18, 2014)

Mr. Frierson:

The Clearing House Association L.L.C. (“**The Clearing House**”), the Securities Industry and Financial Markets Association (“**SIFMA**”) and The Financial Services Roundtable (collectively, the “**Associations**”)¹ appreciate the opportunity to comment on the notice of proposed rulemaking (the “**Proposal**”) by the Board of Governors of the Federal Reserve System (the “**Federal Reserve**”) that would impose additional capital requirements (the “**GSIB surcharge**”) on global systemically important bank holding companies (“**GSIBs**”) headquartered in the United States. The Proposal is based on, but would impose significantly more stringent requirements than, the international GSIB surcharge framework (the “**Basel GSIB Framework**”) adopted by the Basel Committee on Banking Supervision (the “**Basel Committee**”).²

The Associations strongly support the maintenance of robust capital by all banking organizations as an essential tool for promoting the safety and soundness of individual institutions and enhancing the stability of the financial system as a whole. We believe, in particular, that a properly structured GSIB surcharge can have the effect of reducing systemic risk. In addition, we are mindful of the Federal Reserve’s concern that, in certain circumstances, reliance on certain types of short-term wholesale funding (“**STWF**”) can pose risk to the financial system, as well as individual institutions.³

¹ Descriptions of the Associations are provided in Annex A of this letter.

² Basel Committee, “Global systemically important banks: Updated assessment methodology and the higher loss absorbency requirement” (July 2013), *available at* www.bis.org/publ/bcbs255.htm.

³ *See, e.g.*, Federal Reserve System, Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, 79 Fed. Reg. 75,473 at 75,475 (December 18, 2014) (“**Proposing Release**”).

However, to ensure it is appropriate in both structure and effect, we believe that any capital surcharge requirement applicable to U.S.-headquartered GSIBs must meet four key policy tests:

- The GSIB surcharge should appropriately reflect the *actual* systemic risks posed by each U.S. GSIB, including properly taking into account the other enhanced micro- and macroprudential rules already or soon to be enacted that significantly reduce the probability of a GSIB failure and the potential systemic impact in the event of a failure—the very same two principal components behind the Federal Reserve’s stated analytical justification for the proposed GSIB surcharge.
- The GSIB surcharge methodology should be transparent to the public and other stakeholders, both in its design and empirical underpinnings, and allow a GSIB’s own individual actions to have an impact on its systemic indicator score.
- The GSIB surcharge should take appropriate account of not only the benefits, but also the inherent economic costs of higher capital requirements—the resulting surcharge being calibrated so that the additional amount of capital required reduces the probability of failure sufficiently to reduce the potential systemic impact of a GSIB’s failure—no more, and no less.
- The GSIB surcharge should avoid creating competitive inequities and incentives for risk to flow to lesser regulated corners of the financial system.

The Proposal contains significant flaws and falls well short in respect of each of these key policy tests.

- Insensitivity to Actual Systemic Risk. The Proposal adopts a methodology that appears to ignore major developments in micro- and macroprudential regulation since 2011 when the GSIB surcharge was first proposed, including the Liquidity Coverage Ratio (the “LCR”), the Net Stable Funding Ratio (the “NSFR”), the enhanced supplementary leverage ratio (the “ESLR”), Single Point of Entry (“SPOE”) resolution strategies, the Total Loss Absorbing Capacity global standard (“TLAC”) and enhanced clearing and margin requirements. In other words, the Proposal’s methodology would likely assign to a U.S. GSIB that complies with all of these requirements—which both reduce the probability of a GSIB’s failure and the potential systemic impact of such a failure—a surcharge similar to that which would apply if these requirements did not exist, and this despite the fact that several of these requirements, such as the U.S. implementation of the LCR and the ESLR, already are more stringent for U.S. banking organizations than for their global competitors.⁴
- Lack of Transparency. Core elements of the Proposal are opaque in their design, rationale and empirical foundations, such as the doubling of the systemic indicator scores and aspects of the STWF factor calculation. In addition, key elements of the methodology for determining a systemic indicator score, including the use of a common currency aggregate

⁴ See, e.g., Part II.C of this letter.

and a relative market share denominator consisting of only the world's 75 largest banks, undermine the incentive and practical ability of a U.S. GSIB to improve its "measured" systemic profile and manage its individual surcharge. Even clear reductions in a GSIB's systemic footprint, such as moving derivative transactions to less risky central clearing as mandated by the Dodd-Frank Act, have no effect on a GSIB's systemic indicator score.

- Insufficient Consideration of Economic Costs. The Proposal will force U.S. GSIBs either to internalize the costs of a GSIB surcharge "tax" that are well in excess of the actual risks posed by their activities and/or to pass those higher costs on to their customers and other market participants; yet the Proposal provides no meaningful analysis of these potential effects on GSIBs' customers, the markets and the broader economy.
- Lack of Analytical Support. No analysis or discussion is provided to lend qualitative or quantitative support to the proposition that requirements for U.S. GSIBs should be significantly higher than required by international agreement and therefore higher than surcharges for banks in the rest of the world. Nor is analytical support provided for how the funding structures of U.S. GSIBs present particular risks that differ significantly from those of non-U.S. GSIBs, or why a different methodology is appropriate in the United States. If anything, the Proposal should take into account the *lower* relative risk posed by U.S. banking organizations to U.S. financial stability than in other jurisdictions given that the assets of large U.S. banking organizations represent a sharply lower percentage of U.S. gross domestic product ("**GDP**") than banking organizations in virtually any other developed country.⁵

Unless these flaws are addressed by the Federal Reserve before the Proposal is finalized, the credibility and effectiveness of the U.S. GSIB surcharge framework will be significantly undermined from a policy perspective. In particular, the GSIB surcharge will be misaligned with the actual systemic risk profiles of U.S. GSIBs and/or the financial stability considerations underlying the Proposal; markets and shareholders will have little understanding of the Proposal's intended and unintended consequences; and particular banking products and services will be subject to multiple and overlapping regulatory "taxes" that cumulatively can be well in excess of the potential systemic risk they pose, with material impact on the corporations, small businesses, and consumers that rely on those products and services.

More generally, the absence of disclosure of critical analyses supporting the Proposal, including those supporting the need for and details of the Proposal's method 2 ("**Method 2**"), impedes the public's ability to assess whether the doubling of the systemic indicator score and the inclusion of a STWF factor are indeed necessary or sufficient to achieve the stated objective of the GSIB surcharge. The potentially substantial impact of the Proposal makes it critical that analytical and quantitative bases underlying its provisions are fully transparent and subject to public scrutiny and debate consistent with both the letter and spirit of the Administrative Procedure Act.

⁵ International Monetary Fund, Nordic Regional Report: 2013 Cluster Consultation (IMF Country Report No. 13/275, Sept. 2013), available at <http://www.imf.org/external/pubs/ft/scr/2013/cr13275.pdf>.

In light of these significant flaws and their potential consequences, we urge the Federal Reserve to consider at least four key revisions to the Proposal.

- First, we recommend that the Federal Reserve adhere to the Basel GSIB Framework reflected in the Proposal's method 1 ("**Method 1**") commencing in 2016, with appropriate modifications to address the most pressing flaws of that framework by (i) moderating the effect of short-term foreign exchange fluctuations on systemic indicator scores through the use of a rolling five-year average and (ii) expanding the entities in the denominator to reflect more accurately the market for financial services in the United States, including non-GSIB U.S. banking organizations that already report the information necessary for the systemic indicator calculation, central counterparties ("**CCPs**"), and nonbank financial companies designated by the Financial Stability Oversight Council ("**FSOC**").
- Second, we recommend that these and other common conceptual issues with the Basel GSIB Framework discussed below also be addressed by the U.S. and other national regulators in the context of the Basel Committee.
- Third, we suggest that any STWF factor that ultimately may become a part of the U.S. GSIB surcharge framework be revised to avoid imposing unnecessary costs on funding sources that are beneficial to all market participants.
- Finally, we urge the Federal Reserve to release publicly its analysis and data underlying critical elements of the Proposal, including the doubling of the systemic indicator score, the calibration of Method 2, and the elements and calibration of the STWF factor, and then re-open the comment period for the Proposal in order to provide the public the opportunity to more meaningfully evaluate and provide comment on Method 2.

Part I of this letter sets forth an executive summary of our comments. Part II discusses the Proposal's significant conceptual shortcomings and sets forth the crucial reasons that the Federal Reserve needs to release for review and public comment its analytical and quantitative bases for the Proposal's key elements. Part III analyzes the cumulative and tangible cost and other impacts of the Proposal's flawed methodology and excessive calibration on the financial intermediation, capital markets and lending activities performed by U.S. GSIBs in supporting real-world economic activity by their customers. Part IV contains a set of specific recommendations intended to begin to address some of the Proposal's shortcomings. Part V discusses our concerns and recommendations regarding the STWF factor. Part VI sets forth why the GSIB surcharge buffer should not be included as part of any required post-stress minimums under the Federal Reserve's capital plan rule (the "**Capital Plan Rule**"), the Comprehensive Capital Analysis and Review ("**CCAR**") or the Dodd-Frank Act Stress-Testing ("**DFAST**")-related frameworks. Finally, Part VII addresses other technical issues relating to the Proposal.

I. **Executive Summary**

A. **The Proposal should be comprehensively revised to better reflect the actual systemic risks posed by individual U.S. GSIBs, making it more risk-sensitive and therefore better aligned with its stated objectives.**

- At a fundamental level, and reflecting its stated purpose, any GSIB surcharge requirement should reflect the actual level of systemic risk posed by each GSIB and appropriately correspond to those risks. Unfortunately, the Proposal's approaches to quantifying the systemic risk posed by a GSIB—including both the Method 1 approach, which is based on the Basel GSIB Framework, and the Method 2 approach, which deviates sharply from that global standard—contain significant conceptual and methodological flaws that undermine this correlation.
- Although we acknowledge that a number of these flaws have been imported from the internationally-developed Basel GSIB Framework, we recommend the following four basic modifications, at a minimum, to address their most counter-productive effects.
 - First, under either Method 1 or 2, foreign exchange rates are a substantial driver of changes in the surcharge for GSIBs, thereby introducing potentially significant fluctuations in surcharge determinations based entirely on an exogenous factor that (unless occurring for a sustained period of time) has no relationship or relevance to actual systemic importance. The impact of short-term foreign exchange fluctuation should be ameliorated in the systemic indicator calculation through the use of a rolling five-year average exchange rate calculation. Risk-mitigating changes at individual GSIBs should be the most significant factor driving the systemic indicator score to ensure that any such changes actually have an impact on the GSIB's surcharge.
 - Second, the construction of the systemic indicator scores as relative rather than absolute measures means that only relative changes in systemic risk—and not more general, system-wide changes—are taken into account in determining how much additional capital a GSIB must hold. This is exacerbated by the under-inclusive nature of the denominator pool, which excludes other material sources of systemic risk or, put another way, other firms that can and do serve as substitutes for GSIBs in the event of their failure. To address this shortcoming, the market for financial services reflected in the denominator should include other participants in the U.S. financial markets to reflect the amount of banking and other financial sector activity that takes place outside of GSIBs in the United States as compared to other jurisdictions. At a minimum, U.S. banking organizations that already report the information necessary to perform the systemic indicator calculation, CCPs, and those nonbank financial companies designated by FSOC should be included in the denominator for the systemic indicator calculations.
 - Third, the doubling of the systemic indicator scores under Method 2 exacerbates the Proposal's analytical flaws, including the practical inability of a GSIB to reduce its score by taking risk-reducing measures, resulting in higher surcharges for U.S. GSIBs—by up to two percentage points in some cases—than under the Basel GSIB Framework due to

Method 2's doubling of the systemic indicator score produced under Method 1 (and the Basel GSIB Framework). In any event, as an immediate matter, given the conceptual and analytical deficiencies in the Proposal as it now stands, we recommend in this instance use of the Basel GSIB Framework reflected in Method 1—with appropriate modifications for the foreign exchange issue and with an expanded denominator as discussed above—commencing in 2016. This would be fully consistent with the U.S. commitments at the Basel Committee to timely implement a surcharge and would allow additional time to develop more analytical and empirical refinements to the other components of the Proposal for the U.S. We also urge the Federal Reserve to work more broadly with the other members of the Basel Committee, as well as the Financial Stability Board (the "FSB"), to address what we believe to be serious problems with both the Proposal and the Basel GSIB Framework.

- Fourth, to the extent ultimately included in the U.S. GSIB surcharge methodology, the STWF factor should be revised to moderate its underlying assumptions to avoid imposing unnecessary costs on types of funding that are broadly beneficial to all market participants, including unsecured non-operational deposits, secured funding transactions ("SFTs") and shorts coverage.

B. The Proposal should be revised to take into account the cumulative and specific impacts of other enhanced macroprudential rules enacted in recent years that significantly reduce the systemic risks the Proposal is intended to mitigate.

- The Proposal's stated method for reducing overall systemic risk is to attempt to equalize the expected systemic impact of a GSIB failure as compared to a smaller, benchmark institution by decreasing the probability of default of GSIBs through the application of the surcharge (the so-called expected impact approach). As an initial matter, the analytical strength of this approach is uncertain, at best. It may simply not be feasible to attempt to equalize the systemic very limited impacts of a non-GSIB in the event of failure (even if it is "next" to the GSIB group) with a GSIB's purported significant impact (even if it is at the "bottom" of the GSIB group) through an additional capital surcharge. Nevertheless, the GSIB surcharge is meant to force subject banking organizations to internalize the costs related to run-risks and fire-sale risks, combat the perceived effects of "too big to fail," and protect taxpayers from losses in the context of a GSIB failure. However, the Proposal appears to ignore both the cumulative and specific impacts of the substantial improvements in banking organizations' capital, liquidity and risk management that have been achieved since the financial crisis as a result of multi-faceted regulatory reforms (the "**Enhanced Regulatory Framework**") that have been specifically designed to reduce both the risk of a GSIB failure and the impact of such failure—the key elements of the Proposal's underlying "expected impact" rationale.
 - The LCR,⁶ the NSFR and the liquidity related provisions of the Dodd-Frank Section 165 enhanced prudential supervision rules are designed to reduce probability of default by decreasing the risk that U.S. GSIBs fail due to acute liquidity runs and

⁶ 12 C.F.R. Part 249.

ensure that structural long-dated liabilities support less liquid assets. They also address some of the same concerns as the STWF factor, including as to “fire-sale” risks related to non-operational wholesale deposits for which banks hold substantial amounts of high-quality liquid assets (“HQLA”).

- Resolution plan requirements, the Orderly Liquidation Authority provisions of Title II of Dodd-Frank, the U.S. SPOE resolution strategy developed to implement Title II, most recently and crucially, the FSB’s TLAC standard (which is meant to ensure that GSIBs have sufficient gone-concern capital resources available in resolution) and the new ISDA resolution stay protocol⁷ all work together to significantly decrease the expected impact of a GSIB failure—or the systemic risk given default—and thus, the risk of taxpayer bailouts.
- With specific reference to new capital requirements, the U.S. ESLR,⁸ the enhanced capital regime under the Basel III Standardized Approach (the “**Standardized Approach**”) implemented in the United States as part of the U.S. revised capital rules (the “**Revised Capital Rules**”), which came into effect for all U.S. banking organizations on January 1, 2015,⁹ CCAR and company-run capital stress testing, and the FSB’s margin requirements proposal for haircuts on non-centrally cleared SFTs, working both individually and together, reduce the systemic risks that go to the core of the Proposal, both by decreasing the probability of failure and simultaneously reducing the systemic impact of a GSIB failure were it nevertheless to occur.
- Titles I and II of the Dodd-Frank Act and related regulatory changes have eliminated the funding cost advantages that GSIBs may have previously benefitted from as a result of the so-called implicit governmental subsidy. This elimination is evident in both market pricing and rating agency actions, which serve as evidence of the systemic improvements resulting from application of the Enhanced Regulatory Framework.
- Compliance with the Enhanced Regulatory Framework, however, does not appear to affect the score a GSIB would receive under the STWF factor even though many of these measures directly address run and fire-sale risks. Overall, the Proposal’s surcharge methodology leaves very little practical room for a GSIB to reduce its score by individually taking measures that clearly reduce its systemic risk profile.

⁷ 2014 ISDA Resolution Stay Protocol, published November 4, 2014 by the International Swaps and Derivatives Association, Inc., *available at* <http://assets.isda.org/media/f253b540-25/958e4aed.pdf>.

⁸ Supplementary Leverage Ratio, 79 Fed. Reg. 57,725.

⁹ Federal Reserve System, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013) (the “**Revised Capital Rules**”).

- C. The Federal Reserve should disclose publicly the analytical and quantitative bases for the Proposal as part of a transparent rulemaking process to enable investors, market participants and the public to gain a better understanding of the reasoning and evidence for the proposed surcharge.**
- Despite the magnitude of the Proposal’s potential impact, the Proposal provides little or no underlying analysis, empirical or otherwise, for its chosen methodology and the effective increase in the GSIB surcharge it would entail. In particular, the Proposal provides no rational basis for the doubling of the systemic indicator score and does not disclose key assumptions underlying its expected impact approach and the actual calibration of the amount of additional capital a GSIB must hold. Moreover, the foundation of the Proposal is a comparison of a GSIB to a smaller “benchmark” institution, in terms of systemic risk of failure, but the Proposal fails to identify the benchmark institution (whether actual or hypothetical) utilized or provide any analysis whatsoever of how the comparison is made. In addition, the Proposal’s resulting surcharge for U.S. GSIBs is explicitly based on non-public data and templates concerning an undisclosed set of foreign banks, the identity of which neither the Federal Reserve nor the Basel Committee has chosen to make public. This lack of transparency is a cause for significant concern in its own right and fundamentally undermines the Proposal’s credibility.
 - The Federal Reserve’s failure to provide this analysis also impedes the ability of investors, market participants and the public more broadly to assess whether the calibration is indeed necessary or appropriate to achieve the stated objective of the GSIB surcharge, and inhibits the public’s and our ability to meaningfully comment, particularly on the specific design of Method 2 and the STWF factor.
 - Because the Proposal does not provide the analyses underlying key elements of its determinations, the public cannot know whether the Proposal has (or has not) “offer[ed] the rational connection between facts and judgment” that is required under the Administrative Procedure Act. The significant impact of the Proposal makes it imperative that the Federal Reserve provide transparent and fulsome details of the underlying rationale. The Proposal reflects major departures from the international consensus and the currently enhanced capital requirements, and in so doing may have a meaningful impact on U.S. GSIBs in terms of their competitive positions, their attractiveness to investors and their ability to offer products and services to their customer base. If the Federal Reserve “gets it wrong,” the adverse consequences are likely to be substantial. As a result, evaluation of the Proposal requires a constructive comment process, which in turn calls for a special emphasis on transparency.
 - To help ensure the development of a sound GSIB surcharge that is appropriately designed and calibrated to meet its objectives, we urge the Federal Reserve to release publicly, among other things, the analysis and data underlying the doubling of the systemic indicator score and the calibration of Method 2, and the elements of the STWF factor, and to re-open the comment period in order to provide the public the opportunity to provide additional comment on the Proposal in light of such disclosure.

D. The Proposal should be clearly calibrated to the overall quantum of additional capital required of each GSIB by reference to its stated intent—to reduce the potential systemic impact of a GSIB’s failure to that of a non-GSIB—no more, and no less.

- Despite the statement in the Proposal that the U.S. methodology has been “modified to reflect systemic risk concerns specific to the funding structures of large U.S. GSIBs,” there is no discussion as to why the requirements for U.S. GSIBs should be significantly higher than for the rest of the world, how the funding structures of large U.S. GSIBs differ significantly from those for large non-U.S. GSIBs, or why a different methodology is appropriate in the United States. Moreover, there is no discussion of the competitive effects of this “gold-plating,” which is layered on top of a host of other “gold-plated” elements of the Enhanced Regulatory Framework, such as the LCR and the ESLR. The competitive effects should be weighed and considered in the context of the lower relative risk posed by U.S. banking organizations to U.S. financial stability than our foreign competitors in other jurisdictions, because the assets of large U.S. banking organizations make up a sharply lower percentage of GDP than do local banking organizations in virtually any other developed country.¹⁰
- The Proposal ignores the tangible costs to the broader economy of requiring U.S. GSIBs to hold disproportionately high levels of capital, such as impaired market liquidity. Likewise, the Proposal underestimates and dismisses the potential impact on GSIBs’ customers and the financial markets more generally of an excessive capital tax on U.S. GSIBs’ activities.
 - The cumulative effect of the layering of the GSIB surcharge on top of other regulations designed to address the very same risks results in loss of shareholder value by effectively requiring subject banking organizations to limit or discontinue certain business activities. The Proposal ignores both the layering and its effect.
 - The Proposal appears to reflect uncritical acceptance of the Basel Committee’s cost-benefit analysis. That analysis, however, was based on macroeconomic models that incorporate financial sectors that are not an accurate reflection of the modern global financial system. In particular, they do not recognize the importance of markets-based finance, especially in the United States, where the majority of the credit needs of the broader economy are met through issuance of securities, rather than through direct bank lending. Given the importance of securities markets in meeting the credit needs of the broader economy (especially the U.S. economy) and the importance of GSIBs (especially U.S. GSIBs) to the efficiency and liquidity of the securities markets, the potential effects are large,¹¹ yet are simply not captured in

¹⁰ International Monetary Fund, Nordic Regional Report: 2013 Cluster Consultation (IMF Country Report No. 13/275, Sept. 2013), *available at* <http://www.imf.org/external/pubs/ft/scr/2013/cr13275.pdf>.

