



July 24, 2019

*By electronic submission to [fsb@fsb.org](mailto:fsb@fsb.org)*

Secretariat to the Financial Stability Board  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

Re: Evaluation of G20 too-big-to-fail reforms

Ladies and Gentlemen:

The Bank Policy Institute (“**BPI**”)<sup>1</sup> appreciates the opportunity to respond to the request from the Financial Stability Board (the “**FSB**”) for feedback on whether the too-big-to-fail (“**TBTF**”) reforms that have been implemented with respect to systemically important banking organizations (“**SIBs**”) are achieving their intended objectives.<sup>2</sup> Our response relates principally to the TBTF reforms that have been implemented in the United States, and focuses on the reforms that have been adopted for the U.S. global SIBs (“**U.S. G-SIBs**”).

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<sup>1</sup> The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation’s leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation’s small business loans, and are an engine for financial innovation and economic growth.

<sup>2</sup> Financial Stability Board, “FSB launches evaluation of too-big-to-fail reforms and invites feedback from stakeholders” (May 23, 2019), available at <https://www.fsb.org/2019/05/fsb-launches-evaluation-of-too-big-to-fail-reforms-and-invites-feedback-from-stakeholders/>.

## I. Overview of the Effectiveness of the TBTF Reforms in the United States

The TBTF reforms that have been implemented in the United States since the Financial Crisis have largely achieved their two principal objectives:

- to make the U.S. G-SIBs resilient against failure and able to continue to provide credit and maintain critical operations even if confronted with severely adverse stress in the future; and
- to put in place credible, operationally-ready resolution plans and underlying firm-level capabilities that make it possible for U.S. G-SIBs to fail without resulting in contagion, a material contraction in the supply of money or provision of credit or a disruption in critical operations that could destabilize the U.S. or global financial system or harm the wider economy. Critically, resolution under the plans and framework developed in the United States will impose all losses on firm shareholders and long-term debt holders without any need for injections of taxpayer-funded capital or other extraordinary government support.

It is important to emphasize just how extraordinary the range of TBTF reforms has been in the United States, giving rise to a complex – and to date under-explored – suite of interactions among the major reforms. The principal post-crisis reforms to improve the going-concern resiliency of U.S. G-SIBs include:

- sharply higher going-concern capital requirements, with a focus on tangible common equity;
- more stringent methodologies for measuring risk-weighted assets (both on and off balance sheet) and leverage exposure;
- annual, forward-looking and stringent capital stress-testing and capital planning exercises that have resulted in minimum capital requirements that are significantly higher than the Basel III minimum requirements;
- new standardized and heightened liquidity requirements;
- liquidity stress testing and buffer requirements;
- enhancements to capital management and liquidity risk management; and
- recovery planning requirements.

Alongside the measures to reduce the probability of G-SIB failure, the United States has implemented TBTF reforms that allow the U.S. G-SIBs to fail in a manner that involves only their parent holding companies being put into resolution proceedings, with their bank and other material operating subsidiaries being recapitalized and continuing to provide credit and perform critical economic functions without disruption to the broader financial system or economy. Elements of these U.S. reforms include:

- significant private and public sector efforts to advance resolution planning;

- maintenance of substantial levels of Total Loss-Absorbing Capacity (“**TLAC**”) to ensure that the U.S. G-SIBs will have enough remaining loss-absorbing capacity at the point of non-viability (“**PONV**”) to recapitalize their operating subsidiaries;
- requiring U.S. G-SIBs to adopt recapitalization triggers based on conservative projections of the capital and liquidity needs of operating subsidiaries after the U.S. G-SIB’s PONV;
- imposing clean holding company requirements that prohibit the top-tier Bank Holding Company (“**BHC**”) of a U.S. G-SIB from entering into certain financial arrangements that would create obstacles to an orderly resolution, including the issuance of short-term debt to external investors as well as entry into derivatives and certain other types of financial contracts with external counterparties;
- making TLAC debt structurally subordinate to short-term debt through a combination of the clean holding company requirements and secured support agreements;
- proposing, in line with Basel standards, a capital deduction treatment to discourage cross-holdings of TLAC within the regulated banking system;
- substantially reducing the risk of a disruptive termination of qualified financial contracts (“**QFCs**”) and the fire-sale liquidation of underlying collateral by issuing binding regulations designed to make the U.S. G-SIBs and their counterparties adhere to the International Swaps and Derivatives Association (“**ISDA**”) Resolution Stay Protocol; and
- the adoption of resolution regimes and strategies designed to ensure that, in the event of failure, stockholders and TLAC debtholders will bear the losses, management responsible for the failure will be replaced, and taxpayers will bear no losses.

In addition, OTC derivatives market reforms (including central clearing requirements and expanded margin obligations for uncleared swaps) and coordinated efforts to improve the resilience of critical financial market infrastructure have changed the environment in which G-SIBs operate in a manner designed to limit the impact of failure.

Concurrently with these broad categories of reform that have been proposed or endorsed at the FSB level, certain jurisdictions have added further requirements, such as the Volcker Rule, that further limit banking activities. Also beyond the scope of the common FSB framework, the United States imposes upon large non-U.S. banks with substantial U.S. non-branch operations the obligation to place substantially all U.S. subsidiaries underneath an intermediate holding company (“**IHC**”). Correspondingly, the European Union has moved to impose a similar Intermediate Parent Undertaking (“**IPU**”) requirement on large non-EU banks with substantial EU operations. As discussed below, we believe that several of these structural mandates that have arisen outside FSB coordination fail to further, and even undermine, financial stability objectives.

## II. TBTF Reforms in the U.S. Have Largely Achieved their Intended Objectives

In the United States, the major elements of the FSB's TBTF reforms have been implemented and have been effective in achieving their intended objectives.