¹¹ Market-makers are lately focusing on activities that require less capital and less willingness to take risk and in many jurisdictions banks are allocating less capital to market-making activities, despite growth of credit markets. This decline in market-making supply and increased demand imply potentially higher financing costs. *See, e.g.*, Fender, Ingo and Ulf Lewrick, “Shifting tides – market liquidity and market-making in fixed income instruments,” BIS Quarterly Review (March 2015), *available at* http://www.bis.org/publ/qtrpdf/r_qt1503i.htm.

cost-benefit analyses based on macroeconomic models with significant analytical limitations.

E. The GSIB surcharge buffer should not be included as part of any required post-stress minimums under CCAR and other related stress tests.

- The Proposal raises the possibility of incorporating the GSIB surcharge into CCAR and other Federal Reserve stress-test regimes, a proposition that would further exacerbate the flaws of the proposed GSIB surcharge by being (x) unnecessarily duplicative with the already more stringent CCAR stress testing regime applicable to GSIBs in the form of the add-on global market shock scenario (in the case of the six GSIBs with large trading operations) and the counterparty default scenario and (y) inconsistent with the primary objective of CCAR and other stress tests, which is to ensure going-concern viability on a post-stressed basis. CCAR requires GSIBs to emerge from the combination of a severely adverse macroeconomic stress scenario, a large counterparty default scenario, and a global market shock scenario, as applicable, at the same level of capital as a non-GSIB would emerge from the severely adverse macroeconomic stress scenario alone. Incorporation of the GSIB buffer as part of the post-stress minimums under CCAR would also be contrary to the very purpose of a capital buffer, which is to absorb losses in stressful periods. The reduction of the probability of a GSIB default is properly achieved to the extent a banking organization can maintain robust minimum capital ratios throughout a stress scenario.

F. The STWF factor should be revised, and its elements and risk weights reconsidered.

- In light of the Proposal's overly punitive risk weights on certain types of funding transactions, and consistent with Federal Reserve Chair Yellen's recent comments that GSIB "reliance on short-term wholesale funding has dropped considerably,"¹² the STWF factor, at a minimum, should be revised to moderate its underlying assumptions to avoid imposing unnecessary costs on types of funding that are broadly beneficial to all market participants, including unsecured non-operational deposits, SFTs, and shorts coverage. More specifically:
 - Unsecured non-operational deposits. The weightings assigned to non-operational deposits should be reduced to a level that is no higher than that assigned to SFTs that fund collateral equivalent to the collateral that must be funded by non-operational deposits under the LCR. Doing so would reflect the actual run risk of these types of deposits, as demonstrated by empirical study, and the high-quality liquid assets a U.S. GSIB must hold with respect to these deposits under the LCR and potentially other enhanced prudential standards. Holding HQLA in compliance with such standards will significantly reduce, if not eliminate, any related fire-sale risk. This overly punitive approach should be reconsidered to align more properly capital management incentives with prudent asset-liability management ("ALM") practices.

¹² Chair Janet L. Yellen, Speech at the Citizens Budget Commission, "Improving the Oversight of Large Financial Institutions" (March 3, 2015), available at <http://www.federalreserve.gov/newsevents/speech/yellen20150303a.htm>.

- SFTs. The weightings assigned to SFTs overstate their related risk and should be reduced, especially with respect to shorter-dated SFTs that are used to support market activity that is vital to economic growth and stability. Specifically, the weighting assigned to SFTs secured by level 1 assets should be 5%, in alignment with the NSFR, which, among other things, would help reduce the potential impact on primary dealer capacity in U.S. Treasuries and the risk of another “flash crash” similar to the events of October 15, 2014. Risk weightings assigned to other shorter-dated SFTs should be reconsidered, taking into account elements of the Enhanced Regulatory Framework that impact SFTs, as well as the need to align capital management incentives with prudent ALM practices.
- Shorts coverage. Short transactions are not designed for the primary purpose of funding U.S. GSIBs’ balance sheets, but to manage market risk and make markets (firm shorts) or facilitate client trading activity (client shorts). Accordingly, as a conceptual matter, shorts coverage should not be treated as STWF, at least where the coverage is externally borrowed securities. Internal coverage of shorts transactions should be weighted no more than 25% rather than weighted the same as SFTs that are actually relied on as a funding source.

II. The Proposal is conceptually flawed, ignores both the cumulative and specific impacts of the Enhanced Regulatory Framework and lacks transparency regarding its analytical and quantitative bases.

A. The Proposal’s conceptual flaws are exacerbated by the unsubstantiated doubling of the systemic indicator scores under Method 2 and the arbitrary design of the STWF factor.

The Proposal does not provide supporting analysis or explanation for the Method 2 doubling of the systemic indicator score for U.S. GSIBs, which results in surcharges significantly higher than would be applicable under the Basel GSIB Framework. Indeed, the discussion in the preamble to the Proposal on the subject provides no basis for the doubling and is limited only to the following:

Once a GSIB calculates its short-term wholesale funding score, the GSIB would add its short-term wholesale funding score to the systemic indicator scores for the size, interconnectedness, complexity, and cross-jurisdictional activity indicators and multiply this figure by two to arrive at its method 2 score.¹³

The modified band structure is appropriate for the method 2 surcharge because the proposed method’s doubling of a GSIB’s method 2 score could otherwise impose a surcharge that is larger than necessary to appropriately address the risks posed by a GSIB’s systemic nature.¹⁴

¹³ Proposing Release at 75,479.

¹⁴ Proposing Release at 75,480.

Not only is this doubling unsupported, but it exacerbates the flaws of the underlying Basel GSIB Framework. Those flaws—including failing to reflect the high levels of capital required under other regulations, relying on size as a crude proxy for systemic risk, using a denominator that includes only the world’s largest banks, and not providing analysis or empirical support for its methodology—were never addressed despite significant public comment.

By doubling the systemic indicator scores under Method 2 to produce higher systemic indicator scores than would be applicable under the Basel GSIB Framework, the Proposal would impose unfounded capital requirements that may well result in economically deleterious consequences, including competitive inequality. If anything, the nature of the U.S. financial sector and the already “gold-plated” elements of the Enhanced Regulatory Framework would argue for a lower surcharge for U.S. GSIBs. In addition, the Proposal provides no basis for the weightings assigned to STWF components and then augments these already unsubstantiated measures by applying a 175 fixed conversion factor. As a result, the proposed surcharges are significantly higher than necessary to achieve the Proposal’s stated public policy objective.

To support a higher U.S. GSIB surcharge, the Proposal points to capital requirements in other jurisdictions that exceed those mandated by the Basel GSIB Framework,¹⁵ specifically referencing Switzerland, Sweden and Norway.¹⁶ These comparisons, however, are inapposite. The banking sectors in those countries are highly concentrated and very large relative to GDP, implying large contingent liabilities for those sovereigns. For example, the banking sector in Sweden “hold[s] financial assets worth three to four times of GDP (on a consolidated basis)—which places [it] ahead of most of their [Organisation for Economic Cooperation and Development (the “OECD”)] comparators with the exception of the U.K. and The Netherlands.”¹⁷ In addition, Norway, Sweden and other Nordic countries are exposed to vulnerabilities that result from close regional financial linkages.¹⁸ In Switzerland, bank assets amount to more than 700% of GDP.¹⁹ By comparison, the United States banking sector comprises a far lower percentage of GDP than these jurisdictions—approximately 72%²⁰—and the U.S. banking

¹⁵ *Id.*

¹⁶ Proposing Release at 75,480. Sweden and Norway, for instance, have decided in favor of the maximum permissible requirement. Major Swedish banks, for example, must already today hold at least 10% CET1 (a 3% surcharge over the general CET1 requirement of 7%). This requirement will be increased to 12% (resulting in a 5% surcharge) at the beginning of 2015 (in Norway starting in mid-2016). Group of experts on the further development of the financial market strategy (Switzerland), Final Report, Annex 4: Review of the Swiss TBTF regime by international standards, at 19 (Dec. 5, 2014), *available at* <http://www.news.admin.ch/NSBSubscriber/message/attachments/37606.pdf>.

¹⁷ International Monetary Fund, Nordic Regional Report: 2013 Cluster Consultation (IMF Country Report No. 13/275, Sept. 2013), *available at* <http://www.imf.org/external/pubs/ft/scr/2013/cr13275.pdf> (“**IMF Report**”).

¹⁸ IMF Report.

¹⁹ Basel Committee on Banking Supervision, Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III regulations – Switzerland at 5 (2013).

²⁰ European Central Bank, Banking Structures Report: November 2013 at 30-31 (2013), *available at* <http://www.ecb.europa.eu/pub/pdf/other/bankingstructuresreport201311en.pdf>.

system is also significantly less concentrated.²¹ According to World Bank estimates, the concentration rates for Norway, Sweden and Switzerland are 95.6%, 87% and 94%, respectively, compared with a 35.4% concentration rate for the United States and an average rate for high-income countries of 75.9%.²² The size and structure of the banking sector in these countries—which also rely less on capital markets activities than on bank lending—may well account for the capital standards imposed in these jurisdictions as a result of the greater systemic concerns from a domestic perspective. They certainly do not analytically justify the higher relative GSIB surcharge for countries, like the United States, whose financial assets comprise a much lower percentage of GDP and where the banking system is far less concentrated.

B. The Proposal’s enumerated purposes, including the perception that some banking organizations remain “too big to fail,” are already specifically addressed by other regulations.

The Proposal identifies the following as central goals of the GSIB surcharge: (i) to eliminate the competitive distortions that arise from “too big to fail”; (ii) to address the risk of sudden withdrawals of STWF—that is, so-called “run”—and “fire-sale” risks, including those related to non-operational wholesale deposits; and (iii) to decrease the risk of taxpayer losses by ensuring that GSIBs have sufficient gone-concern capital resources available for effective resolution.²³ Each of these objectives is addressed by other regulations, but the Proposal appears to give them little or no weight, neither individually nor in combination. This failure to take into account the relevant elements of the Enhanced Regulatory Framework—or at the very minimum, to credibly explain why the Proposal does not do so—leads to unnecessary and unjustified double or even triple layers of “taxation” of necessary financial intermediation activity by GSIBs with concomitant adverse effects on markets and the broader economy.

The Proposal’s conclusory statement that “a perception exists in the markets that some companies remain too big to fail, which poses a significant threat to the financial system” is not supported by the current evidence. In fact, the evidence is now to the contrary. The Proposal explains the risks of “too big to fail” as follows: “the perception of too big to fail reduces incentives of shareholders, creditors, and counterparties of these companies to discipline excessive risk-taking by these companies and produces competitive distortions because these companies can often fund themselves at a lower cost than other companies.” This discussion is substantially similar—and in some cases identical—to that used to support a series of other post-crisis reforms.²⁴ Furthermore, the

²¹ The World Bank measures bank concentration as “the percentage of assets of the three largest commercial banks to total commercial banking assets.” World Bank, *The Little Data Book on Financial Development: 2014* at 220 (2014), available at <https://openknowledge.worldbank.org/bitstream/handle/10986/15896/81331.pdf>.

²² *Id.* at 155, 192-93, 210 (2014).

²³ Proposing Release at 75,475.

²⁴ See, e.g., Enhanced Supplementary Leverage Ratio, 79 Fed. Reg. 24,528 at 24,528 (May 1, 2014) (“[T]he recent financial crisis showed that some financial companies had grown so large, leveraged, and interconnected that their failure could pose a threat to overall financial stability ... A perception persists in the markets that some companies remain ‘too big to fail,’ posing an ongoing threat to the financial system.”).

Proposal identifies no relevant markets and no relevant evidence, and any putative advantage is unquantified. The most recent and comprehensive review of the issue of subsidy by the U.S. Government Accountability Office demonstrates that the Proposal's premise in this regard is counterfactual. The GAO found that, while "large bank holding companies had lower funding costs than smaller ones during the financial crisis," most models suggest that "such advantages may have declined or reversed" in recent years.²⁵ In fact, according to the GAO Study, although an advantage is seen during the financial crisis, by 2013, 30 out of the 42 models tested found a funding cost *disadvantage* for large banks, which suggests that GSIBs are actually paying a premium rather than benefitting from a "too big to fail" discount. The GAO Study is notable and credible both because of the GAO's independence and because it is the first such study based on post-crisis data. In addition, the Proposal does not deal with the fact that, even if a funding advantage existed, funding cost differentials may reflect factors other than a too-big-to-fail belief, which are difficult to isolate. Furthermore, as the evidence of the end of "too big to fail" continues to mount, the perception is ending. The major U.S. credit rating agencies rendered decisions to reduce or eliminate the "uplift" they had assigned to the credit ratings of eight of the largest bank holding companies on account of an implicit subsidy, citing the Enhanced Regulatory Framework as a key factor.²⁶ We submit that the Federal Reserve cannot responsibly and credibly base the Proposal in large part on a purported subsidy unless it is prepared to counter data that is directly and persuasively to the contrary. There is no persistence of "too big to fail" to be used to justify a higher capital surcharge, and, seemingly even if there were, it would do so only if other potentially responsible factors are discounted.

Indeed, even if there were still a perception that "too big to fail" exists notwithstanding the evidence to the contrary, it would be inequitable and illogical to impose a capital tax on GSIBs as "compensation." Such an approach would foster rather than correct the misapprehension. If a misapprehension exists, the appropriate response is to correct it.

²⁵ GAO, *Large Bank Holding Companies: Expectations of Government Support at 1* (GAO-14-621, July 2014), available at <http://www.gao.gov/assets/670/665162.pdf> ("**GAO Study**"). The GAO Study reviewed a number of studies that estimate differences in funding costs between large and small banks. In 2013, 30 out of 42 models tested, which used bond yield spreads to measure funding costs, found a funding cost disadvantage for large banks.

²⁶ For example, Standard & Poor's Ratings Services has stated that it "believe[s] it is becoming increasingly clear that holding company creditors may not receive extraordinary government support in a crisis," at 24; Press Release, Standard & Poor's Ratings Services, *Outlooks on U.S. G-SIB Holding Companies Remain Negative Pending Actionable Resolution Plan* (Feb. 6, 2015); Moody's Investor Services has noted that "[r]ather than relying on public funds to bail-out one of these institutions, we expect that bank holding company creditors will be bailed-in and thereby shoulder much of the burden to help recapitalize a failing bank." Standard & Poor's Ratings Services, *Various Outlook Actions Taken on Highly Systemically Important U.S. Banks*; Ratings Affirmed (June 11, 2013). Moody's Investor Services, *Rating Action: Moody's Concludes Review of Eight Large U.S. Banks*, Global Credit Research, 1 (Nov. 14, 2013).

C. The Proposal ignores elements of the Enhanced Regulatory Framework that address the bases of the expected impact approach—probability of GSIB default and possible systemic impact of such default.

Throughout the Proposal there is an unexplained lack of consideration for the Enhanced Regulatory Framework and resulting market changes that have materially reduced the systemic risk that the Proposal purportedly is designed to capture. We believe that rather than inducing GSIBs to internalize legitimate negative externalities, the Proposal would impose an unwarranted tax on capital markets activities—which are predominantly conducted by GSIBs—in the form of an improperly calibrated surcharge that is disproportionate to the actual risks posed by U.S. GSIB activities.

The current regulatory and industry landscape is far different from the landscape that existed in 2007. As recently noted by the FSB Chair Mark Carney, “[b]anks are now much more resilient. They have more capital, more liquidity and are less susceptible to pro-cyclical spirals.”²⁷ In the United States, for example, “the liquidity positions and management practices of [Large Institution Supervision Coordinating Committee (the “LISCC”)] firms have improved considerably over the past several years. Since 2012, the LISCC firms’ combined buffer of high-quality liquid assets has increased by about a third, and their reliance on short-term wholesale funding has dropped considerably.”²⁸ It has recently been suggested that “[w]e need to learn, but not overlearn, the lessons of the crisis.”²⁹ This means taking into account elements of the Enhanced Regulatory Framework introduced both before and since the introduction of the Basel GSIB Framework, which have reduced the likelihood of GSIB failures and reduced their reliance on STWF. Their cumulative effect should be directly taken into account in the calibration of the GSIB surcharge.

1. Elements of the Enhanced Regulatory Framework that Address Probability of Default by GSIBs

Each of the following reforms, both individually and through their cumulative impact, mitigates systemic risk by lowering the probability of default for U.S. GSIBs.

²⁷ Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board, 2014 Monetary Authority of Singapore Lecture at 4 (November 17, 2014), *available at* <http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf>.

²⁸ Speech by Governor Daniel K. Tarullo, Federal Reserve Board of Governors, at the Clearing House 2014 Annual Conference, New York, NY, at 17 (Nov. 20, 2014), *available at* <http://www.federalreserve.gov/newsevents/speech/tarullo20141120a.pdf>. The LISCC firms are American International Group, Inc., Bank of America Corporation, The Bank of New York Mellon Corporation, Barclays PLC, Citigroup Inc., Credit Suisse Group AG, Deutsche Bank AG, General Electric Capital Corporation, The Goldman Sachs Group, Inc., JP Morgan Chase & Co., MetLife, Inc., Morgan Stanley, Prudential Financial, Inc., State Street Corporation, UBS AG, and Wells Fargo & Company.

²⁹ Governor Jerome H. Powell, Speech at the Stern School of Business, New York University, New York, NY: Financial Institutions, Financial Markets, and Financial Stability at 17 (Feb. 18, 2015), *available at* <http://www.federalreserve.gov/newsevents/speech/powell20150218a.pdf>.

- Risk-based capital. Heightened risk-based capital requirements have already caused banking organizations to increase significantly the amount and quality of Common Equity Tier 1 (“**CET1**”) capital held from pre-crisis levels.³⁰ With respect to risks associated with SFTs in particular, the Revised Capital Rules impose capital requirements on SFTs that address the risk of loss associated with SFTs, including through the “collateral haircut approach,”³¹ which conservatively measures exposures on SFTs by applying a haircut, which is dependent on asset quality, maturity and currency.³²
- CCAR and DFAST. The Federal Reserve’s robust stress-testing processes under CCAR, the Capital Plan Rule³³ and DFAST ensure that U.S. GSIBs in particular³⁴ have sufficient capital to endure severely adverse market and economic conditions at least as and likely even more adverse than the 2007-2008 financial crisis.

³⁰ The ratio of common equity capital to risk-weighted assets for the 31 firms in CCAR has more than doubled from 5.5 percent in the first quarter of 2009 to 12.5 percent in the fourth quarter of 2014. Board of Governors, Federal Reserve System, Comprehensive Capital Analysis and Review 2015: Assessment Framework and Results (March 2015), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20150311a1.pdf>.

Federal Reserve System, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013).

³¹ Revised Capital Rules at 62,018.

³² Revised Capital Rules at 62,107 (“[A] banking organization may use the collateral haircut approach to recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, repo-style transaction, collateralized derivative contract, or single-product netting set of such transactions.”). This collateral haircut approach implicitly assumes—simultaneously for every counterparty and for every trade—that (i) each security posted as collateral increases in value, (ii) each security received as collateral decreases in value, and (iii) the impact of foreign exchange movements is always negative. This approach does not recognize that the value of posted collateral and borrowed instruments is likely to move in the same direction. Additionally, applying the haircut approach on a trade-by-trade basis without netting causes larger trade portfolios with a single counterparty to have higher exposures relative to an approach which permits netting.

³³ See 12 C.F.R. 225.8.

³⁴ See, e.g., Federal Reserve Board, Comprehensive Capital Analysis and Review 2015: Summary Instructions and Guidance at 12, 27 (2014) (“Eight BHCs with substantial trading or custodial operations will be required to incorporate a counterparty default scenario component into their supervisory adverse and severely adverse stress scenarios. Like the global market shock, this component will only be applied to the largest and most complex BHCs, in line with the Federal Reserve’s higher expectations for those BHCs relative to the other BHCs participating in CCAR ... The Federal Reserve has differing expectations for BHCs of different sizes, scope of operations, activities, and systemic importance in various aspects of capital planning. In particular, the Federal Reserve has significantly heightened expectations for BHCs that are subject to the Federal Reserve’s Large Institution Supervision Coordinating Committee (LISCC) framework.”) (“**CCAR 2015 Instructions**”).

- Supplementary leverage ratios. A more rigorous ESLR,³⁵ which is an enhanced calibration of the supplementary leverage ratio,³⁶ also meaningfully constrains banking organizations' ability to hold shorter-duration assets. This helps to ensure that in times of economic stress, banking organizations will have sufficient resources available to absorb unexpected losses that may not be adequately captured by the risk-based regulatory capital regime.
- Liquidity regulation. A comprehensive new liquidity regime that already includes the U.S. LCR,³⁷ which is more stringent than the international standard, and liquidity stress testing, as well as the Federal Reserve's Comprehensive Liquidity Analysis and Review and 5G monitoring, enhance banking institutions' ability to withstand runs and counter market participants' concerns that they may need to curtail their funding. The anticipated NSFR should further reduce systemic risks posed by U.S. GSIBs.³⁸ Recently, it has been observed that the LCR and NSFR, along with liquidity stress testing, "have left the GSIBs far stronger than they were before the crisis. Together, they significantly reduce the probability of a large bank failure."³⁹

Indeed, fire-sale risk, a central concern of the STWF factor, is at its core a liquidity issue that already is addressed in important ways through the requirement to hold HQLA under the LCR. By definition, HQLA is meant to avoid fire-sale risks because such assets "generally tend to have prices that do not incur sharp declines, even during times of stress" and "generally experience 'flight to quality' during a crisis."⁴⁰

Additional areas of anticipated rulemaking include implementation of the FSB October 2014 shadow banking framework's margin requirements,⁴¹ which would formally link market-based SFT regulation

³⁵ Enhanced Supplementary Leverage Ratio, 79 Fed. Reg. 24,528.

³⁶ Supplementary Leverage Ratio, 79 Fed. Reg. 57,725.

³⁷ 12 C.F.R. Part 249.

³⁸ As has been noted in the context of modifications to the final Basel Committee NSFR, "requiring banks that make short-term loans to hold stable funding ... would help limit the liquidity risk that a dealer would face if it experiences a run on its SFT liabilities but is unable to liquidate corresponding SFT assets. In addition, by making it more expensive for the dealer to provide short-term credit, the charge could help lean against excessive short-term borrowing by the dealer's clients." Testimony of Governor Daniel K. Tarullo, Federal Reserve Board of Governors, before the U.S. Senate Committee on Banking, Housing and Urban Affairs (September 9, 2014), *available at* <http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm>.

³⁹ Governor Jerome H. Powell, Speech at the Stern School of Business, New York University, New York, NY: Financial Institutions, Financial Markets, and Financial Stability at 2 (Feb. 18, 2015), *available at* <http://www.federalreserve.gov/newsevents/speech/powell20150218a.pdf>.

⁴⁰ Federal Reserve System, Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61,440 (October 10, 2014) (the "LCR Release").

⁴¹ Financial Stability Board, "Strengthening Oversight and Regulation of Shadow Banking – Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions" (October 14, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141013a.pdf.

with capital standards. Properly implemented, these requirements should help address fire-sale risk by imposing margin requirements both within and outside the banking sector.

2. Elements of the Enhanced Regulatory Framework that Reduce the Possible Systemic Impact of a GSIB's Failure

Several post-crisis reforms are aimed at enabling large financial institutions to be resolved in a manner that avoids negative systemic consequences and taxpayer exposure. However, despite the Proposal's stated objective of measuring the systemic impact of a GSIB failure, it seemingly disregards significant advancements in the resolution framework for systemically important financial institutions.

- Dodd-Frank Title II. The Orderly Liquidation Authority provided under Title II of Dodd-Frank is a central example of the reforms that have addressed systemic risk given default. As noted in the Orderly Liquidation Authority adopting release, “[w]ith the enactment of the Dodd-Frank Act, Federal regulators have the tools to resolve a failing financial company that poses a significant risk to the financial stability of the United States ... in a way that addresses the concerns and interests of legitimate creditors while also protecting broader economic and taxpayer interests.”⁴²
- U.S. Single Point of Entry. The U.S. SPOE strategy developed by the FDIC to implement Title II is targeted at “provid[ing] stability to financial markets by allowing vital linkages among the critical operating subsidiaries of the firm to remain intact and preserving the continuity of services between the firm and financial markets that are necessary for the uninterrupted operation of the payments and clearing systems, among other functions.”⁴³ In combination with the FSB's TLAC proposal (described below), SPOE “should permit a large, consolidated entity that owns banks or broker-dealers to continue to function even if the ultimate holding company ceases to be viable and must be recapitalized or wound down.”⁴⁴
- ISDA Resolution Stay Protocol. The ISDA Resolution Stay Protocol⁴⁵ significantly improves the resolvability of global banking organizations by preventing a destabilizing run by derivatives counterparties on an operating subsidiary when its parent enters a bankruptcy or Title II resolution.⁴⁶ The protocol addresses the risk that “counterparties of the foreign subsidiaries and branches of GSIBs [with] contractual rights and substantial economic incentives to accelerate or terminate those contracts as soon as the U.S. parent GSIB enters

⁴² Orderly Liquidation Authority, 76 Fed. Reg. 4,207, 4,208 (Jan. 25, 2011).

⁴³ Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,615 (proposed Dec. 18, 2013).

⁴⁴ Governor Jerome H. Powell, Speech at the Stern School of Business, New York University, New York, NY: Financial Institutions, Financial Markets, and Financial Stability at 3 (Feb. 18, 2015), *available at* <http://www.federalreserve.gov/newsevents/speech/powell20150218a.pdf>.

⁴⁵ 2014 ISDA Resolution Stay Protocol, published November 4, 2014 by the International Swaps and Derivatives Association, Inc., *available at* <http://assets.isda.org/media/f253b540-25/958e4aed.pdf>.

⁴⁶ *Id.*

[resolution]” would exercise these rights, which could, in turn, “render a resolution unworkable by resulting in the disorderly unwind of an otherwise viable foreign subsidiary and the disruption of critical intra-affiliate activities that rely on the failing subsidiary.”⁴⁷ The protocol supports orderly resolution by contractually barring closeouts as part of the cross-border application of special resolution regimes applicable to certain financial companies.⁴⁸

- TLAC. The FSB’s TLAC standard⁴⁹ (which is also anticipated to be implemented in the United States in some form) ensures that “globally systemic banks finally have the quantum of total loss absorbing capacity that extensive analysis shows balances the benefit of greater resilience against the higher funding costs for the banks that results from the removal of public subsidies.”⁵⁰ In the United States and other countries that employ a SPOE resolution regime, TLAC will ensure that there are sufficient loss-absorbing resources available to fully recapitalize any failed (material) subsidiary even under extreme loss assumptions.⁵¹ Indeed, The Clearing House’s quantitative analysis demonstrates that, even with an external TLAC requirement at the low end of the FSB’s proposed range, U.S. GSIBs in resolution (that is, after giving effect to applicable write-down or conversion) would have ample gone-concern loss-absorbing capacity to emerge from such process with capital levels meeting Basel III minimum requirements.⁵² Even this alone would mitigate systemic loss given default and, therefore, the “expected impact” of a U.S. GSIB failure. Assuming that TLAC is calibrated to ensure adequate loss-absorbing capacity to achieve the level of absorbency sufficient to appropriately mitigate the expected impact of a U.S. GSIB failure, it follows that adding a substantial surcharge under Method 2, which will “sit above” TLAC, upsets that balance and results in excessive levels of capital.

⁴⁷ Testimony of Governor Daniel K. Tarullo, Federal Reserve Board of Governors, before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Sept. 9, 2014), *available at* <http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm>.

⁴⁸ 2014 ISDA Resolution Stay Protocol, published November 4, 2014 by the International Swaps and Derivatives Association, Inc., *available at* <http://assets.isda.org/media/f253b540-25/958e4aed.pdf>.

⁴⁹ Financial Stability Board, “Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution” (November 10, 2014), *available at* <http://www.financialstabilityboard.org/2014/11/adequacy-of-loss-absorbing-capacity-of-global-systemically-important-banks-in-resolution/>.

⁵⁰ October 12, 2014, Annual G30 International Banking Seminar, Remarks given by Mark Carney, Governor of the Bank of England, “Regulatory work underway and lessons learned.”

⁵¹ The Clearing House, February 2, 2015 Letter re: Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banking Groups in Resolution – Consultative Document, *available at* <https://www.theclearinghouse.org/issues/banking-regulations/international-regulation/financial-stability-board/20150202-joint-letter-to-fsb-on-tlac-proposal>.

⁵² See The Clearing House, February 2, 2015 Letter re: Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banking Groups in Resolution – Consultative Document, *available at* <https://www.theclearinghouse.org/issues/banking-regulations/international-regulation/financial-stability-board/20150202-joint-letter-to-fsb-on-tlac-proposal>.

As such, the elements of the Enhanced Regulatory Framework that have been adopted since the financial crisis (or that will soon be finalized and implemented), working both individually and together, have already served, or will shortly serve, to reduce the expected impact of GSIB failure, both by decreasing the probability of failure of a GSIB and simultaneously reducing the systemic impact of failure were it to nevertheless occur. These two aspects go to the core of the stated, but not explained, rationale behind the Basel GSIB Framework and the Proposal—namely to equalize the expected systemic impact of GSIB failure versus an unidentified smaller, benchmark institution by decreasing the probability of default of GSIBs. In addition, many of these reform elements also address the risks posed by STWF by allowing supervisors to evaluate the funding profiles of banking organizations and through measures that mitigate the fire-sale risks potentially posed by STWF sources. The Proposal does not seem to take these elements of regulatory reform into account, there is virtually no mention of them. We strongly believe that they should be explicitly considered—certainly in terms of the calibration of Method 2.

D. In order for the U.S. GSIB surcharge to be credible, the Federal Reserve needs to disclose publicly the analytical and quantitative bases for the Proposal as part of a transparent rulemaking process to enable investors, market participants and the public to gain a better understanding of the reasoning and evidence for the capital increases as embodied in the Proposal.

1. Key elements of the Proposal, including the Method 2 deviations from the Basel GSIB Framework, are not analytically or empirically justified.

By providing little or no analytical support for the doubling of the systemic indicator score or for the calibration of the surcharge, there is no way for U.S. GSIBs and other interested parties to know whether the Proposal's methodology for calculating the GSIB surcharge appropriately takes into account many factors that should be considered relevant in determining the GSIB surcharge percentage. At a basic level, the Proposal's determination of the GSIB surcharge has two main components—the calculation of the systemic indicator score and the calibration of the size of the surcharge based on that score. As to the calculation component, the Proposal itself provides no empirical analysis or justification for doubling the systemic indicator scores under Method 2. The only explanation provided is the truism that “increased capital at a GSIB increases the firm's resiliency to failure, thereby reducing the probability of it having a systemic effect.”⁵³ We do not believe this constitutes a sufficient rational basis for a relative increase of \$107.3 billion in required capital across all U.S. GSIBs.⁵⁴ Such an explanation

⁵³ Proposing Release at 75,480. The Proposal states simply that “once a GSIB calculates its short-term wholesale funding score, the GSIB would add its short-term wholesale funding score to the systemic indicator scores for the size, interconnectedness, complexity, and cross-jurisdictional activity indicators and multiply this figure by two to arrive at its method 2 score.”

⁵⁴ This reflects the GSIB capital required for each of the eight U.S. GSIBs under Method 2 as compared to Method 1. To calculate the systemic indicator scores and resulting surcharges under Method 2, we relied on the following assumptions: We calculated the Method 2 scores of each U.S. GSIB using FR Y-15 data from 2013, internal data provided by banks from 2013-2014 (to approximate STWF), and the risk-weighted assets amount reported in the 2014 CCAR results. Using the resulting Method 2 scores, we calculated the total amount of additional capital required using the risk-weighted assets amount reported in the 2014 CCAR results for each U.S. GSIB.

could be used for any multiplier, not only for two, but three or four, times some calculated number, or for no multiplier at all. The Proposal does not provide the public a meaningful opportunity to comment on this significant element of the GSIB surcharge because there is no such explanation. As a result, we cannot fully comment on one of the two main drivers of the amount of the surcharge under Method 2.

As to the calibration component, the Proposal relies on an “expected impact” approach that is designed to “equalize the probable systemic impact from the failure of a GSIB as compared to the probable systemic impact from the failure of a large, but not systemically important, bank holding company,” which is not identified, as the basis for determining the amount of the GSIB surcharge.⁵⁵ We note at the outset that the analytical strength of the expected impact approach itself is, at best, uncertain. In the first place, if one assumes failure, the pre-failure capital is likely to have no or only a limited impact on the systemic impact. In any event, by definition, a non-GSIB is expected to have only a very limited systemic impact if it fails, even if it is “next” to the GSIB group. In contrast, a GSIB is expected to have a significant impact even if it is at the “bottom” of the GSIB group. It is not feasible to attempt to equalize the respective systemic impacts—virtually none and significant—through an additional capital charge.

In addition, the Proposal provides no empirical analysis to support its determination of the amount of capital necessary to equalize the impact. The Proposal notes only that the proposed calibration “builds on analysis of the return on risk-weighted assets that was developed to inform the calibration of the minimums and capital conservation buffers of the Federal Reserve’s regulatory capital rule.”⁵⁶ This analysis, however, is not provided. The Proposal does cite, in considering the longer-term economic impact of stronger capital and liquidity requirements, a 2010 study published by the Basel Committee, which estimated that “the economic benefits of more stringent capital and liquidity requirements, on net, outweighed the cost of such requirements and that benefits would continue to accrue at even higher levels of risk-based capital . . .”⁵⁷ Once again, however, this estimate is largely devoid of analysis. Moreover, this 2010 study is, of course, dated and does not account for significant reforms under the Enhanced Regulatory Framework that GSIBs have become subject to since the study was conducted.

At least two key assumptions cannot be discerned from the Proposal.

⁵⁵ Proposing Release at 75,480. The Expected Impact Approach is a method used by the Basel Committee on Banking Supervision to calibrate the GSIB capital surcharge. Basel Committee on Banking Supervision, “Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement” (November 2011). The premise of the approach is that the expected impact of failure of a GSIB and a non-GSIB should be the same. The GSIB surcharge capital calibration seeks to derive the necessary level of capital to achieve this objective. Although the Proposal relies on the Basel Committee’s Expected Impact approach for the Method 2 calibration, the adjustments to that approach and the underlying assumptions have not been publicly disclosed.

⁵⁶ Proposing Release at 75,480. *See also* Basel Committee on Banking Supervision, “An assessment of the long-term economic impact of stronger capital and liquidity requirements” (August 2010), *available at* <http://www.bis.org/publ/bcbs173.pdf>.

⁵⁷ Proposing Release at 75,480.

- First, the Proposal does not provide any information as to what constitutes a “large but not systemically important bank holding company.” The characteristics of that bank holding company (whether an actual or theoretical bank holding company) and the resultant size of the gap between the systemic profile of that company and a given GSIB will obviously have a major impact on the calibration.⁵⁸ The Federal Reserve should specify the level of risk it seeks to eliminate based on the benchmark bank holding company used as a reference entity to determine the appropriate calibration under its expected impact approach.
- Second, the Proposal does not provide further detail beyond the reference to the Basel Committee’s analysis on how much additional capital is needed—or *why*—to close the gap between a GSIB and the reference entity. As a result, we do not know and cannot comment comprehensively on what adjustments, if any, were made to the assumptions in the Basel Committee’s analysis regarding the additional amount of going-concern loss absorbency that would be required to equalize the impact, and the appropriateness and completeness of any such adjustments.

On the whole, we believe the foregoing falls considerably short of providing a transparent and comprehensive analytical and empirical basis for the chosen calibration, particularly in light of the significant changes implemented in the intervening years since the financial crisis.

The STWF factor and the application of the 175 multiplier in Method 2 similarly lack an underlying analytical basis, or at least display a lack of transparency as to that basis. The proposed STWF factor in Method 2 generally provides no analysis of the systemic risk posed by the elements of STWF identified in the Proposal and how the treatment of those elements in the STWF factor addresses STWF risk. More particularly, no analysis or empirical support is provided for (i) at the very outset, the Proposal’s introduction of STWF, which is unique for U.S. GSIBs, as a factor in the Method 2 calculation “to address the risks presented by those funding sources,” (ii) the Proposal’s selection of the components of STWF, or (iii) the Proposal’s relative weightings of various components of STWF using a “weighting system that is designed to take account of the varying levels of systemic risk associated with the different funding sources comprising its short-term wholesale funding amount.”⁵⁹ Although, as a conceptual matter, assigning weightings based on the risk profiles of various transactions—such as collateral quality and remaining maturity—has merit, in many instances the weightings in the Proposal are insufficiently risk-sensitive and therefore do not reflect actual economic risk. Factors such as business purpose may have a significant impact on the fire-sale risk posed by different sources of liquidity and funding, but are not accounted for in the STWF factor. The STWF factor also ignores the fact that banking organizations hold considerable HQLA with respect to unsecured liabilities—not only as a matter of prudent risk management but as required by the LCR and NSFR (discussed below)—and as a result, assigns weights that are wholly disproportionate to the fire-sale risk posed. In addition, the

⁵⁸ We note that, in the United States, the asset-size differential between the largest and smallest non-GSIB banking organizations with total assets greater than \$50 billion (the threshold for subjecting BHCs to enhanced prudential standards under Title I of the Dodd-Frank Act) is approximately six times. See National Information Center, Holding Companies with Assets Greater than \$10 Billion (as of December 31, 2014), available at <https://www.ffiec.gov/nicpubweb/nicweb/top50form.aspx>.

⁵⁹ Proposing Release at 75,486.

collateral haircut approach under the Revised Capital Rules effectively increases capital requirements for SFTs.⁶⁰ These reforms have caused U.S. banking organizations to reduce reliance on STWF materially in recent years, as U.S. regulators have acknowledged.⁶¹ All STWF factor calibrations—both for specific product areas, as well as the overall calibration, including the 175 multiplier—should be finalized only if supported by clear rationales and empirical justification that have been transparently disclosed.

2. The Federal Reserve should release additional analysis and data on which key elements of the GSIB surcharge are based.

The absence of analysis in the public record impedes the ability to assess whether the Proposal's currently chosen calibration is indeed necessary or sufficient to achieve the stated objective of the GSIB surcharge. The substantial impact of the Proposal makes it critical that analytical and quantitative bases underlying its provisions are fully transparent and therefore subject to public scrutiny and debate. In light of the potential impact of Method 2 and the STWF factor and the foundational importance the Federal Reserve appears to place on these analytical and quantitative bases for the proposed rule, we respectfully submit that the Federal Reserve needs to disclose publicly this information as part of a transparent and effective rulemaking process and reopen the comment period to enable meaningful comment thereon.⁶²

Beyond GSIBs themselves, it is critical that investors, market participants and, indeed, the public more broadly have a better understanding of the underlying quantitative rationale, as well as the Federal Reserve's reasoning and methodology underlying the capital increases embodied by the Proposal. Put another way, shareholders, other market participants and GSIBs' customers should be in a position to understand the Federal Reserve's analytical rationale for the Proposal, especially because it imposes significantly more stringent standards than the Basel GSIB Framework that will be applicable to

⁶⁰ See Part II.C.1, above.

⁶¹ In a recent speech, Chair Yellen acknowledged that "these eight firms['] ... reliance on short-term wholesale funding has dropped considerably." Chair Janet L. Yellen, Speech at the Citizens Budget Commission, "Improving the Oversight of Large Financial Institutions" (March 3, 2015), *available at* <http://www.federalreserve.gov/newsevents/speech/yellen20150303a.htm>.

⁶² At a minimum, at least the following information is necessary to understand key elements of the Proposal: the "Board's analysis of the additional capital necessary to equalize the probable systemic impact from the failure of a GSIB as compared to the probable systemic impact from the failure of a large, but not systemically important, bank holding company," including: (i) data and relevant equations related to the determination of the impact of a GSIB failure relative to a non-GSIB failure in the context of the Expected Impact Approach (as such term is used in the Basel paper referenced below); (ii) the translation of the probability of default to capital charges, along with the relevant equations, data and parameters needed for the calculation; and (iii) the method and the data used in assigning capital surcharges to each of the systemic indicator score intervals; and any written analyses or other material relied upon by the Board in designing Method 2, including (i) the underlying rationale, data and methodology for the doubling of the Method 1 indicators, (ii) aggregate data used for the selection of the components of the short-term wholesale funding score, and (iii) the weightings assigned to the components of the short-term wholesale funding score. See Proposing Release at 75,479-80, 75,487-88 and BCBS, "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement," *available at* <http://www.bis.org/publ/bcbs201.pdf> (July 2011).

all GSIBs outside the United States, as well as has an impact on pricing and product availability for end users.⁶³ Without such public disclosure, we are greatly concerned that the U.S. GSIB surcharge will not be seen as a credible regulation to decrease systemic risk.

Finally, we respectfully request public release of this information as mandated by the letter and spirit of the Administrative Procedure Act and applicable case law, which generally require—to enhance the public’s participation in rulemakings—that the public be provided the “most critical factual material”⁶⁴ used by the agency in developing a rulemaking.⁶⁵ By providing analytical and empirical analyses to demonstrate how it arrived at the specific calibration of the systemic indicator score and resulting surcharge, the Federal Reserve would provide necessary transparency to its proposed methodology.

III. The Proposal ignores the economic costs of requiring disproportionately high levels of capital.

Requiring U.S. GSIBs to maintain inordinately high amounts of capital, whether in general or as a result of specific activities, will impose costs not only on GSIBs, but on customers that rely on GSIBs for financial services, investors, markets and on the broader economy. These effects will be felt not only at the individual institution level but also on the U.S. economy as a whole, yet the Proposal does not appear to provide any meaningful analysis or consideration of these costs.⁶⁶

The cumulative effect of layering the GSIB surcharge onto other regulations designed to address the very same risks results in the destruction of shareholder value. The following example illustrates this impact for a hypothetical U.S. GSIB (Bank A) that receives an unsecured non-operational wholesale deposit from another U.S. financial institution:

- To comply with the LCR:
 - Bank A is required to assume a 100% outflow for a non-operational deposit from another financial institution.

⁶³ Some subject banking organizations have announced plans to reduce the amount of customer deposits held—by billions of dollars—in order to shrink existing exposures in areas penalized by the GSIB surcharge (and further penalized by other regulatory regimes, for example, the LCR), including non-operational deposits. See, e.g., Popper, Nathaniel, “JPMorgan Chase Insists It’s Worth More as One Than in Pieces” (February 25, 2015), available at http://www.nytimes.com/2015/02/25/business/dealbook/jpmorgan-pushes-back-against-suggestion-of-split.html?_r=0.

⁶⁴ See *Chamber of Commerce of the United States v. SEC*, 443 F.3d 890, 900 (D.C. Cir. 2006); *Appalachian Power Co. v. EPA*, 249 F.3d 1032, 1039 (D.C. Cir. 2001).

⁶⁵ *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (internal quotation marks omitted); *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

⁶⁶ See Questions 8 and 9, Proposing Release at 75,481.

- Bank A must acquire HQLA to cover the outflow, that is, cash or cash equivalents that must be held to fund the hypothetical future outflow, and cannot be used for lending or otherwise to support clients.⁶⁷
- To comply with the ESLR:
 - When Bank A acquires HQLA, it must include the HQLA in its calculation of its “total leverage exposure,” or denominator, for purposes of the ESLR.
 - Bank A will have to include 100% of the HQLA in the denominator even if the HQLA is a level 1 asset like a U.S. Treasury because the leverage ratio is not risk based.
- To comply with the Proposal’s GSIB surcharge:
 - The HQLA and the non-operational deposit will have the following effect on Bank A’s GSIB systemic indicator score (other than the STWF):
 - The HQLA acquired to meet the outflow under the LCR increases Bank A’s size indicator, which is Bank A’s total leverage exposure.
 - The non-operational deposit from a financial institution increases the intra-financial system liabilities component of the interconnectedness indicator.
 - In addition, the deposit liability is treated as STWF for the life of the deposit and is assigned a weight that corresponds to its remaining maturity—100%, 75%, 50% or 25% for remaining maturities of less than 30, 31 to 90, 91 to 180, and 181 to 365 days, respectively. Because the STWF factor, unlike the other systemic indicator scores, is an absolute rather than a relative measure, the deposit will cause a direct and immediate increase in Bank A’s STWF score, and that is the case regardless of the nature of the HQLA acquired with respect to the deposit.