### *U.S. Resiliency Achievements*

The higher capital and liquidity requirements implemented in the United States, through both "stand-alone" requirements and, even more importantly, supervisory and company-run stress tests, have made the U.S. G-SIBs resilient against failure and able to continue to provide credit and critical operations to the market in a wide range of severely adverse stress scenarios:

- *Capital.* As shown in Figures 1 and 2 below, U.S. G-SIBs collectively have more than twice as much high quality equity capital as a percentage of their risk-weighted assets as they collectively maintained in 2008. Under the most recently published supervisory stress-test results (2019), U.S. G-SIBs would maintain – *even after* the occurrence of the severely adverse supervisory scenario – risk-based common equity capital ratios substantially in excess of their Basel III minimums and nearly 75% higher than the actual levels that prevailed at year-end 2008.<sup>3</sup> The U.S. regulators have implemented multiple forms of capital super-equivalence in the U.S., including: the higher U.S. calibration of the G-SIB surcharge, the enhanced supplemental leverage ratio applicable to U.S. G-SIBs (on a consolidated basis, and at the bank level) and the effects of the stress-test and CCAR process itself.
- Although it does reflect an impressive doubling in the level of common equity capital since the Financial Crisis, Figure 1 below in fact understates the increase in high-quality capital that U.S. G-SIBs have achieved because it does not take into account the increase in regulatory risk-weights over the post-crisis period. Over the last six years, the ratio of risk-weighted assets ("RWA") to total assets ("RWA density") at the largest U.S. banks has increased approximately 10 percentage points because of the adoption of Basel 2.5 and Basel III in the United States. Specifically, RWA density at U.S. BHCs with assets greater than \$500 billion (all of which are U.S. G-SIBs) experienced a sharp jump of approximately 5 percentage points when the Basel 2.5 Market Risk Final Rule took effect (Q1 2013), and jumped an additional 5 percentage points upon effectiveness of the U.S. rules implementing the revised standardized approach for calculating risk weights under Basel III (Q1 2015).<sup>4</sup> This 10 percentage point

<sup>3</sup> The stress tests also include multiple other conservative, even unrealistic, assumptions, such as the continuation of the originally planned dividend distribution levels notwithstanding the severe financial downturn. This high level of post-stress capital is all the more notable in view of the fact that the severely adverse scenarios to which U.S. G-SIBs have been subjected in recent years are predicated on assumed economic shocks that are generally more severe than were actually experienced during the Financial Crisis.

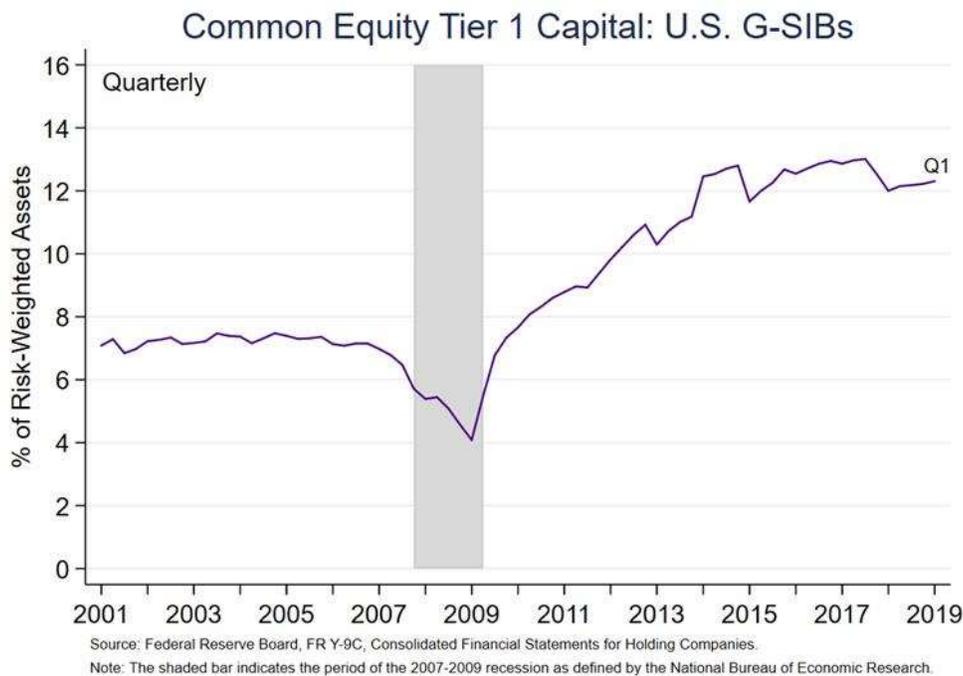
The 2019 severely adverse scenario assumed a larger and much more rapid increase in the unemployment rate than was actually experienced during the 2007-2009 Financial Crisis. In particular, the 2019 scenario assumed that the unemployment rate would rise 4.6 percentage points during the first year, whereas it increased by only 2.1 percentage points in the first year of the 2007-2009 Financial Crisis. The assumed decline in real GDP was twice what was experienced in the Great Recession.