The cumulative effect of these regulations may result in Bank A refusing to accept non-operational deposits, reducing the amount it will accept, or charging its customers a related fee, which will have secondary effects on market liquidity that are largely unnecessary. There are similar consequences for other products. For example, a short-term SFT generates a requirement to hold HQLA to the extent that it is secured by collateral that is not level 1 HQLA (with the outflow amount dependent on the collateral quality). The ESLR requires a U.S. GSIB to include non-netted SFT receivables in the exposure measure regardless of the collateral quality. In addition, the collateral haircut approach under the Standardized Approach applies conservative haircuts to the securities leg of an SFT (based on asset quality and maturity). Under the GSIB surcharge, the SFT is captured in the size indicator (total leverage exposure), the interconnectedness indicator (for SFTs with financial institution counterparties, which constitute the vast majority of SFT transactions), and the cross-jurisdictional indicator (for SFTs with foreign

⁶⁷ The amount and nature of HQLA that must be acquired depends on many factors, including the amount of offsetting inflows (which are capped at 75% of outflows under the LCR), and haircuts applicable to the acquired HQLA.

counterparties). Under the STWF indicator, SFTs receive weightings depending on collateral quality and remaining maturity. At a minimum, the Proposal's apparent failure to consider the cumulative effect of the Enhanced Regulatory Framework and imposition of a capital surcharge tax that is disproportionate to the actual risks posed by certain U.S. GSIB activities means that a U.S. GSIB will be required to hold more capital than is necessary to achieve the Proposal's objectives, with a negative impact on pricing and/or product availability for customers.

To the extent that there is a cost-benefit analysis included in the Proposal, it is cursory at best. The Proposal appears to reflect uncritical acceptance of the Basel Committee's analysis⁶⁸ and assumes either that more capital is always better or that the benefits of more capital are so substantial and ascertainable as to be entitled to significantly more weight than the less tangible detriments of excessive capital, which are difficult to quantify. However, careful consideration of the potential economic costs of each additional capital requirement is necessary.⁶⁹ Such costs cannot be accurately captured by macroeconomic models—including those developed by the Basel Committee—that do not model GSIBs as actors performing functions critical to meeting the credit needs of the economy. In particular, they do not recognize that the importance to the broader economy of markets-based finance, especially in the United States, where the majority of the credit needs of the broader economy are met through issuance of securities rather than through direct bank lending.⁷⁰

The critical functions performed by GSIBs—including underwriting, market-making, prime brokerage, clearing and settlement, securities custody and asset servicing—will not and probably cannot be easily replaced by non-GSIB banking organizations. As cumulative regulatory reforms increase

⁶⁸ See Basel Committee on Banking Supervision, "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement," available at <http://www.bis.org/publ/bcbs201.pdf> (July 2011) (Annex 2: Empirical analysis to assess the maximum magnitude of additional loss absorbency) and Basel Committee on Banking Supervision, "An assessment of the long-term economic impact of stronger capital and liquidity requirements" (August 2010), available at <http://www.bis.org/publ/bcbs173.pdf>.

⁶⁹ See IMF Working Paper, "The Role of Bank Capital in Bank Holding Companies' Decisions" (March 2015), available at <http://www.imf.org/external/pubs/ft/wp/2015/wp1557.pdf> ("... we find that an increase in capital ratios will lead to a reduction in bank lending, through higher interest rates on loans. Our findings suggest that an increase in the capital ratio of 2.5 percentage points will lead to 7 to 8 basis point increases in loan rates, or roughly 5% increases... and a drop in loan demand of roughly 4%").

⁷⁰ In the United States, the economy is only roughly 25% bank-financed, with the majority of financing taking place through securities issuances in the debt and equity markets. By contrast, in Europe, the economy is approximately 75-80% bank-financed. OECD, based on World Bank Database on Financial Development and Structure (2012). See, e.g., Wehinger, Gert, "Bank deleveraging, the move from bank to market-based financing, and SME financing," 2012 OECD Journal: Financial Market Trends.

Financial sector regulators in Europe have bemoaned Europe's overreliance on bank finance and a drive to "secure the benefits that capital markets and market-based finance can offer" to companies within their economies. Dame Clara Furse, External Member, Financial Policy Committee, Bank of England, Liquidity Matters (Feb. 11, 2015) at 4 ("**Furse Speech**"), available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech796.pdf>. See also Fitch Ratings, Press Release, New Basel Market Risk Rules May Reduce Trading Liquidity (Oct. 31, 2014), available at https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/New-Basel-Market?pr_id=912494.

the capital requirements to which GSIBs are subject, the economic model for capital markets intermediation is altered in ways that serve as disincentives to GSIBs to perform these activities, making “the decline in investment bank market-making a growing theme in recent years.”⁷¹ Indeed, of the jurisdictions cited in the Proposal for imposing higher GSIB surcharges than the Basel GSIB Framework, neither Norway nor Sweden has traditionally played an active role in the global capital markets,⁷² and Swiss banks are increasingly retreating from capital markets activities, including fixed income, currency and commodities trading, as a result of regulatory capital pressures.⁷³ Because the U.S. economy makes far greater use of capital markets-based finance than any other major economy, the potential effects of a disproportionate capital surcharge on GSIBs on the cost of credit to the U.S. economy and, therefore, economic growth, are too large to be assumed away as insignificant. What is undebatable is that the Proposal, by its terms, does not take into account the effect of this significant differentiation in financing patterns on the overall impact of the U.S. GSIB surcharge. We submit that this impact cannot be properly evaluated without analysis of such a key factor.

Moreover, although financial regulatory reform has largely made the core of the system safer, reduced capital markets activity by some banking organizations “could be making the market more fragile, hindering their ability to provide essential services to companies and investors in a resilient and cost-efficient way.”⁷⁴ Indeed, potentially damaging effects are becoming apparent. For example, there is now “evidence that liquidity in some key markets has become more fragile,” and “there may be unforeseen consequences for the intermediation and market making functions performed by . . . investment banks that are a source of market liquidity.”⁷⁵ These concerns are becoming more widespread, even among regulators. As SEC Commissioner Gallagher recently stated concerning the number and aggregate impact of regulations that have been imposed on U.S. financial services firms since the enactment of the Dodd-Frank Act in 2010, many of these regulations do not incorporate a

⁷¹ Furse Speech at 7 (further noting that “[f]ive years after the peak of the crisis, global investment banks had reduced their trading inventories by nearly 25% [and] current inventory levels are now at levels last seen in the early 2000s”).

⁷² Ailis, Ivo and Oskars Bauers, Stockholm School of Economics, “Bank debt vs corporate bond choice and its effect on company value: Evidence from bank debt financing in the Nordic countries” (2013), *available at* <http://arc.hhs.se/download.aspx?MediumId=1877> (“The region has always been dominated by banks as the main providers of corporate funding”).

⁷³ UBS AG has exited from its fixed income, currency and commodities (FICC) trading business and Credit Suisse also chose to exit from its commodities trading business. Over the past year, Morgan Stanley, Deutsche Bank AG, Barclays PLC and J.P. Morgan Chase & Co. have all slimmed parts of their commodities trading, following in the footsteps of Royal Bank of Scotland Group PLC and UBS AG which had already wound down their physical commodities-trading desks. *See, e.g.*, The Wall Street Journal, “Credit Suisse to Exit Commodities Trading” (July 22, 2014), *available at* <http://www.wsj.com/articles/credit-suisse-to-exit-commodities-trading-1406046884>; Reuters, “UBS set to exit fixed income, fire 10,000 bankers” (October 29, 2012), *available at* <http://www.reuters.com/article/2012/10/29/us-ubs-idUSBRE89S1BU20121029>.

⁷⁴ Furse Speech at 6. *See also* Fitch Ratings, “New Basel Market Risk Rule May Reduce Trading Liquidity” (October 31, 2014) (“New Basel market risk rule proposals may reduce trading liquidity further if it results in banks cutting inventory further, Fitch Ratings says. Large European banks have already been reducing their portfolios since the introduction of tougher market risk capital requirements under Basel 2.5 in 2011”).

⁷⁵ Furse Speech at 9.

“robust cost-benefit analysis,” and, “even where a cost-benefit analysis [is] performed, such analysis encompass[e] only the incremental effects of the rule being considered for adoption ... [while] no regulator ... has considered the overall regulatory burden on financial services firms when determining whether to impose additional costly regulations.”⁷⁶ For the U.S. economy, the “stakes here are considerable, [as] regulatory burdens divert capital away from the broader economy.”⁷⁷ For purposes of the Proposal, we respectfully request that the Federal Reserve recognize the real economic costs associated with ever higher capital levels, that such costs will increasingly be borne by banking organizations’ customers, investors and the markets more generally, and, therefore, that such costs should be carefully and explicitly considered when designing and calibrating the U.S. GSIB surcharge.

Finally, it is also important that the Federal Reserve consider the fact that unnecessarily higher capital requirements for U.S. GSIBs will encourage the growth of the significantly less regulated and less transparent shadow banking system, including non-bank financial intermediation and maturity transformation. Encouraging non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability increases systemic risk in the financial sector. As acknowledged by the FSB, “a leveraged and maturity-transforming shadow banking system can be vulnerable to ‘runs’ and generate contagion risk, thereby amplifying systemic risk [and] [s]uch activity, if unattended, can also heighten pro-cyclicality...”⁷⁸ Heightened GSIB surcharges could very well drive significant credit intermediation into the less regulated sector as banking organizations subject to the higher surcharge gradually reduce or abandon targeted business lines that are, in effect, unduly taxed by the surcharge. Additionally, as some banks reduce or abandon business lines, the market share of GSIBs that chose not to reduce or abandon may grow, resulting in greater concentration and possibly greater systemic risk.⁷⁹ Although it may be possible to ameliorate some of these effects through systemic designation of shadow banking entities by the FSOC, or the regulation of certain non-bank activities, that process is lengthy and difficult.⁸⁰ Moreover, such designation may not occur before such entities begin to have real systemic effects and may not adequately pick up entities operating largely outside of the United States. Thus, capital surcharges that encourage migration of activities to the shadow banking sector could very well have perverse impacts on systemic stability, taken as a whole.

⁷⁶ Commissioner Daniel M. Gallagher, Statement on the Aggregate Impact of Financial Services Regulations (March 2, 2015), *available at* <http://www.sec.gov/news/statement/aggregate-impact-of-financial-services-regulation.html#.VP22jE3wt9M>.

⁷⁷ *Id.*

⁷⁸ Financial Stability Board, “Strengthening Oversight and Regulation of Shadow Banking – Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions” (October 14, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141013a.pdf.

⁷⁹ Moreover, if one U.S. GSIB abandons a market because of the capital surcharge, it has the anomalous effect of increasing the score of each remaining U.S. GSIB for that market.

⁸⁰ See Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637.

IV. Specific Recommendations to Ameliorate Conceptual Flaws in the Proposal's Design

As discussed above, the Proposal suffers from a series of conceptual flaws in its design and implementation, which undermine the Federal Reserve's stated objectives for the GSIB surcharge. One of the fundamental flaws in the proposed methodology is its lack of meaningful options and incentives for a GSIB to take risk-reducing actions to mitigate its systemic footprint and a more general insensitivity to actual risk. Although a primary objective of the GSIB surcharge seems to be to encourage U.S. GSIBs to reduce or minimize their systemic risk profiles,⁸¹ we do not believe that any of the risk-reducing macro-prudential regulations that have been introduced since 2011 would significantly reduce the surcharge that U.S. GSIBs would incur under Method 1 from the surcharge they would have incurred in 2011, when the Basel Committee's analysis was conducted. This insensitivity is driven largely by the relative nature of the GSIB surcharge denominator calculation, which relies on the aggregate amount for each indicator (other than the STWF indicator under Method 2) across all GSIBs in an unnecessarily small sample. As a result, a given GSIB cannot generally reduce its systemic indicator score and, therefore, its surcharge, as a practical matter, unless the systemic indicator scores for all other GSIBs in the aggregate remain the same. Put another way, the proposed GSIB methodology creates a situation where even if the system as a whole is undoubtedly safer as a result of risk-reducing steps, such as movement of transactions to central clearing by all GSIBs, individual GSIB surcharges would nevertheless remain generally the same. While this approach is problematic as a global standard, it is particularly unjustifiable in the United States. Although in most countries firms other than GSIBs are irrelevant for calculating a GSIB's systemic importance, that is simply not the case in the United States with its relatively unconcentrated banking and financial services markets. The GSIB surcharge should not be designed such that it would effect a shift in systemic risk from highly capitalized and liquid, and highly regulated, GSIBs to less well capitalized and less liquid, and less regulated, institutions.

Furthermore, a major driver of changes in the surcharge for U.S. GSIBs is foreign exchange volatility, a factor that is entirely beyond the control of a GSIB and objectively not indicative of the systemic risk a GSIB poses except when a currency remains relatively strong for a sustained period of time.

We recommend that the Federal Reserve adhere to the Basel GSIB Framework reflected in Method 1—with appropriate modifications for the foreign exchange issue and with an expanded denominator as discussed below—commencing in 2016. This would be fully consistent with the U.S. commitments at the Basel Committee to timely implement a surcharge and would allow additional time to develop more analytical and empirical refinements to the other components of the Proposal for the U.S. At a minimum, we would recommend the following modifications to the Proposal's calculation methodology (we separately address the STWF factor in Part V below) to help mitigate the effect of exogenous factors and help ensure that a U.S. GSIB's risk-reducing actions have a corresponding effect on the GSIB surcharge. We also urge the Federal Reserve to work more broadly with the other members

⁸¹ Opening Statement by Daniel K. Tarullo (December 9, 2014), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/tarullo-statement-20141209.htm> (noting that "the applicable surcharge would be increased as a bank's systemic importance grows, and reduced as a bank reduces its size, interconnectedness, reliance on short-term funding, or other characteristics that determine its systemic significance").

of the Basel Committee, as well as the FSB, to address what we believe to be seriously problematic aspects common to both the Proposal and the Basel GSIB Framework.

A. The Proposal should use a modified conversion factor designed to moderate the effects of foreign exchange rate volatility on the surcharge calculation.

Under the Proposal, foreign exchange rates are a substantial driver of changes in the surcharge for U.S. GSIBs, thereby introducing potentially significant fluctuations in surcharge determinations based entirely on an exogenous factor that (unless occurring for a sustained period of time) has no relationship or relevance to actual systemic importance.⁸² In particular, the Proposal uses a common currency aggregate of the largest global banking organizations for calculation of market share (the denominator for each systemic indicator). This makes the systemic importance scores for U.S. GSIBs proportionate to the strength of the U.S. dollar versus other currencies, notably the euro due to the relative aggregate size of euro-denominated GSIBs. Moreover, as a result of the recent significant weakening of the euro against the dollar, those scores would also have appreciated significantly. Indeed, the consequences of foreign exchange volatility already are apparent. Analyst reports indicate the recent strengthening of the U.S. dollar alone places at least three of the eight U.S. GSIBs at risk of moving up one surcharge tier, or “bucket,” resulting in a 50 basis point increase in required capital at each of these firms.⁸³ This result is purely a factor of the Proposal’s chosen calculation method and has little, if any, relationship to the underlying systemic importance of the affected U.S. GSIBs. Indeed, “because the high exchange rate makes their dollar-denominated assets and operations look larger relative to their European peers,” the recent rise in value of the dollar “would force U.S. GSIBs to hold billions of dollars more in capital than foreign competitors, including weaker European banks.”⁸⁴ This foreign exchange volatility therefore also produces an additional layer of unwarranted uncertainty, compounding the difficulty of capital planning for U.S. GSIBs. Unlike most other foreign exchange-related risks, this exposure is inherently impossible to hedge.

The Basel Committee acknowledged the problem and changed the three-year recalculation to annual recalculation in an attempt to “neutralise the impact of exchange rate movements.”⁸⁵ However, this change does not resolve the inherent volatility concern. The Clearing

⁸² One example of an exogenous move producing extreme market volatility is the Swiss National Bank’s decision to abandon its cap on the Swiss Franc’s exchange rate against the euro in January 2015, which had pinned the currency at 1.20 francs per euro for over three years. This decision produced significant volatility in credit and currency markets around the world, as it prompted a reduction of as much as 30% in the euro versus the Swiss franc.

⁸³ A February 2, 2015 Nomura global markets research report uses a static analysis to demonstrate how each GSIB’s systemic importance score would change if the 2013 indicator values were converted into euro using the spot rate as of year-end 2014, assuming all else remains equal.

⁸⁴ Victoria Mcgrane, James Sterngold & Ryan Tracy, U.S. Banks Say Soaring Dollar Puts Them at Disadvantage, Wall St. J. (Feb. 8, 2015), *available at* <http://www.wsj.com/articles/u-s-banks-say-soaring-dollar-puts-them-at-disadvantage-1423442235>.

⁸⁵ Basel Committee on Banking Supervision, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* (July 2013), *available at* <http://www.bis.org/publ/bcbs255.pdf>.

House's analysis demonstrates that the aggregate GSIB systemic indicator score for U.S. GSIBs can fluctuate from -9.8% to 9.0% under Method 1, and up from -9.1% to 8.0% under Method 2 solely due to foreign exchange volatility resulting from using the spot exchange rate over the 2001 to 2014 period, for example.⁸⁶ Notably, when including the impact of foreign exchange fluctuations from 2013 to 2014 in the systemic indicator scores, three banks under Method 1 and two banks under Method 2 would move into different surcharge buckets.⁸⁷ The problem is most acute in terms of the relatively stronger dollar as compared to the euro today, but the situation could be reversed in the future, whereby European Union banking organizations would then be inappropriately disadvantaged instead of U.S. GSIBs.⁸⁸

For purposes of the current implementation of the U.S. GSIB surcharge, however, we strongly urge the Federal Reserve to use a rolling average over a five-year period to mitigate substantially the effects of foreign exchange volatility.⁸⁹ The Clearing House's analysis demonstrates that using a five-year rolling average exchange rate in place of the spot rate utilized under the Basel GSIB Framework significantly reduces the effect of foreign exchange volatility. For example, while changes in the spot rate from 2013 to 2014 would have caused 9.0% and 8.0% changes in the U.S. GSIB aggregate systemic indicator score for Methods 1 and 2, respectively, the changes over the same time period using a five-year rolling average exchange rate would have been less than 1% under both methods.⁹⁰ Even during a recent period of high volatility in the five-year rolling average exchange rate, from 2005 to 2006, the change to the U.S. GSIB aggregate systemic indicator score attributable to using the five-year rolling average—5.0% and 4.5% under Methods 1 and 2, respectively—would be nearly 2 percentage points less than the change attributable to the spot rate for the same period—6.9% and 6.3% for Methods 1 and 2, respectively. We also note that although recent exchange rate volatility due to the strengthening U.S. dollar would have the effect of increasing the aggregate U.S. GSIB systemic indicator score, other periods of volatility, including from 2005 to 2006, would have caused significant reductions in the score. Using a five-year rolling average exchange rate, therefore, serves to temper the impact of foreign exchange volatility on GSIB surcharges. This solution, although perhaps imperfect, would serve to mitigate substantially the needless volatility effect of the spot exchange rate upon the calculation of the U.S. GSIB surcharge.⁹¹

⁸⁶ See Annex B for illustration of the impact of foreign exchange volatility using spot rates versus a five-year rolling average exchange rate.

⁸⁷ See Annex B.

⁸⁸ It is also possible that a relatively stronger currency over the longer term on a sustained basis could imply a greater systemic impact—although that is a proposition that should be more thoroughly analyzed and empirically tested. This issue is not limited to the dollar as compared to the euro, but has effects for other currencies as well.

⁸⁹ Alternatively, a methodology should be developed that effectively eliminates the foreign exchange effect, for example, through formulaically adjusting the score methodology to be currency-neutral for each relevant yearly calculation period.

⁹⁰ See Annex B.

⁹¹ We also note that expanding the denominator beyond the largest banking organizations designated by the Basel Committee as GSIBs—as discussed below—would also reduce the risk that a U.S. GSIB would move into a higher/lower surcharge bucket merely as a result of the U.S. dollar strengthening or weakening, because
(footnote continued)

B. The Proposal should expand the market for financial services reflected in the Method 2 denominator for the surcharge calculation to include other relevant market participants.

The denominator under the Proposal's calculation methodology should be expanded to include other relevant participants in the U.S. market for financial services, without which the capital calculation methodology will be seriously distorted. The current measure of the denominator leads to particularly anomalous results in the United States given the amount of banking and other financial sector activity that takes place outside GSIBs. Failing to consider financial activity that takes place outside GSIBs in the United States not only creates a distorted calculation of U.S. GSIBs' economic importance and systemic risk, but places U.S. GSIBs at a disadvantage vis-à-vis non-U.S. GSIBs because U.S. GSIBs have a smaller market share yet are treated as comprising the entire sector. Under the Proposal's Method 2 calculation, as under the Basel GSIB Framework, an individual GSIB's indicator score is determined by dividing the GSIB's amount for a particular indicator (for all except the STWF indicator) by the aggregate amount of that indicator for all banking organizations in the sample. This leads to the irrational outcome that a shift in activity from U.S. GSIBs to U.S. regional or other commercial banking organizations has no impact on the charge for any U.S. GSIB, but growth in assets of a non-U.S. bank, including those with little connection to the U.S. markets, would, in fact, decrease the surcharge for U.S. GSIBs. As discussed above, due to the relative nature of this calculation and its industry market share denominator, this formulation limits the ability of management to adjust its surcharge by independently taking steps to reduce potential systemic risk or improve resolvability. This problem is also readily apparent in the context of the transfer of risky activities from GSIBs to other entities. For example, if risks shift collectively from U.S. GSIBs to other banking organizations below the world's largest, or from GSIBs collectively to nonbanks, no individual GSIB's surcharge would be reduced.

To begin to address these concerns, we propose expanding the denominator to include all U.S. banking organizations, based on data already available to the Federal Reserve (for example, the FR Y-9C), CCPs and nonbank financial companies designated by FSOC. Certainly, nonbank institutions to which the risks associated with performing traditional banking activities will naturally migrate should also be included to the extent they perform banking-like functions such as maturity transformation and credit intermediation. Including the broader U.S. financial sector as the market for purposes of the denominator would provide a more accurate picture of a U.S. GSIB's actual presence in the U.S. financial market and, therefore, its likely systemic impact. It would also allow a GSIB to reduce its systemic indicator score if an individual GSIB loses business to a non-GSIB or an institution outside the banking system, because there would be a reduction in the numerator without an offsetting decrease in the denominator. Including smaller U.S. banking organizations in the denominator would not affect those banking organizations because they would not be subject to the surcharge.⁹²

(footnote continued)

including all U.S. banking organizations, from publicly available data, non-bank systemically important financial institutions, and CCPs in the denominator—valued in dollars—would further mitigate the effect of the euro conversion.

⁹² In fact, the inclusion of smaller U.S. banking organizations in the denominator would serve to reduce the chances of any such banking organization being designated as a U.S. GSIB.

CCPs should be included in the denominator for the systemic indicator calculations to reflect the risk reduction from the movement of transactions to CCPs. We support the notion that central clearing provides “a more transparent and orderly structure, like the hub and spokes of a wheel, with the clearinghouse at the center.”⁹³ With respect to cleared OTC derivatives, as noted by CFTC Chairman Massad, “recent data show our progress [in increasing the use of CCPs]. The percentage of transactions that are centrally cleared in the markets we oversee has gone from about 15% in December 2007 to about 75% today.”⁹⁴ This is consistent with efforts to “remove any incentive not to clear” transactions that can be cleared and the consensus of the G-20 leaders to clear derivatives through central counterparties where appropriate.⁹⁵ The Associations urge the Federal Reserve to include CCPs in the denominator in the systemic indicator score in order to give effect, for purposes of the GSIB surcharge calculation methodology, to the shift to CCPs, as well as to support the policy objective of moving transactions to central clearing. Put another way, including CCPs in the denominator would serve to better recognize the growing importance of CCPs in increasing financial stability in their own right. Although we recognize that the incorporation of CCPs in the systemic indicator framework may present some practical complexities, we stand ready to work the Federal Reserve to develop such a methodology.

V. STWF Factor

Although the Proposal, and other statements by the Federal Reserve, attribute, in substantial part, new regulatory requirements to the need to deal with the downward spiral of asset prices as a result of fire sales during the financial crisis of 2007–2008, it contains surprisingly little statistical or other analysis to justify the design or calibration of that factor. In this context, it is important to note that during the crisis, certain asset classes, such as U.S. Treasuries, clearly rose in price, and the downward spiral in other asset classes appears to have been the result of fire sales by lightly or nonregulated institutions.

Nonetheless, the Proposal states that a banking organization’s use of short-term wholesale funding increases its probability of default by making the firm vulnerable to short-term

⁹³ Massad Testimony.

⁹⁴ Massad Testimony.

⁹⁵ In a statement provided in connection with the CFTC’s release of its proposed rule, “Margin Requirements for Uncleared Swaps for Swaps Dealers and Major Swap Participants” (Sept. 23, 2014), *available at* <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister092314a.pdf> at 146, Chairman Timothy G. Massad stated, “Imposing margin on uncleared swaps will level the playing field between cleared and uncleared swaps and remove any incentive not to clear swaps that can be cleared.” The preamble to the Proposed Rule also notes that the swaps margin requirements in the Dodd-Frank Act are “consistent with the consensus of the G-20 leaders to clear derivatives through central counterparties where appropriate.” 79 Fed. Reg. at 57351. The dealer community has also recognized the importance of clearing—beginning in 2009, in an effort led by the Federal Reserve Bank of New York, the dealer community agreed to increase central clearing for certain credit derivatives and interest rate derivatives. *See* Press Release, Federal Reserve Bank of New York, New York Fed Welcomes Further Industry Commitments on Over-the-Counter Derivatives (June 2, 2009), *available at* www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html.

creditor runs and increases the likely social costs of the firm's distress, including by giving rise to "fire-sale externalities."⁹⁶ The purpose of the STWF factor would therefore appear to be to take into account the absolute (as this factor, unlike the other four, is not calculated on a relative basis) amount of these types of transactions that a GSIB engages in through an increase in the applicable capital surcharge—and hence decrease the GSIB's probability of failure.⁹⁷ Although excessive reliance on STWF could destabilize a GSIB and lead to fire sales of certain less liquid assets, as a conceptual matter, that risk need not be addressed, and indeed is not addressed, through the GSIB capital surcharge alone.

As discussed in Part II.C, other elements of the Enhanced Regulatory Framework more precisely and accurately address concerns regarding the nature and tenor of the funding that banking organizations use (specifically, requiring HQLA "coverage" of STWF or providing strong incentives for a firm to move towards longer-term funding) and the fire-sale risk that the STWF factor is, in part, designed to protect against. Under the LCR, banks must hold significant amounts of HQLA in respect of their STWF transactions, which decreases the probability of failure because they will have sufficient liquidity from the sale of the HQLA held in case of the sudden withdrawal of such funding.⁹⁸ Moreover, HQLA is by definition meant to avoid fire-sale externalities because such assets "generally tend to have prices that do not incur sharp declines, even during times of stress" and "generally experience 'flight to quality' during a crisis."⁹⁹ The Proposal's approach to fire-sale risk, in contrast, is a crude effort to deal with this issue, because it ignores or discounts these two important factors.

The Proposal identifies no specific gaps in the Enhanced Regulatory Framework that the STWF factor must fill. Although not mentioned directly in the Proposal, we understand that there has been supervisory concern that existing regulations do not sufficiently address fire-sale risk in the context of a matched book.¹⁰⁰ The Associations believe that this concern is misplaced in light of the positive impacts of holding HQLA set forth above, and that it does not provide a sufficient basis for the STWF factor's failure to differentiate its treatment of liabilities based on the layered application of other regulatory requirements. Furthermore, the LCR requires a banking organization to hold some HQLA buffer in any event by imposing a cap on inflows that can be included in the denominator of the LCR ratio of 75% of outflows, and provides strong structural incentives to extend the maturity profile of a banking organization's secured funding utilizing an appropriate tool (liquidity regulation) to address policy concerns with short-dated funding models. In addition, as has been recognized, the NSFR introduces an asymmetry that will require banking organizations to hold some stable funding against SFTs. A banking organization cannot run a "matched book" of SFTs and receive offsetting credit for repurchase and reverse repurchase transactions on the same underlying assets under the NSFR. The

⁹⁶ Proposing Release at 75,479.

⁹⁷ *Id.*

⁹⁸ LCR Release at 61,450.

⁹⁹ LCR Release at 61,440.

¹⁰⁰ See Governor Daniel K. Tarullo, Federal Reserve Board of Governors, Speech at the Americans for Financial Reform and Economic Policy Institute Conference, Washington, D.C.: Shadow Banking and Systemic Regulation at 11 (Nov. 22, 2013), *available at* <http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.pdf> ("the current regulatory framework does not impose any meaningful regulatory charge on the financial stability risks associated with SFT matched books.").

NSFR balances the LCR's focus on short-term liquidity risk management with a focus on long-term funding, which is achieved by penalizing funding sources below one year and, more severely, funding sources below six months.¹⁰¹ While the LCR is focused on a 30-day stress period and arguably leaves unchanged funding incentives in longer maturity periods, the NSFR applies to the entire one-year funding horizon, just like Method 2.

We are, of course, cognizant of the fact that no single regulatory framework, or perhaps even combination of regulatory frameworks, will fully address any and all risks. Thus, we recognize that some form of STWF factor, and some form of Method 2 more generally, could be motivated from a policy perspective as another prudential layer on top of other regulations in this context. However, we are deeply concerned that the Proposal's methodology and calibration are flawed as they do not appear to take into account the Enhanced Regulatory Framework and should be better tailored and calibrated to the actual risks posed and the considerable progress made by banking organizations—as acknowledged by regulators—to reduce reliance on STWF.¹⁰² A revised STWF factor should also address tensions between regulatory regimes such as the fact that the debt required to comply with TLAC would be penalized under the STWF factor once the remaining maturity is less than one year, despite the difference in risk profile between TLAC debt and STWF. Senior debt issued by banking organizations for TLAC or other purposes has a minimal run and fire-sale risk profile—even in the last year before maturity—relative to other types of funding captured by the STWF and should be eliminated from the calculation of that factor. At a minimum, the STWF factor should be revised to identify more accurately the types of funding that should be treated as STWF and assign more realistic risk weightings to particular types of funding.

In light of the foregoing more general analytical concerns regarding the design of the STWF factor, the Associations believe the following specific aspects and components of the STWF factor should be revised as set forth below.

A. Unsecured wholesale deposits.

The treatment of non-operational unsecured wholesale deposits is inconsistent with the level of run risk and fire-sale risk they pose. Wholesale deposits from other financial intermediaries serve a critical role in the financial system, by allowing banking organizations to “satisfy investor demand for safe and liquid investments, lower[ing] funding costs for borrowers, and support[ing] the functioning of important markets.”¹⁰³ Under the Proposal, however, “unsecured wholesale funding,”¹⁰⁴

¹⁰¹ For example, the NSFR provides 0% available stable funding recognition when banks receive funding of less than six months' maturity from financial institution counterparties, an extremely severe calibration that assumes 100% of such counterparties would eliminate (as soon as contractually possible) all shorter-dated funding.

¹⁰² In a recent speech, Chair Yellen acknowledged that “the Federal Reserve's increased focus on liquidity has contributed to significant increases in firms' liquidity. The high-quality liquid assets held by these eight firms has increased by roughly one-third since 2012, and their reliance on short-term wholesale funding has dropped considerably.” Chair Janet L. Yellen, Speech at the Citizens Budget Commission, “Improving the Oversight of Large Financial Institutions” (March 3, 2015), *available at* <http://www.federalreserve.gov/newsevents/speech/yellen20150303a.htm>.

¹⁰³ Proposing Release at 75,474.

including wholesale deposits, is weighted from 0% to 50% for non-financial sector counterparties and from 25% to 100%, depending on remaining maturity, for financial sector counterparties. We note that all wholesale deposits are already subject to an expense surcharge pursuant to Section 331 of the Dodd-Frank Act, which includes such deposits as part of the “assessment base” for determining an insured depository institution’s premium, even though they are typically far in excess of the insurance cap.¹⁰⁵

Although runs by wholesale creditors in times of stress can trigger asset liquidations that can result in fire-sale externalities, the Proposal’s treatment of these deposits does not reflect the actual run risk associated with these types of deposits or account for significant changes in liquidity regulation since the financial crisis. Empirical study demonstrates that such deposits tend to be sticky—that is, not quickly withdrawn—even, and sometimes especially, during times of market stress when there is a flight to safety. An analysis of wholesale deposit behavior during the 2007–2010 crisis across 12 U.S. banking organizations (including two failed institutions) representing 60% of all wholesale deposits suggests that the run off during crises is considerably lower than regulatory assumptions.¹⁰⁶ Indeed, the median month-on-month run off was 14%, with the highest run off of 38% for non-operational deposits at a failed institution.¹⁰⁷ Given that failure of the two banking organizations occurred prior to significant government intervention, this data is likely a realistic representation of runoff behavior that would be expected during a crisis. As such, non-operational deposits should not be excessively penalized by the GSIB buffer computation.

Deposits that do not tend to run axiomatically carry lower related fire-sale risk. To the extent there remains related fire-sale risk, the LCR lowers the potential systemic impact of such sales by requiring GSIBs to hold substantial HQLA with respect to these deposits to meet these potential short-term funding requirements. Holding HQLA with respect to certain types of funding means, by definition, that, even if such funding is lost, GSIBs will have a significant supply of stable HQLA that can be monetized quickly and without large systemic impacts.¹⁰⁸ Moreover, Section 165 of the Dodd-Frank Act may require GSIBs to hold additional liquid assets above and beyond the LCR mandate to the extent

(footnote continued)

¹⁰⁴ The proposal would also align the definition of “unsecured wholesale funding” with the definition of that term in the LCR rule. Such funding typically includes: wholesale deposits; federal funds purchased; unsecured advances from a public sector entity, sovereign entity, or U.S. government-sponsored enterprise; unsecured notes; bonds, or other unsecured debt securities issued by a GSIB (unless sold exclusively to retail customers or counterparties); brokered deposits from non-retail customers; and any other transaction where an on-balance sheet unsecured credit obligation has been contracted.

¹⁰⁵ 12 U.S.C. § 1817(b). *See also* 76 Fed. Reg. 10,6712 (Feb. 25, 2011); 77 Fed. Reg. 66,000 (Oct. 31, 2012). This premium already serves as a disincentive for institutions to hold these deposits, and thus, in our view, reduces the need for a capital surcharge on the same deposits.

¹⁰⁶ *See* The Clearing House, *The Basel III Liquidity Framework: Impacts and Recommendations* at 4 (Nov. 2, 2011), *available at* <https://www.theclearinghouse.org/~media/files/association%20documents/20111102%20tch%20study%20of%20basel%20iii%20liquidity%20framework.pdf>; The Clearing House, *Assessing the Liquidity Coverage Ratio at 1* (Nov. 2, 2011), *available at* <https://www.theclearinghouse.org/~media/files/association%20documents/20111102%20tch%20study%20of%20basel%20iii%20liquidity%20framework.pdf>.

¹⁰⁷ *Id.*

¹⁰⁸ *See* LCR Release at 61,450.

their particular non-operational wholesale deposits pose idiosyncratic risks as identified under the relevant company-run liquidity stress tests of each subject institution. In addition, the NSFR applies a structure very similar to the LCR, but with a focus on a longer time horizon,¹⁰⁹ to ensure that banking organizations have longer term available stable funding and prudent ALM practices. Under the NSFR, a banking organization is limited in the amount of unsecured wholesale deposits it can use as available stable funding (“ASF”), if any. When the effects of the LCR and the NSFR are considered together, for example, overnight wholesale financial counterparty deposits receive a 100% outflow rate under the LCR, meaning that banking organizations must hold unencumbered HQLA (or inflows) equal to the entire amount of the deposit; under the NSFR, overnight wholesale financial counterparty deposits receive 0% recognition as a funding source. As a result, a banking organization is already unable to “rely” on such deposits—these deposits must be supported by HQLA, which require separate funding support in the NSFR, since the deposits themselves provide 0% ASF. Thus, while these wholesale deposits are not secured as a legal matter in the same manner as a repurchase transaction, they are nevertheless effectively backed by HQLA as a result of the application of the LCR and NSFR for purposes of related fire-sale risk and its impact.

The Proposal also does not recognize that non-operational deposits are held for a variety of different purposes. For example, customers may leave excess, variable deposits with the banking organization as a result of operational servicing relationships, such as a recently closed deal, or a “flight to safety” during market stress. For customer deposits at a custody and trust bank, it would be very difficult as a practical and reputational matter to turn away customer deposits that arise from existing operational servicing relationships. In addition, the banking system is the natural residing place for excess customer deposits during periods of uncertainty, and regulators should not want to disrupt, as a policy matter, that natural flow, either by forcing banking organizations effectively to turn away deposits or diverting funds in a different format to the shadow banking system.¹¹⁰ Furthermore, in many cases, non-operational deposits are redeposited at central banks. Deposits placed at national central banks simply do not lead to the fire-sale risk the STWF factor is meant to address because the banking organization will have ready access to the funds in the event that wholesale counterparties withdraw the deposits at the banking organization. Weightings assigned to non-operational deposits should take into consideration the purpose such deposits serve.

At a minimum, for purposes of the STWF factor, non-operational deposits should receive a weighting under the Proposal’s matrix approach that is no higher than that assigned to SFTs secured by equivalent collateral. Although the Associations believe, for the reasons discussed in Part V.C, that the risk weightings for SFTs are too high, the risk weights for SFTs secured by Level 1 liquid assets would receive a maximum risk weight of 25%, and an SFT backed by Level 2B liquid assets would receive a maximum risk weight of 75%, while the maximum risk weights under the Proposal are 50% for unsecured non-operational deposits to non-financial sector entities and 100% for unsecured non-operational deposits from a financial sector entity. The Federal Reserve should also reconsider this overly punitive approach to the extent that it misaligns capital management incentives with prudent ALM practices.

¹⁰⁹ *Id.*, at 61,445.

¹¹⁰ See *supra* note 54.

Finally, we note our support for the existing exclusion for operational deposits and urge that the exclusion be retained in any final STWF factor. As noted in connection with the LCR, these deposits are inherently sticky because of the difficulties involved in moving the underlying relationship as a practical matter,¹¹¹ and therefore necessarily pose little fire-sale risk.

B. Brokered deposits.

The treatment of brokered deposits should be adjusted (i) to distinguish between affiliate and non-affiliate deposit arrangements in order to reflect the difference in their respective stability profiles in stress periods and (ii) to exclude deposits entirely from the STWF calculation where the Federal Deposit Insurance Corporation (“**FDIC**”) has granted a brokered deposit waiver for purposes of the Federal Deposit Insurance Act. Use of brokered deposits is unique to the United States as a significant funding source for depository institutions. Under the FDIC’s rules, only well-capitalized banking organizations can solicit and accept brokered deposits, which can allow banking organizations to gain access to a larger pool of potential investment funds and improve liquidity. Accepting brokered deposits also enables banking organizations to efficiently source deposits in large denominations in fewer individual transactions. Under the proposed STWF factor, all brokered deposits and brokered sweep deposits provided by a retail customer or counterparty with remaining maturities of 30 days or less (or no maturity) are assigned a 50% weighting, with lower factors applied to term deposits in excess of 30 days, “because these forms of funding have demonstrated significant volatility in times of stress” as they can “be easily moved from one institution to another during times of stress.”¹¹² As a practical matter, we expect that most brokered deposits and brokered sweep deposits at some U.S. GSIBs would become subject to the 50% weighting, which is unjustifiably high. Brokered deposits are an important source of cost-effective and stable funding for many banking organizations that enable them to, in turn, better fund credit needs in the economy.

1. STWF factors for affiliate deposit relationships should be lowered.

Unlike the LCR, the STWF methodology does not distinguish between affiliate and non-affiliate deposit arrangements, which have very different stability profiles during stress periods. As the Federal Reserve and the other U.S. federal banking agencies (collectively, the “**Agencies**”) explained in the LCR preamble:

Affiliated brokered sweep deposits generally exhibit a stability profile associated with retail customers, because the affiliated sweep providers generally have established relationships with the retail customer that in many circumstances include multiple products with both the covered company and the affiliated broker-dealer. Affiliated brokered sweep deposit relationships are usually developed over time. Additionally, the agencies believe that because such deposits are swept by an affiliated

¹¹¹ LCR Release.

¹¹² Proposing Release at 75,487.

company, the affiliated company would be incented to minimize harm to any affiliated depository institution.¹¹³

The stability of affiliated brokered sweep deposits is particularly relevant when a banking organization provides broker-dealer and banking services to retail clients. In moments of market turmoil, retail investors often liquidate securities and move their positions to cash, which are then swept into accounts at the affiliated banking organization, resulting in durable deposits throughout the stress period in the case of fully insured deposits. Accordingly, we recommend that the STWF factors for affiliate deposit relationships be significantly lowered from the current 50% weighting applied to overnight deposits in the Proposal, with the exact calibration to be based on further empirical work. Preliminarily, however, we recommend that the Federal Reserve consider a 10% STWF factor for all affiliate brokered deposit relationships, including both fully and partially insured deposits. A 10% factor may very well be appropriate because it would reflect the significant HQLA reserves held by GSIBs as a result of the LCR and the resulting reduction in liquidity and funding risk.

2. FDIC “brokered deposit” exemption

Brokered deposits that are excluded from the definition under the FDIC’s regulations should not be treated as brokered deposits for purposes of the STWF factor and, therefore, should be excluded from STWF altogether. FDIC regulations define “brokered deposit” as “any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker.”¹¹⁴ The definition of “deposit broker” has been interpreted very broadly by the FDIC.¹¹⁵ Indeed, over the years, the FDIC has expanded the scope of deposits that are considered “brokered”¹¹⁶ and recently issued guidance that potentially further expands the scope of “brokered” deposits beyond what was the general industry understanding.¹¹⁷ In our view, the FDIC’s definition already is overly broad and encompasses deposits that do not pose risks that the STWF is meant to address.

At a minimum, deposits that are not captured by the FDIC’s definition should not be included in the STWF factor. The FDIC has recognized certain categories of exclusions, such that a

¹¹³ LCR Release at 61,493.

¹¹⁴ 12 C.F.R. § 337.6(a)(2).

¹¹⁵ Federal Deposit Insurance Corporation, “Guidance on Identifying, Accepting, and Reporting Brokered Deposits: Frequently Asked Questions” (December 24, 2014), *available at* <https://www.fdic.gov/news/news/financial/2015/fil15002a.pdf>.