<sup>4</sup> See Federal Reserve Bank of New York, *Quarterly Trends for Consolidated U.S. Banking Organizations*, available at [https://www.newyorkfed.org/research/banking\\_research/quarterly\\_trends.html](https://www.newyorkfed.org/research/banking_research/quarterly_trends.html) (data set indicates the notable increase in RWA density that took place for banks above \$500 billion in assets between the fourth quarter of 2012 and the first quarter of 2013 (effectiveness of Basel 2.5) and between the fourth quarter of 2014 and the first quarter of 2015 (effectiveness of Basel III)).

increase in RWA density corresponds to an overall 17% increase in RWA density relative to 2009 (before implementation of the Basel 2.5 and Basel III reforms).<sup>5</sup>

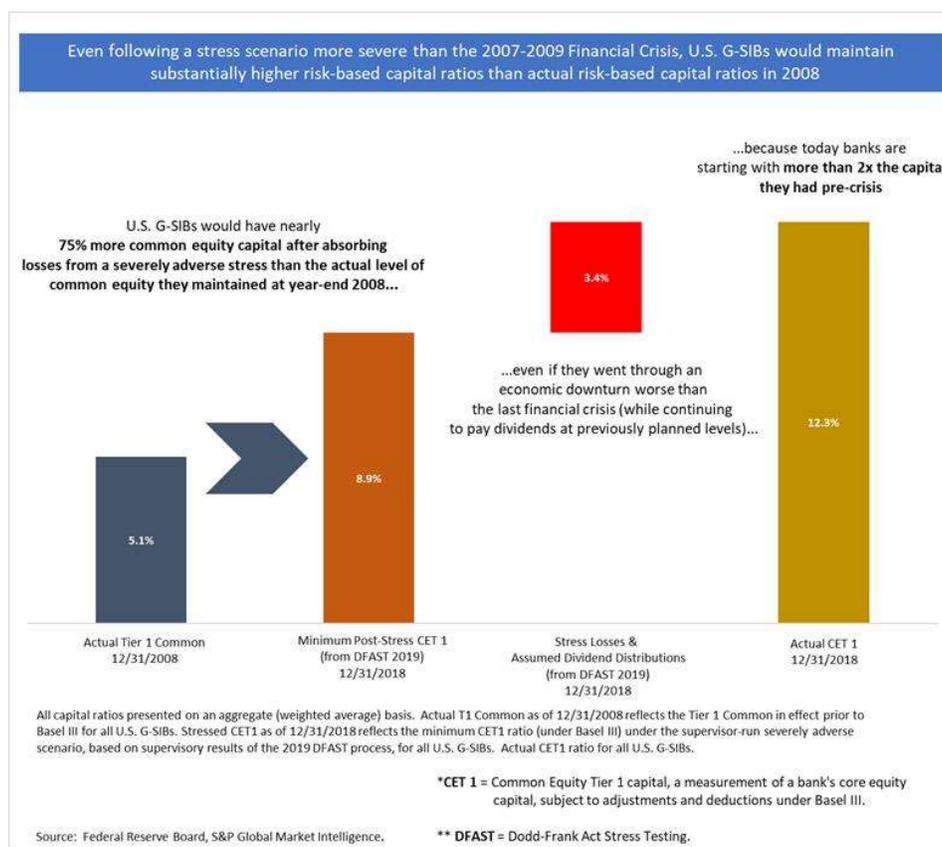
- Because regulatory increases in the stringency of risk weights have ratcheted up RWA density in the U.S., the U.S. G-SIBs must achieve a greater absolute level of capital for any given risk-based capital ratio. This increased “toughness of the yardstick” with respect to RWA measurement means that the current CET1 ratio for the U.S. G-SIBs in fact exceeds 14% when expressed in 2009-era RWA weightings. On an “apples to apples” basis (using a consistent 2009 measurement scale), CET1 at the U.S. G-SIBs has increased by approximately 10 percentage points since 2009 – an amount materially higher than the already significant 8 percentage point gain in the CET1 ratio shown in Figure 1.

Figure 1:



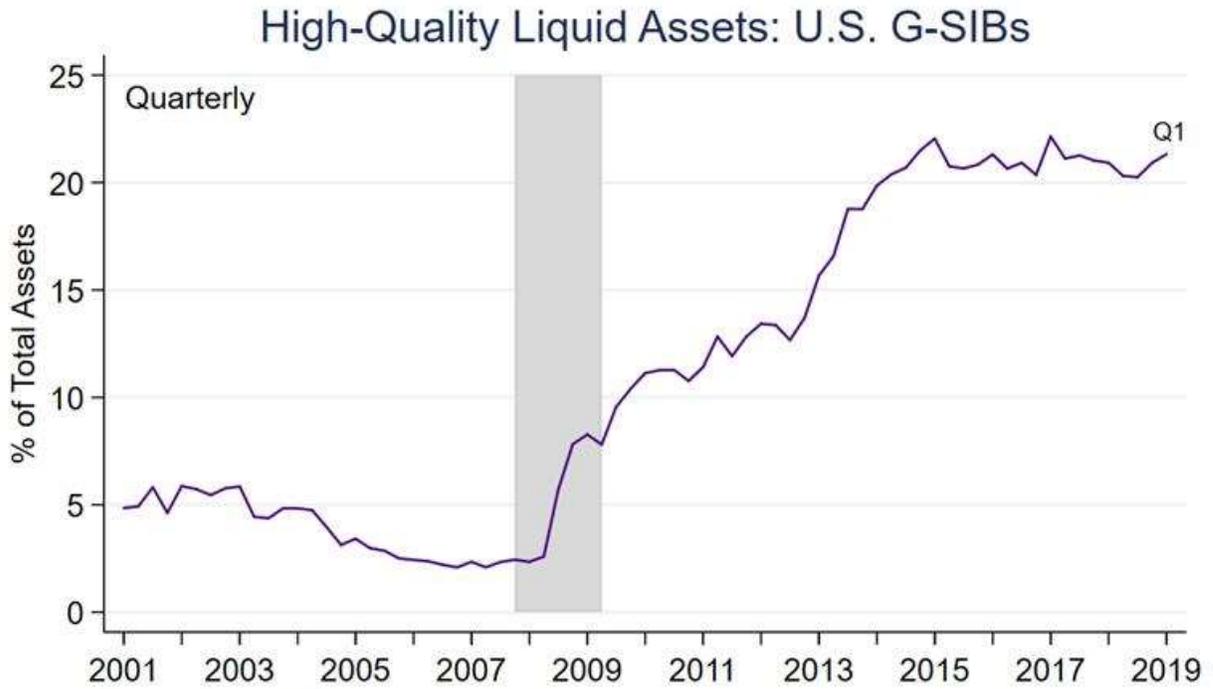
<sup>5</sup> This conservative estimate if anything tends to understate the overall increase that has occurred in the stringency of RWA measurement because it does not control for compensating changes that U.S. G-SIBs may have made to their portfolios to blunt the impact of these changes in the run-up to their effectiveness.

Figure 2:



- **Liquidity.** U.S. G-SIBs have more than *four* times as much high-quality liquid assets (“HQLA”) as a percentage of their total assets as they had in 2008, and short-term wholesale funding as a percentage of assets has dropped to almost *half* the level that it was at before 2008. See Figures 3 and 4. U.S. G-SIBs are subject to super-equivalent enhancements relating to the LCR (such as calibrating the requirement based on peak net outflow within the 30-day window, as opposed to cumulative net outflow at the end of the 30-day window), liquidity stress-testing and buffer requirements, and the responsibility under resolution plan requirements to plan for the self-funding of liquidity needs in resolution. The strength and resiliency of liquidity at large U.S. BHCs is further reinforced via firm-specific and horizontal assessments conducted via the Large Institution Supervisory Coordinating Committee’s (“LISCC”) Comprehensive Liquidity Adequacy and Review (“CLAR”) Program, under which the Federal Reserve, where appropriate, may require firms to adjust or improve existing liquidity risk management processes.

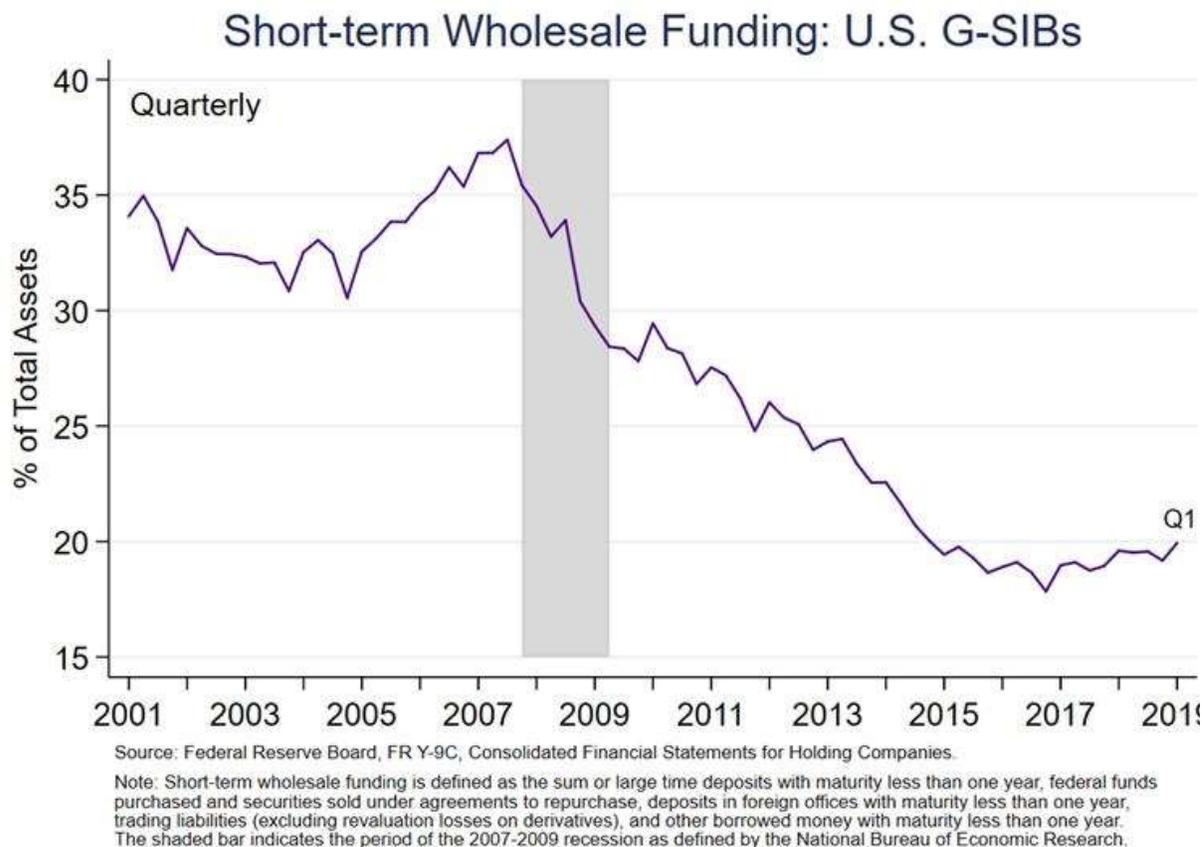
Figure 3:



Source: FR Y-9C and FFIEC 031/041.

Note: High-quality liquid assets is defined as the sum of level 1 and level 2A assets. Level 1 assets include reserve balances, Treasury securities, mortgage-backed securities (MBS) guaranteed by Ginnie Mae, and agency debt that is explicitly guaranteed by the full faith and credit of the U.S. government. Level 2A assets comprise government-sponsored enterprise (GSE) debt, GSE MBS and GSE commercial MBS. Under the LCR, level 2A assets receive a 15 percent haircut, and those amounts must be less than two-thirds of Level 1 assets for each bank. The shaded bar indicates the period of the 2007-2009 recession as defined by the National Bureau of Economic Research.