¹¹⁶ Federal Deposit Insurance Corporation, “Study on Core Deposits and Brokered Deposits, Submitted to Congress pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act” (July 8, 2011), *available at* <https://www.fdic.gov/regulations/reform/coredeposit-study.pdf> (noting the broad definition of “deposit broker” used in the FDI Act and various considerations taken into account in characterizing deposits as brokered other than the traditional characteristics such as high volatility and high rates).

¹¹⁷ Federal Deposit Insurance Corporation, “Guidance on Identifying, Accepting, and Reporting Brokered Deposits, Frequently Asked Questions” (December 24, 2014), *available at* <https://www.fdic.gov/news/news/financial/2015/fil15002a.pdf> (noting that, “as a result of this broad definition, a brokered deposit may be any deposit accepted by an insured depository institution from or through a third party, such as a person or company or organization other than the owner of the deposit”).

deposit placed by an entity in any excluded category would not be deemed a “brokered deposit” for purposes of FDIC regulation.¹¹⁸ We believe that these recognized exclusions result from an acknowledgment that certain defined categories of deposit relationships have demonstrated a degree of stability such that they do not pose the same policy concerns as brokered deposits generally, and this is particularly the case in light of the already broad definition of brokered deposit used by the FDIC.

The Method 2 STWF factor methodology disregards the distinctions the FDIC has drawn by expanding the category of “brokered deposits” to include “brokered sweep deposits,” which has the effect of including various categories of deposit relationships in Method 2 that would otherwise be excluded under the FDIC regulatory definition. This disregard for FDIC regulatory classifications is inappropriate, especially because the FDIC, in practice, generally reviews the facts and circumstances of any particular deposit arrangement before consenting to its classification in one of the excluded categories, especially in the case of exemptions for affiliate sweep deposits. Accordingly, we recommend that the definition of “brokered deposit” in Method 2 not expand beyond the FDIC’s already broad regulatory standard, including the various designated exception categories, reliance on which would be reflected in a waiver (or similar acknowledgement) from the FDIC.

C. Secured funding transactions

As previously noted in Part II.D above, the Proposal provides remarkably little explanation for the SFT calibrations in the STWF factor other than noting that the definition of “secured funding transaction” aligns with the LCR definition, and that “the proposed weights would progressively decrease as the remaining maturity of a funding transaction increases, and would progressively increase as the quality of the collateral securing a funding transaction decreases.” Apart from this general statement, however, the Proposal does not explain the bases of particular calibrations (for example, 50% weighting for Level 2B secured funding with remaining maturity of 31 to 90 days) or how Method 2 is designed to support liquidity and funding regulation in the LCR and NSFR.

Based on the limited information available in the Proposal, the Associations are concerned that the proposed risk weights for SFTs are flawed in important respects and not properly aligned with other areas of prudential regulation, such as the LCR and the NSFR, that are actually specifically designed to address liquidity and funding concerns. More specifically:

1. Shorter-dated SFTs

In its current form, the STWF factor penalizes all shorter-dated SFTs, regardless of transaction purpose or over-collateralization practices. In addition, we are concerned that the proposed Method 2 SFT calibrations would harm normal course financing transactions that support well-regulated market activity vital to economic growth and stability. Shorter-dated SFTs provide counterparties with the flexibility to adjust funding relationships dynamically in response to changes in their own funding needs and balance sheet management requirements, and over-collateralization practices mitigate fire-

¹¹⁸ 12 C.F.R. § 337.6(a)(5)(ii). Exclusions Include, for example, deposits obtained from a trust department of an insured depository institution, from a trustee of a pension or employee benefit plan fund, a trustee of a testamentary account or irrevocable trust, and an insured depository institution acting as an intermediary or agent of certain U.S. government departments or agencies.

sale risks. SFTs facilitate important normal course transactions for all market participants necessary for the broader economy, such as financing U.S. Treasury securities and high-quality corporate bonds. Method 2 and the STWF calculation effectively penalize GSIBs, as an element of the surcharge, for conducting any volume of shorter-dated SFTs, with STWF weightings ranging from 10% to 100%, depending on the maturity profile, counterparty category, and collateral quality securing the transaction. Shorter-dated SFTs are not *per se* unstable or risky. The relative stability of an SFT relationship depends, among other factors, on the counterparties' reasons for executing the SFT, the extent of over-collateralization, and the role of the SFT in a larger ALM program.

For instance, U.S. states and municipalities execute SFTs with major banking organizations to fund their investment inventories and to invest their cash in short-dated reverse repurchase agreements, which allow them to earn a modest return while retaining flexibility over cash management. A municipality, for example, may decide to invest \$10 million in a 30-day reverse repo with a U.S. GSIB to earn a small return for the municipal treasury (secured by high-quality assets provided by the GSIB) while preserving the ability to utilize the cash for general purposes at the end of 30 days. In substance, this transaction is similar to a collateralized deposit arrangement, with the difference that the municipal treasury may earn a greater return on the reverse repurchase agreement than would be the case through the collateralized deposit. From the banking organization's perspective, this SFT would be a repurchase agreement subject to a 50% weighting in Method 2, which may compel the banking organization to reduce the investment return for the municipal treasury to absorb the incremental capital charge. In this example, however, the purpose of the transaction is primarily to support the client municipal government's cash management program rather than to fund the banking organization's balance sheet.

Likewise, shorter-dated SFTs do not necessarily pose larger fire-sale risks if they are appropriately over-collateralized, a factor ignored by Method 2. The risk profile of a \$100 funding transaction secured by \$101 of collateral is very different than one secured by \$120 of collateral. Although collateralization requirements generally correlate with asset quality (for example, additional collateral is generally required for riskier asset classes), HQLA asset status is not an exact proxy for collateralization practices, since counterparties will dynamically negotiate collateral requirements in response to evolving market conditions and counterparty credit analyses. The STWF factor, however, applies flat capital charges irrespective of over-collateralization practices, missing one of the key risk factors in SFTs.

Finally, a well-run ALM program will include a mix of short-, medium- and long-dated liabilities. A balanced maturity range is necessary to meet day-to-day fluctuations in customer needs while protecting the foundation of a banking organization's funding sources. Liquidity and funding regulation incorporate this principle, at least in part, by recognizing a limited scope of SFT inflow categories (in the LCR) and less than six-month available funding sources (in the NSFR). Method 2, however, flatly penalizes any shorter-dated SFT liabilities, resulting in capital incentives at odds with a well-balanced ALM program.

The Federal Reserve should reconsider the overly punitive approach taken toward shorter-dated SFTs in Method 2 because it does not reflect reasonable collateral risk management practices and misaligns capital management incentives with prudent ALM practices.

2. SFT weightings in Method 2

Although it is difficult to comment meaningfully on the particular weightings assigned to different SFT categories in Method 2 in the absence of a thorough explanation of the calibrations, our preliminary recommendations concerning the calibration of Level 1-secured SFTs and other SFTs are as follows:

a. Level 1-secured SFTs

Method 2 would impose a 25% weighting on Level 1-secured SFTs with a remaining maturity of 30 days or less and a 10% weighting on Level 1-secured SFTs with a remaining maturity of 31 to 90 days. We are concerned that the relative severity of the calibrations could disrupt low-risk, critical market activities of major banking organizations. U.S. GSIBs are among the largest primary dealers in U.S. Treasury securities, holding a combined \$295 billion of such instruments at December 31, 2013. U.S. GSIBs receive and provide financing for large volumes of such securities in short-term markets on a regular basis with virtually no risk, since the securities are direct claims on the U.S. Treasury and fully secure the amount of any financing, as recognized in the Federal Reserve's own discount window standards. The 25% calibration may very well have the effect of reducing primary dealer capacity to support basic liquidity operations in U.S. Treasury securities.

For instance, GSIBs commonly finance these inventories of U.S. Treasuries through shorter-term SFTs, which, in turn, provide SFT counterparties with a small return on the cash investment. These arrangements are extremely stable and resilient, experiencing no significant disruptions in the financial crisis or the U.S. government rating agency downgrade in 2011.

Acting as a primary dealer in sovereign debt securities is generally a high-volume, low-risk, low-return business line, with large transaction volumes matched by relatively small profits. Incremental increases in risk-based capital requirements would further erode U.S. GSIBs' ability to support these markets, which are already under pressure as a result of the ESLR. We respectfully urge that the Federal Reserve consider a much smaller weighting for Level 1-secured SFTs, such as 5%, which would conceptually align with the required stable funding assumption in the NSFR for unencumbered Level 1 assets.

b. Other SFTs

The Associations have found it difficult to evaluate, at this stage, the specific weightings in Method 2 for non-Level 1 SFTs in light of the absence of an explanation for how such calibrations were developed. At a minimum, however, it appears that higher SFT risk-based capital charges would apply generally to all shorter-dated non-Level 1 SFTs, irrespective of transaction purpose, over-collateralization practices, ALM strategies or the effectiveness of more targeted SFT regulatory standards. For the reasons provided above, the SFT calibrations in Method 2 require revision.

D. FHLB advances

Advances from a Federal Home Loan Bank ("FHLB") should be excluded from the STWF factor because the risks of relying on funding from FHLBs are sufficiently addressed under other regulations. FHLB advances serve as an important source of funding that enables banking organizations

to extend credit to finance lending to individuals as well as for various housing and community development projects. Under the Proposal, FHLB advances are treated as SFTs, stating that such funding “generally gives rise to cash outflows during periods of stress because counterparties are more likely to abruptly remove or cease to roll over secured funding transactions as compared to longer-term funding.”¹¹⁹ The proposed risk weights for FHLB advances are, at minimum, unduly high and should, more appropriately, be eliminated. The risk associated with the ability of a banking organization to roll over its transactions at maturity and maintain the associated funding from an FHLB are also already addressed in the context of the LCR, which assigns an outflow rate of 25% for funds from an FHLB that are not secured by Level 1 or Level 2A collateral (with lower outflow rates for funds secured by Level 1 and Level 2A collateral).

The Associations note, however, that in the context of the LCR, the banking agencies sought to adhere to the internationally agreed standards reflected in the Basel LCR framework. In the context of the STWF factor, however—which is itself a fundamental departure from the Basel GSIB Framework—the Federal Reserve need not be tethered to the assessment of FHLBs as counterparties reflected in the Basel LCR framework. Indeed, such a departure is seemingly compelled by the actual record. FHLB advances proved to be a stable source of funding throughout the financial crisis, even at institutions that failed or were acquired under distress.¹²⁰ The Clearing House’s analysis shows that the FHLBs continued to provide liquidity that banks could draw upon during the crisis, increasing its lending to members in every part of the country by more than 50%—or \$300 billion—between the second quarter of 2007 and the third quarter of 2008.¹²¹ Given this stability profile—and concomitant lack of associated fire-sale risk—it would be entirely appropriate for the Federal Reserve to eliminate FHLB advances from the calculation of the STWF factor or, at a minimum, decrease the applicable risk weight in the STWF matrix to better reflect the soundness and stability of this funding source that is unique to the U.S. financial system.

E. Shorts coverage

So-called “short” transactions are not executed for the primary purpose of funding U.S. GSIBs’ balance sheets but to manage market risk and make markets (firm shorts) or facilitate client trading activity (client shorts). The facilitation of firm and client short positions necessarily generates shorter-dated liabilities. Short positions are typically covered by externally borrowed securities in which the bank must pass the proceeds from the short sale to the securities lender as collateral. Accordingly, shorts covered by externally borrowed securities do not provide funding to a banking organization. In other cases, a bank utilizes client assets or firm assets to facilitate the short transaction. In these cases, the bank has control over the closeout of the short (firm shorts) or provides contractual incentives through margin requirements for clients to maintain a balanced portfolio (that is, closing longs and shorts simultaneously) (client shorts). Extending the maturities of banking organizations’ shorts, as

¹¹⁹ Proposing Release at 75,486.

¹²⁰ See The Clearing House, “Assessing the Basel III Net Stable Funding Ratio in the Context of Recent Improvements in Longer-Term Bank Liquidity” (August 2013).

¹²¹ The Clearing House, “The Basel III Liquidity Framework: Impacts and Recommendations” (November 2011), available at <https://www.theclearinghouse.org/~media/files/association%20documents/20111102%20tch%20study%20of%20basel%20iii%20liquidity%20framework.pdf>.

encouraged by the Proposal, would not be feasible because of the purpose behind entering into the transactions in the first place. Accordingly, the Associations respectfully recommend that the treatment of firm and client short positions in Method 2 be modified in the following ways:

- Firm and client shorts supported by external securities borrows should be excluded entirely because they are not STWF; and
- Firm and client shorts supported by internal coverage of other clients' assets or firm assets should receive STWF weightings lower than those proposed and in no case greater than a 25% weighting.

1. Treatment under STWF Factor: Firm and client shorts supported by external securities borrows

Shorts covered by external borrows do not provide funding to the bank executing the short. Consider two banks, Bank A and Bank B, and a scenario in which Bank A lends firm assets to Bank B, in return for cash collateral, for purposes of Bank B's short coverage (either firm or client positions). In this example, the cash proceeds received by Bank A would be deemed a "secured funding transaction" for purposes of Method 2, attracting an STWF capital charge. However, the same short coverage transaction would also give rise to an STWF capital charge for Bank B when Bank B executes the short, either in the form of a "secured funding transaction" (in the case of client shorts) or as funding received from a short position (in the case of firm shorts). The same underlying economic activity—borrowing assets to facilitate shorts—would be counted by both Bank A and Bank B as STWF. But, in economic reality, only one bank (Bank A) is actually receiving funding in this example.

When a bank borrows securities externally to facilitate short coverage, the short transaction is not a funding transaction for the banking organization because the bank must absorb the cost of funding the cash collateral provided to the securities lender. When the bank unwinds the liability, it also unwinds the asset; the bank's own balance sheet is not being funded, and liquidity risk is already correctly captured in the LCR. Accordingly, this category of short transactions should be excluded from Method 2 entirely.

2. Treatment under the STWF Factor: Firm and client shorts supported by internal coverage of other clients' assets or firm assets

In other cases, a bank utilizes other clients' assets or firm assets to facilitate the short transaction. In these cases, there is some residual funding risk if clients or the firm reduce the short position. If the short is removed, the cash proceeds resulting from the short position will no longer be available, creating a potential need to source alternative funding. As a practical matter, however, clients generally do not unwind short positions without concurrently bringing down long positions, because removing only the short positions would lead to extensive margin requirements, which would be expensive for the client but would serve as an alternative source of funding for the bank. As such, any residual funding risk is significantly mitigated by portfolio margining arrangements.

For firm shorts, the banking organization itself sells the security (rather than lend it to the client) and the bank has greater market risk when executing firm shorts (because it is taking a principal position on the market price of the security rather than acting as an intermediary to facilitate

the client position). Accordingly, Method 2 significantly overstates the extent of this funding risk by assigning short coverage transactions the same weightings as SFTs that are actually relied on for funding purposes. As compared with repurchase agreements, the funding risk from internal coverage of short transactions is more indirect, and would arise only in situations where short positions are removed, portfolio margining practices failed to generate sufficient alternative funding, and the bank has a residual need to fund assets previously utilized to cover the short positions. For this reason, we believe that internal coverage short transactions should receive no more than a 25% STWF weighting in Method 2.

F. Covered asset exchanges

The weightings assigned to covered asset exchanges should mirror the approach of the LCR to reflect incremental—rather than absolute—liquidity needs. Covered asset exchanges, as defined in the Proposal, are transactions in which a GSIB provides assets of a given liquidity category in exchange for assets of a higher liquidity category (that is, the level of HQLA assets and non-HQLA assets under the LCR). Under the Proposal, a GSIB must treat as STWF the fair value of an asset that a bank holding company must return under a “covered asset exchange” with a remaining maturity of one year or less. Covered asset exchanges involving the future exchange of a Level 1 asset for a Level 2A asset with a remaining maturity of 30 days are assigned a 50% weight (with lower weightings for longer duration maturities). All other covered asset exchanges with a remaining maturity of 30 days or less are assigned a 75% weighting (with lower weighting for longer duration maturities). As stated in the Proposal, this approach is meant to address the concern that in times of stress, a GSIB may be forced to obtain funding for a less liquid asset or security or because the counterparty is unwilling to roll over the transaction.¹²²

This proposed treatment of covered asset exchanges assigns excessive risk weights given the incremental nature of the liquidity need. In practice, a GSIB that has received an asset in a covered asset exchange already will be financing the asset, and thus the asset exchange gives rise only to an incremental funding need. For example, using the weightings reflected in the Proposal, which, as discussed, we believe are too high in many cases, assuming a transaction with a remaining maturity of 30 days or less where the GSIB has posted a Level 2A liquid asset and will receive a Level 1 liquid asset, instead of a weighting of 50%, the weighting should be 25%—the difference between the weighting assigned to the covered asset exchange and the weighting assigned to the secured funding transaction secured by a Level 1 liquid asset. The LCR, in contrast to the Proposal, assigns an outflow rate for covered asset exchanges based on the incremental liquidity need. Under the LCR, the incremental need is reflected in the percentage of the fair value of the asset that is treated as the outflow amount for each type of asset exchange.

Failing to reflect the incremental nature of the liquidity need associated with this source of funding would result in requiring excess capital and thus, a contraction in available credit. The Proposal does not offer publicly available analytical or empirical support for the absolute nature of its calibration for covered asset exchanges. To reflect the fact that the asset exchange will give rise only to an incremental funding need, the Associations recommend that the weightings for covered asset

¹²² 79 Fed. Reg. 75,473, at 75,487.

exchanges be modified to reflect only the increment, which would align with the approach taken in the LCR for asset exchanges.

G. Cleared transactions

The Proposal should exclude SFTs cleared through qualifying CCPs (“QCCPs”) from a U.S. GSIB’s calculation of its STWF indicator score in order to reflect the lower systemic risk posed by cleared transactions. Such an exclusion under Method 2 would reflect the risk-reducing nature of central clearing and support important policy objectives of increasing central clearing as reflected by Title VII of the Dodd-Frank Act.¹²³ Increased use of central clearing will reduce systemic risk by interposing the CCP between SFT counterparties, becoming the “buyer to every seller and seller to every buyer.”¹²⁴ As noted by the Bank for International Settlements, “[d]epending on the adequacy of their risk management, [CCPs] can play an important role in helping financial institutions manage their counterparty risk in repo markets.”¹²⁵ For these reasons, the Basel Committee’s large exposure framework exempts banking organizations’ exposures to QCCPs on a provisional basis while it considers the appropriateness of a large exposure limit for exposures to QCCPs.¹²⁶ The Associations urge the Federal Reserve to take consistent action and exclude SFTs cleared through a QCCP from the calculation of the STWF factor to account for the risk mitigation achieved by central clearing and to support, and be consistent with, the policy objective of incentivizing the movement of such transactions to central clearing.

At a minimum, the Proposal should meaningfully reduce the weight otherwise assigned to SFTs if cleared through a QCCP.¹²⁷ Under the Proposal, risk weights assigned to SFTs are not

¹²³ Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies, 77 Fed. Reg. 41,602, 41,603 (July 13, 2012) (“Title VII [of the Dodd-Frank Act] was designed to provide greater certainty that, wherever possible and appropriate, swap and security-based swap contracts formerly traded exclusively in the OTC market are centrally cleared.”); Report of the Senate Committee on Banking, Housing, and Urban Affairs regarding The Restoring American Financial Stability Act of 2010, S. Rep. No. 111–176 at 34; 156 Cong. Rec. S-6192 (daily ed. July 22, 2010) (letter from Sen. Dodd and Sen. Lincoln to Rep. Frank and Rep. Peterson).

¹²⁴ Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, “Consultative Report: Recommendations for Central Counterparties” (March 2004), available at <http://www.bis.org/cpmi/publ/d61.pdf> (“CCPs have long been used by derivatives exchanges and a few securities exchanges and trading systems. In recent years they have been introduced by many more securities exchanges and have begun to provide their services to over-the-counter markets, including markets for securities repurchase agreements and derivatives.”).

¹²⁵ Bank for International Settlements, Strengthening repo clearing and settlement arrangements at 1 (September 2010), available at <http://www.bis.org/cpmi/publ/d91.pdf>.

¹²⁶ Basel Committee on Banking Supervision, Supervisory framework for measuring and controlling large exposures at 15 (April 2014), available at <http://www.bis.org/publ/bcbs283.pdf>.

¹²⁷ A QCCP is a licensed CCP that is permitted by the appropriate regulator to operate as such, subject to the requirement that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator has established (and publicly indicated that it applies to the CCP on an ongoing basis) domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures. Basel Committee on Banking Supervision, *Capital requirements for bank exposures to central counterparties* (April 2014), available at <http://www.bis.org/publ/bcbs282.pdf>.

differentiated based on whether or not they are cleared through QCCPs, in spite of the vastly different counterparty risks posed by cleared versus non-cleared SFTs. The Proposal does not explain this lack of differentiation based on the systemic risk posed, thus assigning unjustifiably high risk weights for SFTs cleared through QCCPs. Using a QCCP that is subject to heightened supervision and risk management requirements in place of bilateral settlement mitigates counterparty risk and provides an increased range of funding counterparties.¹²⁸ The FSB's shadow banking framework exempts centrally cleared SFTs,¹²⁹ presumably on the basis of lower risk and support for the objective of promoting central clearing.¹³⁰ Failure to recognize this difference in systemic risk threatens to undermine the policy objective of promoting central clearing.¹³¹

In light of these risk-mitigating factors, the Proposal's weighting of cleared SFTs should be reduced by 20% relative to the general secured funding weights in order to preserve incentives for central clearing using QCCPs. This treatment would appropriately reflect the risk mitigation achieved by central clearing and support the policy objective of incentivizing the use of central clearing for such transactions.

H. HQLA Adjustment

As an alternative to the foregoing recommendations regarding STWF factors, the STWF calculation should be adjusted to explicitly take into account the amount of HQLA that a firm holds with respect to such transactions. As noted above, firms are currently holding significant amounts of HQLA in order to maintain sufficient liquidity during a severe stress scenario, as prescribed under existing regulations. This HQLA, by design, minimizes materially the likelihood that a firm would need to liquidate non-HQLA collateral in the event of a run on such firm, and is one of the cornerstones of the Basel III reforms.