Figure 4:



### U.S. Resolvability Achievements

Through the U.S. resolution planning process, the U.S. G-SIBs have put in place credible, operationally ready resolution plans based on single-point-of-entry (“SPOE”) resolution strategies. These plans make it possible for the U.S. authorities to allow the U.S. G-SIBs to fail without fostering contagion, a material contraction in the supply of money or credit or a disruption in critical operations that could destabilize the U.S. or global financial system or harm the wider economy. None of these plans assume or rely on any extraordinary support by the United States or any other government. Critically, under the U.S. resolution framework this can be done while imposing all of a U.S. G-SIB’s losses on its shareholders and long-term debt holders and without the need for taxpayer-funded capital injections or other extraordinary government support.

- ***SPOE resolution strategies.*** As part of the resolution planning process required by Title I of the Dodd-Frank Act, all U.S. G-SIBs have adopted single-point-of-entry (SPOE) resolution strategies for their Title I plans, and the FDIC has outlined its approach to conducting an SPOE resolution of a U.S. G-SIB if called upon to exercise its backstop resolution powers under the Title II Orderly Liquidation Authority (“OLA”) provisions of Dodd-Frank.
- ***TLAC and clean holding company requirements.*** Under the U.S. TLAC framework, U.S. G-SIBs are subject to both a very substantial overall TLAC requirement and a specific minimum

long-term debt requirement, as well as a clean holding company requirement, designed to ensure that, if a U.S. G-SIB were to reach the point of non-viability, its top-tier BHC would have sufficient loss-absorbing resources in the form of high-quality equity capital and unsecured long-term debt to absorb all the losses incurred by the firm's operating subsidiaries in order and recapitalize the operating subsidiaries in order to successfully execute an SPOE resolution strategy.

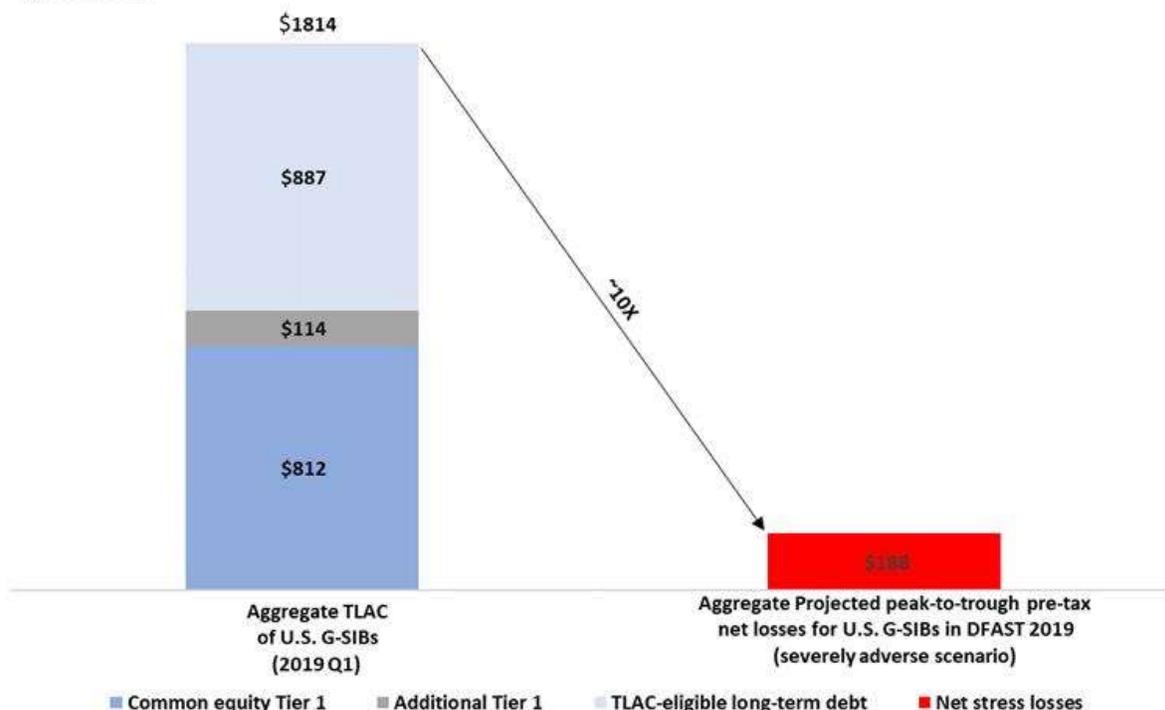
- The current amount of TLAC (including common and preferred equity and eligible long-term debt) maintained by U.S. G-SIBs exceeds \$1.8 trillion, or approximately 28% of risk-weighted assets.<sup>6</sup> In light of the robust levels of going-concern capitalization described above, U.S. G-SIBs effectively maintain loss-absorbing resources sufficient to withstand a stress event more severe than the 2008 Financial Crisis *twice* – first, in the sense that such a crisis (as demonstrated by the 2019 stress test results) would leave the U.S. G-SIBs viably capitalized in terms of common equity on a going concern basis, and second, the amount of long-term debt and other remaining TLAC would permit full recapitalization even if the firm were to *again* be subjected to a severe stress, one extreme enough to ultimately result in full depletion of this substantial level of remaining going concern capital. Figure 5 sets out an estimate of the combined loss absorbing resources of the U.S. G-SIBs.

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<sup>6</sup> As of the first quarter of 2019, all U.S. G-SIBs report their current amount of TLAC on their 10-Qs.

Figure 5:

**Combined Total Loss Absorbing Capacity of the U.S. GSIBs is Almost 10X the Aggregate Peak-to-Trough Net Losses from DFAST 2019 (\$ billions)**



Source: S&P Global and Market Intelligence, Federal Reserve Board, Company Reports (10-Qs).  
TLAC = Total Loss Absorbing Capacity.

- ***Metrics and triggers to assure sufficiency of resolution resources.*** In connection with the U.S. Title I resolution planning process, U.S. G-SIBs have developed Resolution Capital Execution Need (“RCEN”) and Resolution Liquidity Execution Need (“RLEN”) metrics that are designed to project the capital and liquidity resource needs that operating subsidiaries would have during the execution of an SPOE resolution. The U.S. G-SIBs have put in place triggers, playbooks and governance mechanisms to facilitate the timely commencement of parent company bankruptcy proceedings if the group’s capital or liquidity resources decline to a point at which they are approaching the RCEN or RLEN projected to be required for a successful SPOE resolution.
- ***Pre-positioning of resolution resources.*** Resolution Capital Adequacy and Positioning (“RCAP”) and Resolution Liquidity Adequacy and Positioning (“RLAP”) frameworks are used to guide a balanced allocation of consolidated capital and liquidity resources between contributable resources held at the top-tier BHC (or another affiliate, such as an IHC or other funding vehicle) and pre-positioned resources that are held at operating subsidiaries.
- ***Secured support agreements.*** Secured support agreements impose a legally binding obligation on the top-tier BHC and IHCs and other funding vehicles in a resolution scenario to use their

contributable resources to provide capital and liquidity support to the G-SIB's key operating subsidiaries until the SPOE resolution strategy has been completed.

- *Legal entity rationalization and separability.* U.S. G-SIBs have adopted principles to align their legal entity structures to support an SPOE resolution strategy and have undertaken simplification and streamlining of internal group legal entity configurations in accordance with such principles. Additionally, U.S. G-SIBs have implemented structural changes to enable more streamlined divestiture of significant businesses to provide optionality in both recovery and resolution.
- *Operational continuity arrangements.* The U.S. G-SIBs have developed strategies and playbooks designed to maintain access to payment, clearing and settlement services; have developed granular mappings of critical services to core business lines and critical operations; and have made changes to internal and external service agreements to ensure continuity in resolution.
- *Limitations on closeouts by financial contract counterparties.* The U.S. G-SIBs participated in the development of, and have adhered to, the ISDA Resolution Stay Protocol. U.S. regulators have issued binding regulations designed to implement the ISDA Protocol on a market-wide basis through the U.S. QFC stay rules.<sup>7</sup>
- *The OLA.* Consistent with the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*, the backstop FDIC-led resolution regime established by Title II of the Dodd-Frank Act includes an express prohibition on taxpayers bearing any losses associated with temporary liquidity provision from the Orderly Liquidation Fund ("OLF"). Dodd-Frank instead provides for these losses to be absorbed by shareholders and debtholders of the failed institution or, as an ultimate backstop in the unlikely event these sources prove insufficient, other U.S. G-SIBs and large financial firms.

### III. Assessment of the U.S. TBTF Reforms and Path Forward

The demonstrable result of the U.S. and international post-crisis reforms focused on eliminating TBTF has been a U.S. banking system that is far safer and sounder and should instill far greater confidence in the financial system as a whole the next time a period of significant financial or economic stress is encountered. The Federal Reserve, in its most recent Financial Stability Report, found that the U.S. financial sector "appears resilient," with low leverage and limited funding risk.<sup>8</sup>

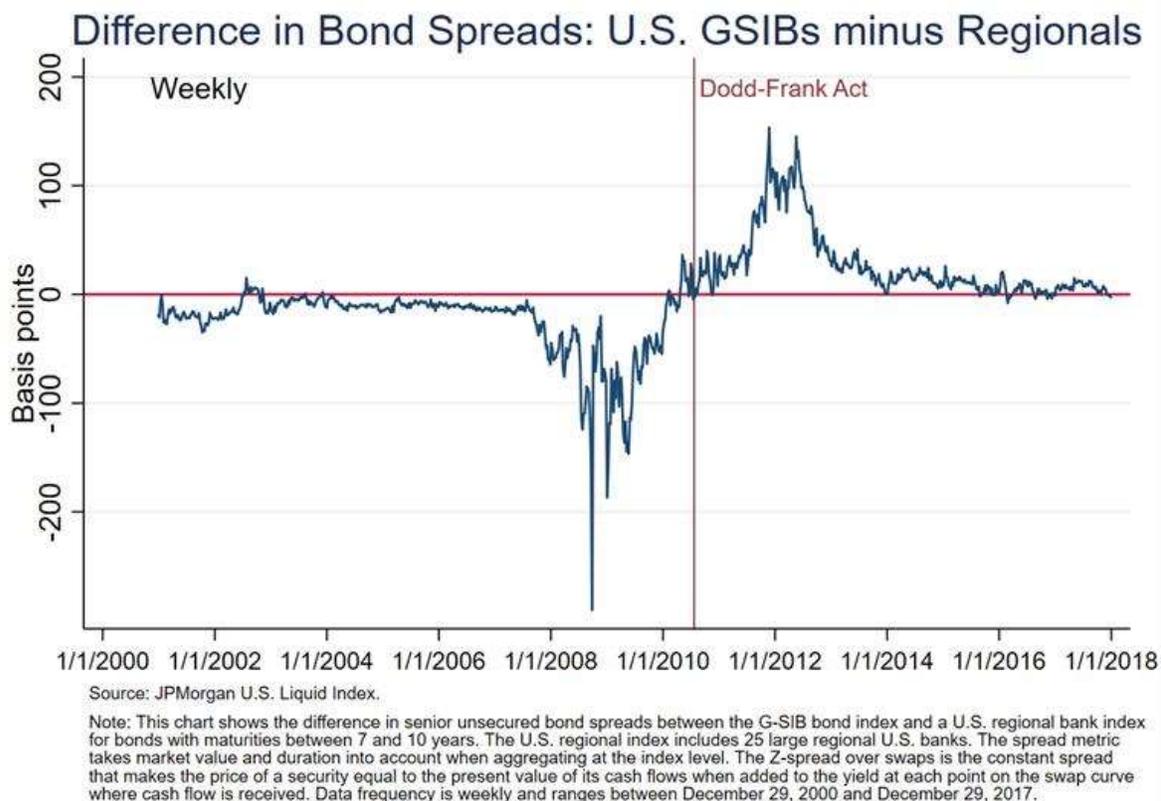
In addition, the empirical record supports the conclusion that the package of international TBTF reforms has also been successful in reducing moral hazard, particularly in the United States. Available