An HQLA adjustment could be transparently structured by reducing the amount of STWF in the numerator by the amount of HQLA held by the firm relating to STWF, after the application of the

¹²⁸ Governor Jerome H. Powell, Speech at the Stern School of Business, New York University, New York, NY: Financial Institutions, Financial Markets, and Financial Stability at 5 (Feb. 18, 2015), *available at* <http://www.federalreserve.gov/newsevents/speech/powell20150218a.pdf> ("Central clearing holds the promise of enhancing financial stability through the netting of counterparty risks, creating greater transparency, and applying stronger and more consistent risk-management practices.").

¹²⁹ Financial Stability Board, "Strengthening Oversight and Regulation of Shadow Banking—Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions" (October 14, 2014) *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141013a.pdf.

¹³⁰ Financial Stability Board, Strengthening Oversight and Regulation of Shadow Banking at 17 (29 Aug. 2013), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141013a.pdf (noting, in its discussion of centrally cleared SFTs, that "there may be a case for welcoming the establishment and wider use of CCPs for inter-dealer repos against safe collateral (i.e., government securities) for financial stability purposes," though the FSB noted that the market appears to already be moving towards increased use of centrally cleared SFTs, adding that "existing incentives to use CCPs in these markets seem sufficiently strong (e.g., balance sheet netting) and no further regulatory or other actions appear necessary.").

¹³¹ *Id.*

standard LCR haircuts. For example, if a firm's weighted STWF score is 200 and the firm held 30 of Level 1 HQLA and 10 of Level 2A HQLA in respect of STWF transactions, the STWF score would be reduced from 200 to 161.5.¹³² Such an adjustment would have a number of advantages. First, it would better align the Proposal with the other elements of the Enhanced Regulatory Framework, an area that regulators internationally have signaled will be a focus in coming years.¹³³ Second, it would allow for differentiation between firms that might have the same weighted levels of STWF but differ in their risk profile due to the overall amount of HQLA held by such firms. For example, consider two firms with an identical STWF score of 200, one of which holds 50 of HQLA and one of which holds 100. The second firm would have much greater capacity to meet outflows through central bank deposits and high quality, liquid securities than the first firm, but, absent an HQLA adjustment, the two would be treated identically for capital calculation purposes. Third, because the STWF component is intended to be calculated by data provided on a firm's 2052a report, where firms will also report their HQLA amounts, it would likely be a simple adjustment to introduce.

Finally, while this concept is focused on the amount of HQLA that firms hold, fire-sale risk would also be affected by the amount of long-term funding a firm has relative to its short-term funding. Forthcoming rulemaking in the United States to implement the NSFR and TLAC likely will also cause U.S. GSIBs to hold longer-term debt. We recommend that the Federal Reserve consider the impact of these proposals on the STWF calculation and reduce the charge under that factor once they are implemented.

VI. Neither the GSIB buffer, nor the capital conservation buffer, should be included as part of any required post-stress minimums under CCAR, the Capital Plan Rule or DFAST-related stress testing frameworks.

The Associations note, with the utmost concern, the Proposal's statement that the Federal Reserve "will be analyzing in the coming year whether the . . . capital plan and stress test rules should also include a form of GSIB surcharge."¹³⁴ Although we recognize that, "[i]f the [Federal Reserve] were to decide to propose a GSIB surcharge for the capital plan and stress test rules at a later date, the [Federal Reserve] would do so through a separate notice of proposed rulemaking,"¹³⁵ we nonetheless believe it is essential to address this issue in this letter in light of the significance of the interaction between capital buffers and stress testing requirements under CCAR,¹³⁶ the Federal Reserve's Capital Plan Rule,¹³⁷ and the other stress testing provisions implemented pursuant to Section 165(i) of the

¹³² There may need to be some adjustments to take into account HQLA held for outflows that are not captured as part of the STWF calculation (e.g., retail funding and commitment outflows). This could be accommodated either through an overall cap or haircut on the HQLA adjustment or by reducing the amount of the HQLA adjustment to reflect such amounts (which would be easily derivable from the 2052a).

¹³³ See, e.g., Liquidity matters—speech by Dame Clara Furse (11 February 2015), available at <http://www.bankofengland.co.uk/publications/Pages/speeches/2015/796.aspx>.

¹³⁴ Proposing Release at 75,482.

¹³⁵ *Id.*

¹³⁶ See 12 C.F.R. 225.52, Subpart F.

¹³⁷ See 12 C.F.R. 225.8.

Dodd-Frank Act.¹³⁸ Including the applicable GSIB surcharge as part of the required minimums under CCAR and related stress testing frameworks would ignore the fact that GSIBs are already subject to significantly more stringent CCAR requirements and would be fundamentally incompatible with the objectives of CCAR and the inherent character of the GSIB surcharge as a capital buffer under the Revised Capital Rules.¹³⁹

First, incorporating the GSIB surcharge into CCAR post-stress minimums would be unnecessarily duplicative, given the fact that GSIBs are already subject to a more stringent version of the standard CCAR stress test in the form of the global market shock (in the case of the six GSIBs with large trading operations) and the counterparty default scenario.¹⁴⁰ The ostensible purpose of the GSIB surcharge methodology is to measure the systemic importance—and hence expected impact of GSIB failure—based on the chosen indicators for size, interconnectedness, cross-jurisdictional activity, complexity and substitutability (or STWF, under Method 2), and derive the amount of capital necessary such that the expected impact of failure of a GSIB and a non-GSIB would be the same. The assets measured by these systemic indicators are largely those that will experience significant loss of value under the CCAR global market shock and large counterparty failure additions to the severely adverse supervisory scenario—including, in particular, trading assets measured by the complexity and interconnectedness indicators. Because losses associated with these two CCAR components are exogenous to the macroeconomic and financial market environment otherwise specified in the severely adverse supervisory scenario—that is, they represent an addition to the estimates of losses under the macroeconomic scenario—and because they are specifically applied to GSIBs, these banking organizations are already subject to additional constraints tailored specifically to them under the CCAR exercise. Thus, as currently constructed, CCAR requires a GSIB to emerge as a viable going concern from the combination of a severely adverse macroeconomic stress scenario, a large counterparty default scenario, and a global market shock scenario, as applicable, at the same level of capital as a non-GSIB would emerge from the severely adverse macroeconomic stress scenario alone. As such, incorporating the GSIB surcharge into required post-stress minimums would effectively ignore the fact that GSIBs are already subject to more stringent stress testing requirements to begin with.

Second, the stated purpose of CCAR is to ensure that GSIBs and other subject banking organizations “have sufficient capital to withstand a highly stressful operating environment and be able to continue operations, maintain ready access to funding, meet obligations to creditors and counterparties, and serve as credit intermediaries.”¹⁴¹ Thus, the focus of CCAR is ensuring that GSIBs have sufficient going-concern capital to continue their functions *after* giving effect to the combination of CCAR supervisory scenarios. The incorporation of the GSIB surcharge into post-stress minimum requirements would undeniably result in GSIBs holding capital well in excess of minimum regulatory capital requirements on a *pro forma* basis even after taking into account the additive stressed scenarios. We do not believe that this is required or appropriate because a GSIB that meets minimum regulatory capital requirements is, by definition, a viable going concern, as the Basel Committee noted in its final

¹³⁸ See, e.g., 12 C.F.R. 225.52, Subpart G.

¹³⁹ See 12 C.F.R. 217 *et seq.*

¹⁴⁰ CCAR 2015 Instructions, at 11-12.

¹⁴¹ CCAR 2015 Instructions, at 1.

Basel III framework—“banks will be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses. The constraints imposed only relate to distributions, not the operation of the bank.”¹⁴² Thus, the purpose of CCAR is fully achieved by ensuring that GSIBs “maintain capital levels above each minimum regulatory capital ratio and above a tier 1 common ratio of 5%, after making all capital actions included in their capital plans . . .”¹⁴³ without the addition of the GSIB surcharge or other capital buffers. While the Associations recognize that supervisors may, as a prudential matter, want to ensure that GSIBs hold capital in excess of required minimums, this function is already served by CCAR and the Capital Plan Rule themselves, which test regulatory capital after the application of a combination of extremely severe scenarios all occurring at the same time. Moreover, CCAR and the Capital Plan Rule are also not designed to ensure gone-concern capital—that function is left to TLAC.¹⁴⁴ As discussed above, it is imperative for the Federal Reserve to consider the aggregate impact of its Enhanced Regulatory Framework (see Part II.C, above). Therefore, the incorporation of the GSIB surcharge and other capital buffers into required post-stress minimums is incompatible with the express purpose of CCAR of ensuring post-stress going-concern viability.

Third, incorporating the GSIB surcharge, or the capital conservation buffer for that matter, into the required post-stress minimums under CCAR and the Capital Plan Rule would require banking organizations to effectively hold large amounts of capital in excess of regulatory minimums plus buffers in order to avoid having to dip into the buffers in the very circumstances buffers are meant to be used. Under the Proposal, the GSIB surcharge “would become an extension of the GSIB’s capital conservation buffer”¹⁴⁵ and “would expand each quartile of a GSIB’s capital conservation buffer by the equivalent of one fourth of the GSIB surcharge.”¹⁴⁶ As such, the GSIB surcharge serves to “augment”¹⁴⁷ the Revised Capital Rule’s capital conservation buffer.¹⁴⁸ The capital conservation buffer was introduced to mitigate concerns regarding the pro-cyclical nature of capital requirements and designed to “bolster the resilience of banking organizations throughout financial cycles.”¹⁴⁹ Treating part of the buffer as a minimum would necessarily increase pro-cyclicality by removing subject banking organizations’ ability to dip into buffers under stressed circumstances—and simultaneously limiting capital distributions¹⁵⁰—as a

¹⁴² Basel III, at ¶ 129.

¹⁴³ CCAR 2015 Instructions, at 3.

¹⁴⁴ See Financial Stability Board, “Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution,” November 10, 2014, available at <http://www.financialstabilityboard.org/2014/11/adequacy-of-loss-absorbing-capacity-of-global-systemically-important-banks-in-resolution/>.

¹⁴⁵ Proposing Release at 75,482.

¹⁴⁶ Proposing Release at 75,481.

¹⁴⁷ *Id.*

¹⁴⁸ See 12 C.F.R. 217.11.

¹⁴⁹ Federal Reserve System, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 at 52,803.

¹⁵⁰ Indeed, the only consequence for breaching the capital conservation buffer (as extended by the GSIB surcharge) is the imposition of “increasingly stringent limits on capital distributions and certain discretionary
(footnote continued)

way to continue to provide needed credit intermediation in difficult macroeconomic environments while maintaining necessary going-concern capital. As the Agencies have previously recognized, capital buffers are “designed to absorb losses in stressful periods . . .” and a banking organization “must be able to use some of its capital conservation buffer”¹⁵¹ without breaching regulatory capital minimums. Incorporating the GSIB surcharge into the Federal Reserve’s stress testing framework, including, most significantly, for purposes of the required post-stress minimums under CCAR and the Capital Plan Rule, is contrary to the basic notion that buffers can and should be used during times of stress. This approach to capital buffers is fully consistent with the Basel Committee’s view that “a buffer can be seen as an amount sufficient for the bank to withstand a significant downturn period and still remain above minimum regulatory levels.”¹⁵² CCAR and the Capital Plan Rule are designed to specifically test the set of circumstances where the hypothetical “significant downturn” has occurred and the buffers would already have been effectively put to use as a result.

Fourth, the incorporation of the GSIB buffer in post-stress minimums under the Capital Plan Rule, CCAR and the other requirements of DFAST would be inconsistent with the stated justification for the Proposal. The Federal Reserve states that the GSIB surcharge is meant to “reduce a GSIB’s probability of default such that a GSIB’s expected systemic impact is approximately equal to that of a large, non-systemic bank holding company.”¹⁵³ Thus, the basic issue that the surcharge is trying to address is the expected impact of GSIB failure, as determined by the probability of the failure of GSIBs and the systemic impact of any such failure were it to occur. Avoiding such a default under stressed conditions is, by definition, a function of such banking organization’s not falling below required *minimum* capital ratios and not the capital levels that would be required for a banking institution to emerge with capital buffers fully intact from a hypothetical severely adverse macroeconomic scenario and related market shock and counterparty default.

In addition, the possible incorporation of the GSIB surcharge into post-stress minimums also suffers from other conceptual flaws. As stress tests, the Capital Plan Rule and CCAR appropriately and implicitly give value to diversification insofar as different asset classes will likely perform differently depending on the stress scenario. Including the GSIB surcharge would therefore appear incompatible with asset diversification, as the surcharge methodology is a largely blunt instrument which focuses on the size of the balance sheet without regard to how different types of risk-weighted assets may perform under stressful conditions. Furthermore, the size, substitutability, interconnectedness, complexity and

(footnote continued)

bonus payments as the banking organization’s buffer falls below specified thresholds.” Proposing Release at 75,476.

¹⁵¹ 72 Fed. Reg. at 62,041.

¹⁵² Basel Committee on Banking Supervision, “Calibrating regulatory minimum capital requirements and capital buffers: a top-down approach” (October 2010), at 1. *See also* Basel Committee on Banking Supervision, “Strengthening the Resilience of the Banking Sector,” (December 2009) (the capital conservation buffer “. . . 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.”). Furthermore, the HQLA required by the LCR “can be used in acute liquidity stress events without adversely affecting the broader financial system and economy.” LCR Release at 61,451.

¹⁵³ Proposing Release at 75,475.

cross-jurisdictional activity factors have little or no independent relevance when it comes to CCAR and Capital Plan Rule stress testing, which instead focus on “the estimates of [pre-provisioning net revenues] and losses under the macroeconomic scenario” based on the institution’s asset mix.¹⁵⁴

Finally, although additional capital above the minimum requirement is not necessary for a banking organization to remain viable, a banking organization must maintain adequate liquidity to do so because there is a liquidity component to viability. For a banking organization to remain viable, it must have enough HQLA to “face the market” and meet its near-term obligations, while capital serves to absorb unexpected losses and permit the banking organization to remain solvent. Liquidity required to ensure viability is already addressed under the LCR’s requirement that subject banking organizations hold levels of liquid assets sufficient to protect against constraints on their funding during times of extreme stress in the financial markets. Holding incremental capital beyond minimum requirements is far less important in terms of going-concern viability than compliance with the liquidity frameworks of the LCR and the NSFR.

VII. Other Issues

A. **The Proposal should make appropriate adjustments for any differences in data reporting across jurisdictions to ensure cross-jurisdictional comparability.**

The surcharge imposed under the Proposal is, with the exception of the STWF factor, based on a market share test—thus, based on a particular numerator and a common denominator for each banking organization. Such a market share-based test must use a numerator and a denominator that are calculated in the same way using standard inputs. The majority of the large banking organizations comprising the denominator, however, are non-U.S. banking organizations, reporting under regimes different from the FR Y-15. This presents the risk of inconsistent treatment and competitive disadvantage beyond that already presented by other aspects of the Proposal. In the Proposal, the Federal Reserve notes that it intends to propose modifications to the FR Y-15 to include disclosure of bank holding companies’ systemic indicator scores and information pertaining to GSIBs’ short-term wholesale funding scores, as calculated under the Proposal. We strongly support republishing the FR Y-15 for comment to allow the reporting form to be appropriately integrated into the final rule on a consistent basis. We also recognize that in many cases, the language in the FR Y-15 mirrors that in the Basel Committee’s reporting templates, and therefore urge the Federal Reserve to seek a re-proposal by the Basel Committee as well.¹⁵⁵

The calculation of the denominator for those large global banking organizations in the denominator that are non-U.S. banking organizations raises significant issues, however. As the Proposal notes, foreign banks report data to the Basel Committee, and the Basel Committee then publishes an aggregate number for each of the Method 1 factors. The Proposal provides no information regarding

¹⁵⁴ CCAR 2015 Instructions, at 12.

¹⁵⁵ Reporting Forms, FR Y-15: Banking Organization Systemic Risk Report, *available at* <http://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYJ+5BzDaRHakir9P9vg==>. *See also* Basel Committee, Global systemically important banks: Assessment methodology and the additional loss absorbency requirement (January 30, 2015), *available at* <https://www.bis.org/bcbs/gsib/>.

how the other countries' banking regulators require their banking organizations to report this data—that is, how those countries have adopted, modified or interpreted the original Basel Committee templates. For example, it is entirely unclear whether foreign banks are reporting derivatives notionals in the same way that U.S. banking organizations are required to report in the FR Y-15. It is likely the case that across all the factors and relevant countries, there is considerable variation in how this data is collected and reported by non-U.S. banking organizations. As a result, there is a material risk that the GSIB surcharge as proposed may utilize a numerator for U.S. GSIBs that is calculated on an entirely different basis from the global denominator.

We are not aware of any precedent involving a U.S. regulatory capital requirement—or any other U.S. bank regulatory requirement more broadly—that is calculated and imposed based on estimates compiled by foreign regulators. At the very least, we believe that, before the Proposal is finalized, the Federal Reserve should review the reporting rules under which foreign banks report their systemic risk data and publish for comment an analysis of how those rules compare to U.S. rules—either in conjunction with the FR Y-15 rulemaking or otherwise. Prior to finalizing this rule, the Federal Reserve should consider how data items are being reported by the non-U.S. banking organizations in the denominator, determine whether they are consistent with the U.S. reporting rules for the numerator and make an appropriate adjustment for any differences.

B. The Federal Reserve should resolve other significant reporting uncertainties to ensure the framework is credible and transparent.

As part of this review, we urge the Federal Reserve to address the following anomalies in the reporting framework. Without changes that address these significant drawbacks, banking organizations will not be able to forecast the denominator for the GSIB surcharge calculation for estimation and planning purposes.

- The individual banking organizations included in the denominator for the surcharge calculation are unknown. In addition to the 75 largest banks identified by the Basel Committee, the denominator could include banks that were designated as GSIBs in the previous year (unless supervisors agree that there is a compelling reason to exclude them) and banks that have been added to the sample using supervisory judgment.¹⁵⁶ Because not all jurisdictions have imposed reporting requirements (or perhaps not all banking organizations in a jurisdiction must comply with the requirement), it is not currently possible to determine the individual banks, and the Basel Committee discloses only the total reported figure for the denominator, without identifying the individual banks comprising the sample. As such, there is currently no known system of checks on this process or procedures by which the calculation can be evaluated in terms of its design or operational effectiveness.
- It is unprecedented in our experience that a major piece of U.S. regulation which would significantly increase the capital requirements for some U.S. banking organizations is, in

¹⁵⁶ Basel Committee, "Global systemically important banks: Updated assessment methodology and the higher loss absorbency requirement" (July 2013), *available at* www.bis.org/publ/bcbs255.htm.

large part, explicitly based on non-public data and templates concerning an undisclosed set of foreign banks, without any of the procedural and substantive safeguards of the Administrative Procedure Act. To ensure transparency and credibility, the Federal Reserve should delay finalizing the Proposal until the composition of the denominator is clear and accessible to the public.

- Timing of disclosure varies widely across jurisdictions, including in the United States. The Basel Committee requires disclosure of the systemic risk data used to calculate the surcharge denominator “no later than four months after the financial year-end—and, in any case, no later than end-July.”¹⁵⁷ This would, for instance, appear to require banks with a December 31 fiscal year-end to report by April 30, and banks with a March 31 year-end to report by July 31. However, many subject banking organizations and their national regulators interpret the July 31 date as a “drop-dead” date and delay disclosure until that date regardless of fiscal year-end.¹⁵⁸ The significant gap in time between the July 31 submission date and the publication of the denominator in November suggests that reports initially submitted require additional attention to resolve issues with reported data, which further underscores our concerns with the consistency, transparency and, ultimately, the reliability of the data reported by banks composing the denominator.
- It is unclear how restatements of reported data flow into the denominator calculated by the Basel Committee. When a banking organization restates the systemic risk data required to calculate the denominator, it is unclear how the information flows to the Basel Committee for the purposes of aggregation and denominator calculation are designed and controlled.¹⁵⁹ Furthermore, it is unclear whether reported amounts that are sourced from other regulatory filings will be automatically updated if the underlying regulatory report is restated.¹⁶⁰

¹⁵⁷ Basel Committee, “Global systemically important banks: Updated assessment methodology and the higher loss absorbency requirement” (July 2013), *available at* www.bis.org/publ/bcbs255.htm.

¹⁵⁸ Eleven of the European Union GSIBs with year-ends of December 31 disclosed around July 31, as did another eight European Union institutions that were likely included in the industry denominator; others reported as late as September.

¹⁵⁹ The relevant Basel Committee guidance merely provides that “should the disclosed data be revised, national supervisors must submit the revisions to the BCBS prior to the final submission deadline (generally around 1 August) in order for the changes to be included in the official score calculation. If the data are amended after the final deadline, banks should ensure that the values used in the official calculation remain publicly available.” Basel Committee on Banking Supervision, “The G-SIB assessment methodology—score calculation” (November 2014), *available at* <http://www.bis.org/bcbs/publ/d296.pdf>.

¹⁶⁰ For example, FR Y-15 amounts for cross-jurisdictional claims for U.S. GSIBs are sourced directly from the FFIEC 009 report, which upon restatement will automatically restate the amount in the FR Y-15. Whether or how the restated amount would flow into the data reported to the Basel Committee is unknown. Assuming that a banking organization restated its systemic risk data in the FR Y-15 after the Basel Committee’s disclosure of the denominator in November of a given year, if the restatement were large enough to move the bank into a different surcharge bucket, it is unclear whether the GSIB would automatically become subject to a different surcharge as a result of the restatement. Likewise, assuming that a non-U.S. GSIB restated the data impacting

(footnote continued)

In light of these significant shortcomings of the current reporting framework, forecasting the denominator for the GSIB surcharge calculation for estimation and planning purposes is exceedingly difficult. A variety of factors may alter year-over-year changes in a given GSIB's surcharge, including rule changes, attempts to manage the surcharge, interpretive issues, and other issues. Without comparative disclosure of year-over-year changes and accompanying explanations, subject banking organizations will be required to speculate as to potential drivers of year-over-year changes in the denominator. This inherent uncertainty makes long-range forecasting for operational planning purposes difficult.