<sup>7</sup> 12 CFR § 252.85 (Federal Reserve); 12 CFR § 382.5 (FDIC); 12 CFR § 47.6 (OCC).

<sup>8</sup> Board of Governors of the Federal Reserve System, *Financial Stability Report* (May 9, 2019), available at <https://www.federalreserve.gov/publications/2019-may-financial-stability-report-purpose.htm>. The most recent Monetary Policy Report also noted that "[v]ulnerabilities stemming from leverage at financial institutions remain low . . . Results of the annual Dodd-Frank Act Stress Tests, released on June 21, 2019, indicate that participating banks are sufficiently resilient to continue lending to creditworthy borrowers even in a severe macroeconomic scenario." Board of Governors of the Federal Reserve System, *Monetary Policy Report* (July 5, 2019), available at <https://www.federalreserve.gov/monetarypolicy/2019-07-mpr-summary.htm>.

evidence contradicts any remaining argument that the largest U.S. banking organizations enjoy a funding “spread” advantage that may be attributable to marketplace assumptions about the potential for future bank bailouts.<sup>9</sup> Indeed – as shown in Figure 6 – bond spreads observed for U.S. G-SIBs now equal or exceed those of U.S. regional banks, a reversal of the relationship generally observed in the years leading up to, and especially during, the crisis. BPI’s separately submitted Research Note contains a review of the literature in this area compiled by economists from BPI’s research staff.<sup>10</sup>

Figure 6:



This significant evidence of success in overcoming moral hazard should be an essential factor in the assessment of TBTF reforms. Indeed, the assessment of the cumulative effect of TBTF reforms should

<sup>9</sup> Randall Kroszner, *A Review of Bank Funding Cost Differentials*, 49 J. FIN SERVICES RES. 151-174 (2016), available at <https://link.springer.com/article/10.1007/s10693-016-0247-0#Fn12>. Relatedly, in 2015 two major credit rating agencies eliminated their expectations of government support to bank holding companies, citing progress in Dodd-Frank implementation and other changes. Federal Reserve Bank of New York, *What Do Rating Agencies Think About “Too-Big-to-Fail” Since Dodd-Frank?*, LIBERTY STREET ECONOMICS (June 19, 2015), available at <https://libertystreeteconomics.newyorkfed.org/2015/06/what-do-rating-agencies-think-about-too-big-to-fail-since-dodd-frank.html>; U.S. Gen. Accounting Office, GAO-14-621, *Large Bank Holding Companies: Expectations of Government Support* at 25 (July 2014), available at <https://www.gao.gov/assets/670/665162.pdf>; see also Federal Reserve Bank of New York, *Resolving “Too Big to Fail”* (June 2018), available at [https://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr859.pdf](https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr859.pdf).

<sup>10</sup> BPI, *BPI Research response to FSB questions on post-crisis reforms* (July 18, 2019), available at <https://bpi.com/bpi-research-response-to-fsb-questions-on-post-crisis-reforms/>.

explore the possibility that, having eliminated any funding benefit associated with any historical TBTF presumption, the cumulative set of constraints may now actually impose economic bias against more heavily regulated G-SIBs, which may distort efficient financial intermediation and feed an undesirable migration of activity to unregulated institutions.

We recognize that there has not been a full test of the current policy regime in light of the current benign interest, credit and economic environment. That same economic environment also suggests that the regulatory reforms have not dramatically constrained banks' ability to promote a healthy economy, although again, the testing period has been too limited to draw definitive conclusions and the FSB itself has acknowledged that over-calibration has caused counterproductive distortions in some areas.<sup>11</sup> As detailed in our separately submitted Research Note, post-crisis gains in resiliency and resolvability have not been cost-free from the perspective of GDP growth and credit availability within the economy.<sup>12</sup>

Fundamentally, we believe that the record of public and private sector achievement in addressing TBTF issues over the past decade supports the conclusion that U.S. and FSB-level reform initiatives in this area may now properly be considered complete, and that the emphasis going forward should be on operational implementation and the assessment of opportunities to eliminate redundancies and unintended consequences. Any further imposition of new restrictive requirements could upset the appropriate balance that has, on the whole, been struck between a robust regulatory system and a robust economy.

For example, although the "precisely correct" capital ratios can never be calculated, because there is no such thing, those who are critical of the current capital ratios as too low seem to ignore the inescapable relationship that exists between ever-greater capital requirements and the lending capacity of the banking sector as a whole.<sup>13</sup> Although raising bank capital requirements to a certain point may reduce

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<sup>11</sup> For instance, although a longstanding policy goal at the FSB level has been to increase central clearing of derivatives in order to reduce systemic risk, over-calibration of the G-SIB surcharge and the Basel leverage ratio may actually result in G-SIBs withdrawing from the clearing business. *See, e.g.*, U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities, Banks and Credit Unions*, at 51 (June 2017) (hereinafter the "**Treasury Banking Report**"), available at <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf> ("Because of the low-margin and high-volume nature of the business of providing clients access to central clearing, high leverage ratio capital charges [on initial margin] discourage firms from providing such services.").