* * *

The Associations appreciate the opportunity to provide comments on the Proposed Rule. We greatly appreciate your consideration of our comments and would welcome the opportunity to discuss them further with you at your convenience. If we can facilitate arranging for those discussions, or if you have any questions or need further information, please contact David Wagner at (212) 613-9883 (email: david.wagner@theclearinghouse.org), Ken Bentsen at (202) 962-7400 (email: kbentsen@sifma.org), or Richard Foster at (202) 589-2424 (Richard.Foster@FSRoundtable.org).

Respectfully Submitted,



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The Clearing House Association L.L.C.



Kenneth E. Bentsen, Jr.
President & CEO
Securities Industry and Financial Markets Association

(footnote continued)

the aggregate denominator such that the surcharge bucket for a U.S. GSIB changed as result, it is unclear whether the U.S. GSIB would automatically become subject to the different surcharge.



Rich Foster
Senior Vice President & Senior Counsel for
Regulatory and Legal Affairs
Financial Services Roundtable

cc: The Honorable Janet L. Yellen
Board of Governors of the Federal Reserve System

The Honorable Stanley Fischer
Board of Governors of the Federal Reserve System

The Honorable Daniel K. Tarullo
Board of Governors of the Federal Reserve System

The Honorable Jerome H. Powell
Board of Governors of the Federal Reserve System

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ANNEX A

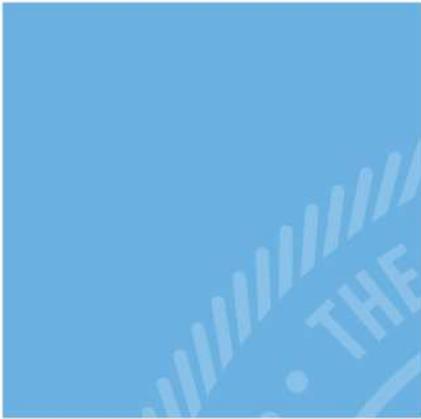
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GSIB Capital Surcharge Sensitivity to Foreign Exchange (“FX”) Rates

April 2, 2015



Summary

Context

- **A GSIB's systemic indicator score ("systemic score")** is calculated each year using various systemic indicators contained in the Proposal
 - **The numerator** for the calculation is based on an individual GSIB's data
 - **The denominator** for the calculation is based on the aggregate of the 'Top 75' global banks (as defined by the Basel Committee), which have been converted to a common Euro currency
- **FX rates can affect the systemic score** in the calculation of both the numerator and the denominator, where appreciation of a bank's currency (e.g., USD) relative to a common currency (e.g., EUR) would lead to a higher systemic score and depreciation of the currency would lead to a lower systemic score
- **Under the methodology contained in the Proposal, FX rates are calculated using a 'spot rate'** (calculated on 12/31 of each year)
- **'Spot rate' movements can have a significant effect on a GSIB's systemic score:**
 - Since the inception of the Euro, 'spot rates' have increased by as much as 14% and decreased by as much as 17% over a one-year period
 - If these FX fluctuations are applied to a GSIB's systemic score, the impact on the systemic score can be as great as -9.8% to +9.0%

Proposed solution

- **We propose using a 5-year rolling average of FX rates to reduce the year-to-year volatility in systemic scores**
 - The 5-year rolling average can be calculated by taking the straight average of the daily FX spot rates from the 5-years prior to the calculation date

Methodology

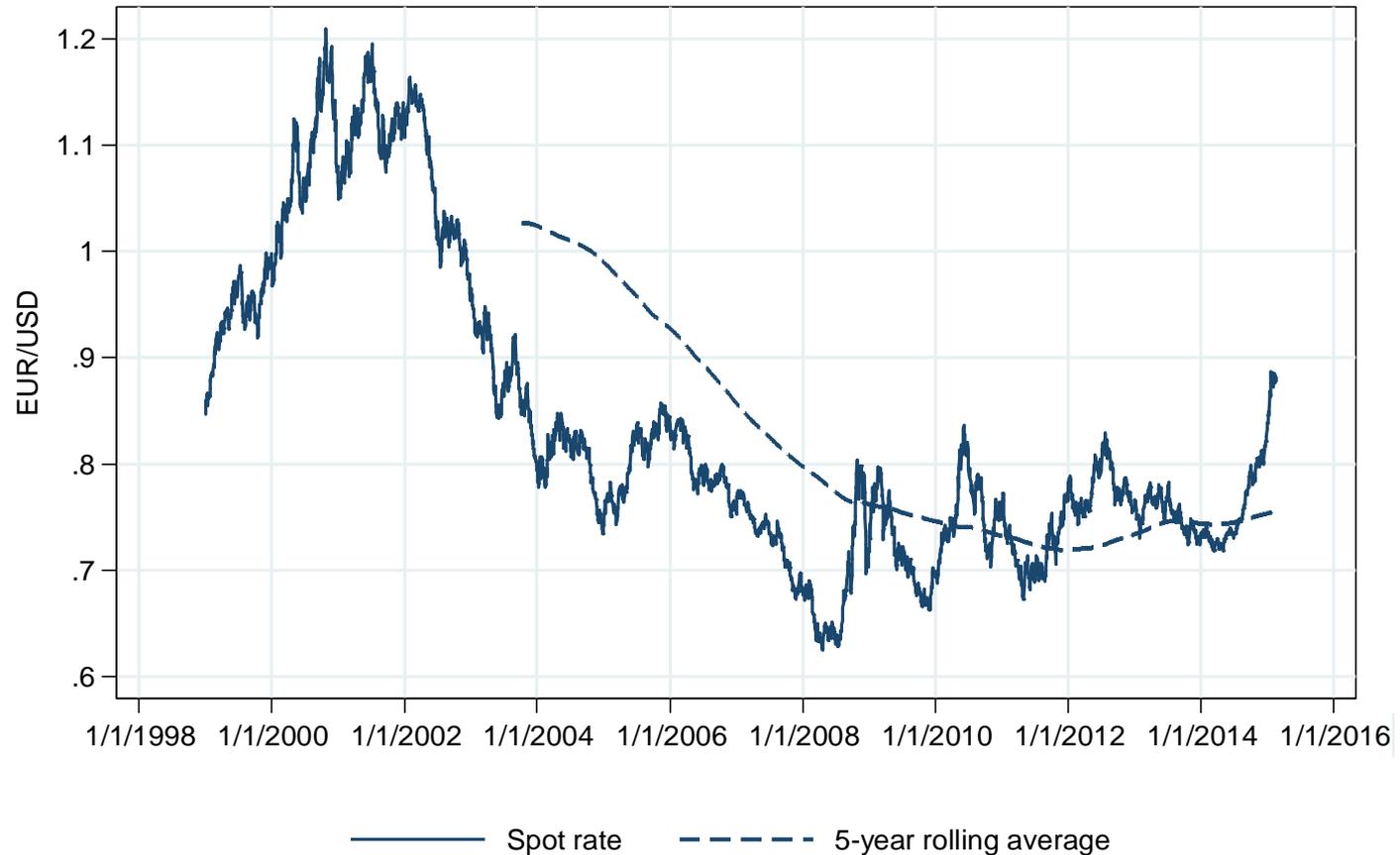
Approach for calculating the systemic score

- All analyses are shown as the aggregated systemic score for the 8 U.S. GSIBs, which is the average of the 8 individual GSIB systemic scores, weighted by total exposures
- For all FX analyses, only fluctuations between USD and EUR were considered, and the FX impact from other currencies (e.g., CNY, JPY) was not accounted for
- We assumed that all bank holdings are entirely in the currency of their home country and did not account for the fact that banks may have holdings in other currencies that would also be impacted by FX volatility
- **Method 1:**
 - Estimated systemic scores for the 8 U.S. GSIBs using the GSIB Method 1 formula in the Proposal
- **Method 2:**
 - Estimated systemic scores for the 8 U.S. GSIBs using the GSIB Method 2 formula in the Proposal
 - The STWF indicator of the score was approximated using internal bank data pulled from a single point in time from 2013-2014 (dependent on the bank), which is representative of the average STWF held by the U.S. GSIBs in 2013
- **FX:**
 - In order to account for the impact of FX on systemic scores, we applied the relevant FX rate to the numerator and the proportion of the denominator attributable to U.S. banks
 - To approximate the proportion of U.S. banks to the 'Top 75' banks in the denominator, we assumed the proportion of 8 U.S. GSIB assets to the assets of the 30 global GSIBs (approximately ~22% as of 12/31/2013) to be the same proportion of U.S. banks to the 'Top 75' banks in the denominator

Data and sources

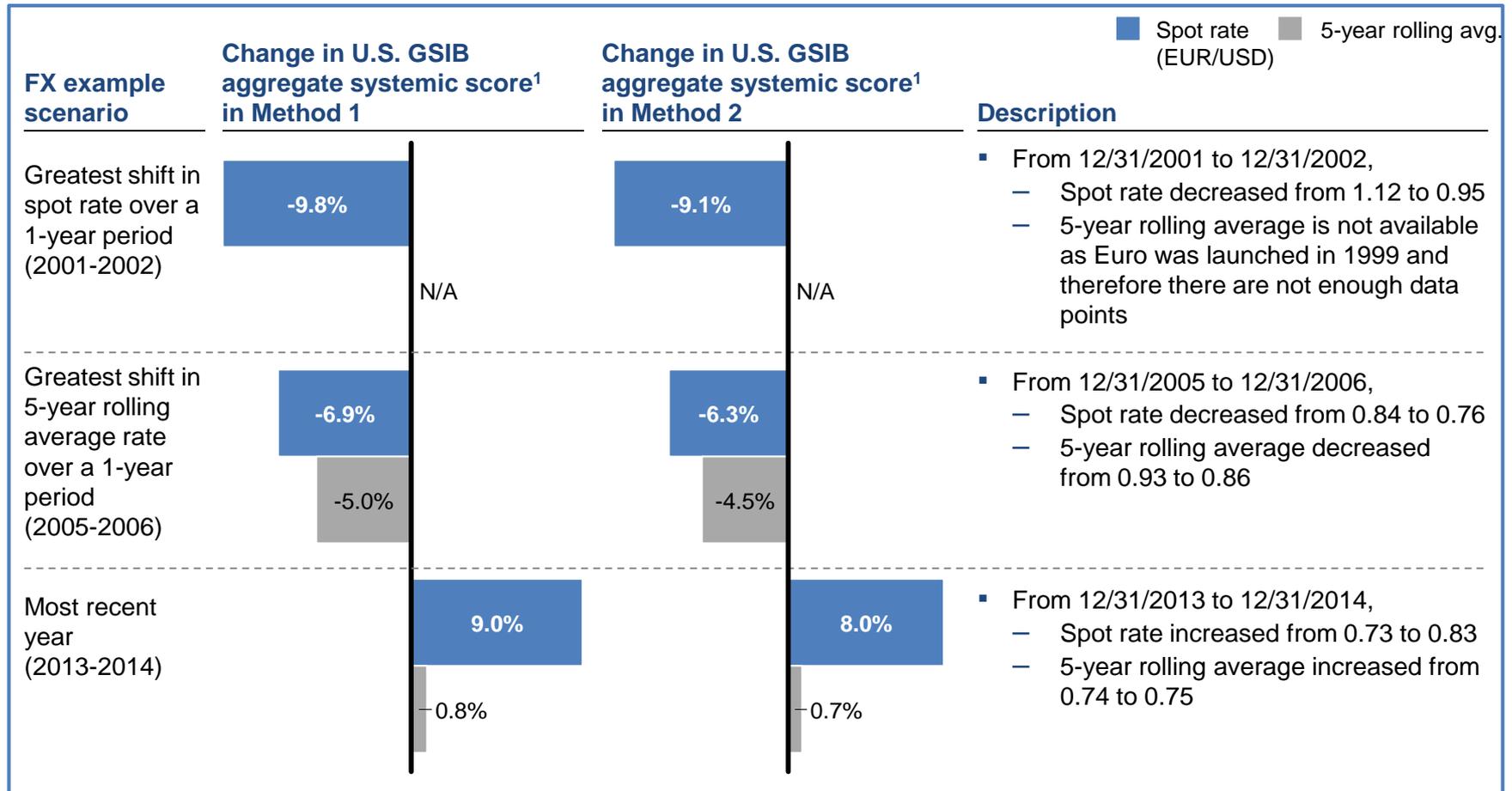
- FR Y-15 reports of 8 U.S. GSIBs as of December 31, 2013 and December 31, 2014
- Board of Governor of the Federal Reserve System, Foreign Exchange Rates (H.10)
- Basel Committee
- Internal STWF Data from 8 U.S. GSIBs

Figure 1 – Foreign exchange rate since the inception of Euro



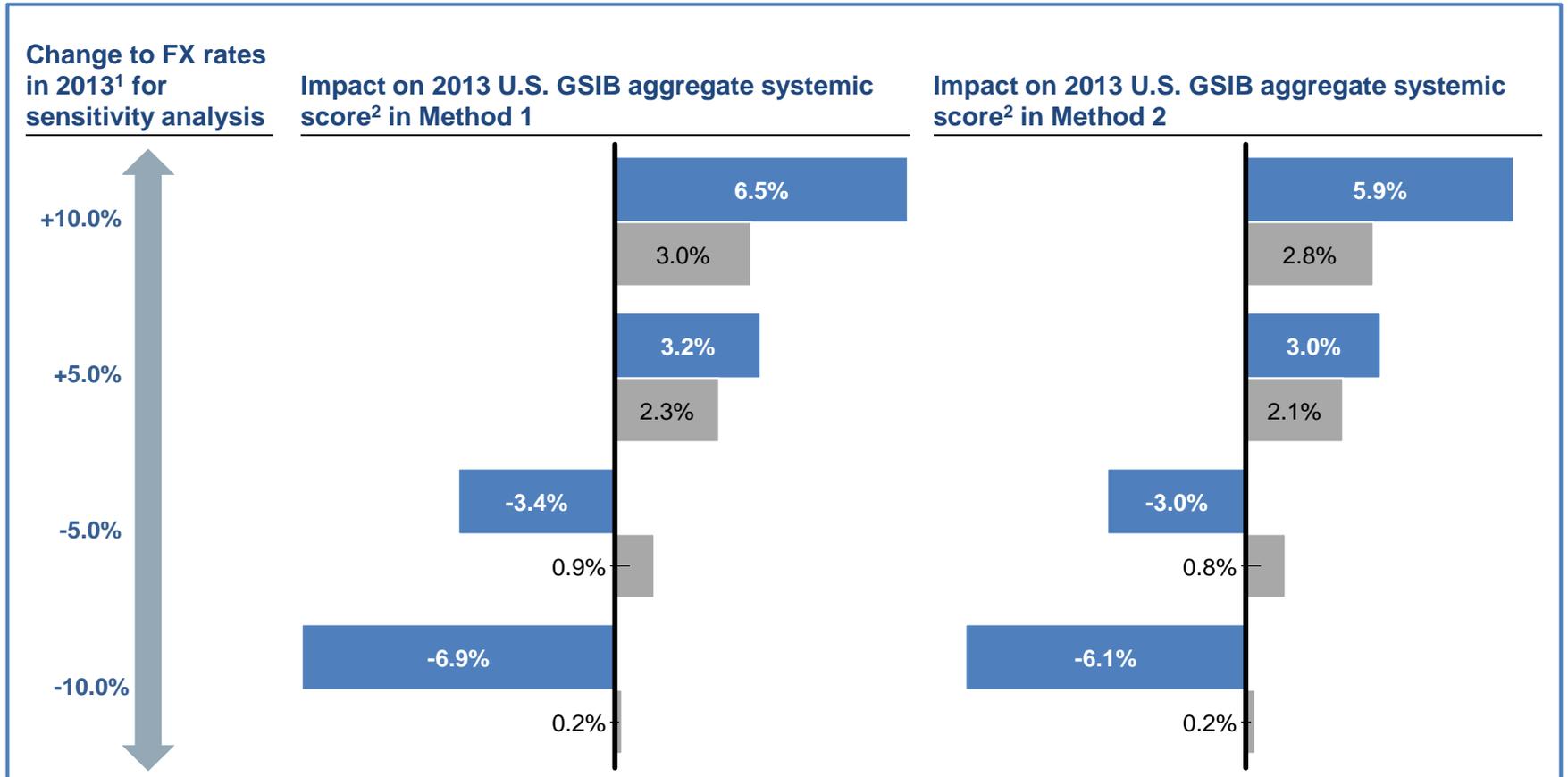
Source: Daily exchange rates are from the Board of Governors of the Federal Reserve System, Foreign Exchange Rates (H.10).

Figure 2 – Change in U.S. GSIB aggregate systemic score under various scenarios of greater FX volatility



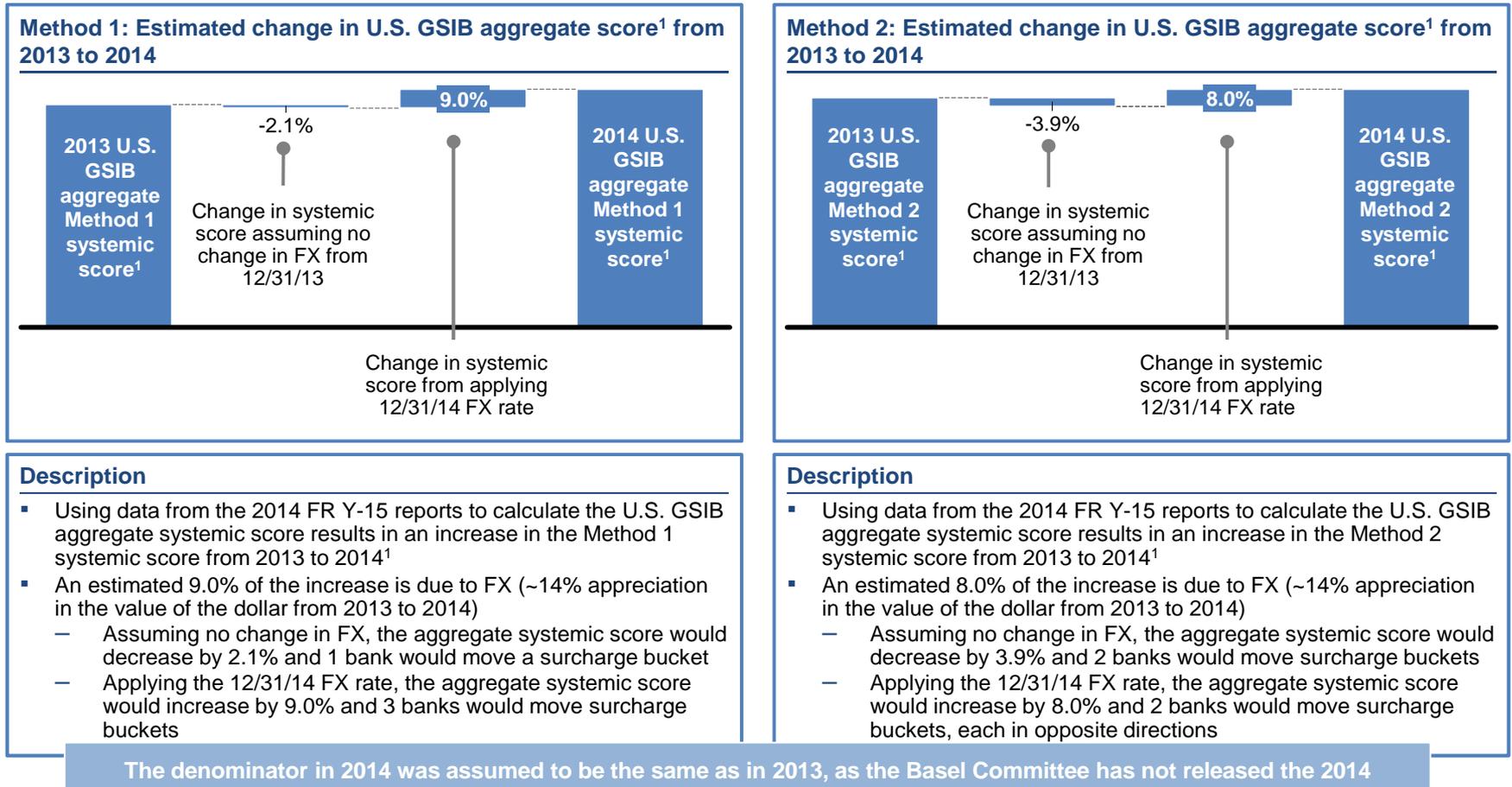
1 All analyses are shown as the aggregated score for U.S. GSIBs, which is the average of the 8 individual GSIB bank scores, weighted by total exposures.

Figure 3 – Sensitivity of U.S. GSIB aggregate systemic score to changes in FX



- 1 The sensitivity changes are applied to all daily exchange rates throughout all of 2013. For the calculation of the 5-year rolling average the FX rates from 2013 were changed based on the sensitivity scaling, and averaged with the true daily FX rates from 2008-2012.
- 2 All analyses are shown as the aggregated score for U.S. GSIBs, which is the average of the 8 individual GSIB bank scores, weighted by total exposures.

Figure 4 – Impact of FX volatility from 2013-2014 on the U.S. GSIB aggregate systemic score



¹ All analyses are shown as the aggregated systemic score for U.S. GSIBs, which is the average of the 8 individual GSIB bank scores, weighted by total exposures.