The FSB itself has found that treatment of initial margin in the leverage ratio can be a disincentive for client clearing service providers to offer or expand client clearing. FSB, *Incentives to Centrally Clear Over-the-Counter (OTC) Derivatives* at 4 (Nov. 19, 2018), available at <https://www.fsb.org/2018/11/incentives-to-centrally-clear-over-the-counter-otc-derivatives-2/>. We note that the Basel Committee has recently changed the treatment of client clearing exposures to permit banking organizations to recognize initial margin and non-cash variation margin from their clients in determining their exposures associated with client cleared derivatives for purposes of the Basel leverage ratio. Basel Committee on Banking Supervision, *Leverage Ratio Treatment of Client Cleared Derivatives* (June 2019), available at <https://www.bis.org/bcbs/publ/d467.pdf>. Although we welcome this positive change, there are additional changes that could be made (*e.g.*, treatment of cleared derivatives for purposes of the G-SIB surcharge and similar adjustments to RWA) that could further address the current disincentives for G-SIBs to provide clearing services.

<sup>12</sup> BPI, *BPI Research response to FSB questions on post-crisis reforms* (July 18, 2019), available at <https://bpi.com/bpi-research-response-to-fsb-questions-on-post-crisis-reforms/>.

<sup>13</sup> *See* Treasury Banking Report at 37 (stating that "an excess of capital and liquidity in the banking system will detract from the flow of consumer and commercial credit and can inhibit economic growth"); *id.* at 49 (observing that "the continual ratcheting up of capital requirements is not a costless means of making the banking system safer").

the likelihood and costs of financial crises, raising these requirements too much may also push banks' cost of capital and lending rates up, with implications for investment and economic growth.<sup>14</sup> Advocates of higher capital requirements also fail to account for the resultant limitations that are imposed on deposit taking. We believe that the system would be made riskier if those deposits had to find a "home" outside the regulated banking system.<sup>15</sup>

A similar concern exists with respect to liquidity. Any consideration of still-higher liquidity requirements (beyond the significant increases that have already been achieved) must confront the potential that any requirement to devote an incremental share of balance sheet capacity to HQLA will naturally lead to the loss of a comparable unit of lending capacity to the real economy as well as reduced bank profitability.<sup>16</sup>

If anything, the FSB assessment team should consider exploring whether the cumulative set of post-crisis liquidity regulations has already generated these kinds of negative unintended consequences for economic growth.

Now that the TBTF and other post-crisis reforms are largely operational, the time is appropriate to evaluate on a holistic basis whether recalibrations or other adjustments would both maintain a strong international framework and mitigate unintended consequences. Responding to the understandable demand in the immediate post-crisis aftermath to implement reforms, regulators often did not have the luxury of taking a "wait and see" approach to allow the impact of one regulation to be fully understood

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<sup>14</sup> See Natalya Martynova, *Effect of Bank Capital Requirements on Economic Growth: A Survey*, DNB WORKING PAPER No. 467 (March 2015), available at <https://bpi.com/seeing-the-forest-for-the-trees-gsib-capital-and-enhanced-gsib-regulation/> (estimating, based on a review of academic research, that a one percentage point increase in capital requirements results in between a 1.0 and 4.5 percentage point reduction in lending); see also Malcom Baker & Jeffrey Wurgler, *Do Strict Capital Requirements Raise the Cost of Capital? Bank Regulation, Capital Structure, and the Low Risk Anomaly*, 105 Am. Econ. Rev. 315-20 (2015); Bank of England, *Measuring the Macroeconomic Costs and Benefits of Higher UK Bank Capital Requirements*, FINANCIAL STABILITY PAPER NO. 35 (Dec. 2015). Indeed, the Bank of England found that, once resolution requirements and standards for additional loss-absorbing capacity are in place, the appropriate level of capital in the banking system is significantly lower than estimates made in the aftermath of the Financial Crisis.

Indeed, taken to the extreme advocated by some, the premise that higher capital ratios always correlate to greater safety and soundness is questionable. In order to avoid the adverse impact on return on equity resulting from higher capital requirements, banks may be forced to turn to higher yielding (and presumably riskier) assets.

<sup>15</sup> See, e.g., Harry DeAngelo and René M. Stulz, *Why High Leverage is Optimal for Banks*, NAT'L BUREAU OF ECONOMIC RES. WORKING PAPER SERIES (2013) ("If conventional banks face regulatory limits on leverage while shadow banks do not, the former will be at a competitive disadvantage to the latter. Liquidity production will migrate from regulated banks into the unregulated shadow-banking sector.").

<sup>16</sup> See Christopher J. Curfman and John Kandrak, *Finance and Economics Discussion Series*, Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C. ("Loans are crowded out by both HQLA that banks are required to hold and HQLA that banks voluntarily hold as a buffer above the requirement. A 1 percentage point increase in the HQLA requirement causes banks to reduce their loan-to-assets ratio by between 0.25 and 0.4 percentage points." "We find that banks build up a buffer of HQLA over and above the regulatory requirement, and that the increase in HQLA comes at the expense of lending . . . we find that banks pass on some of the regulatory costs to depositors, but that this pass-through is incomplete and is swamped by the reduction in interest income owing to the substitution out of loans and into HQLA. Consequently, liquidity requirements cause banks' profitability, as measured by NIMs and ROA, to contract").

before the next major reform was implemented. We support the decision by the FSB – at this juncture – to consider rigorously the cumulative effect of all reforms as part of its TBTF evaluation, which in our view also should include an assessment of the costs and benefits of the individual component reforms.

#### **IV. The Need for Coordinated FSB Effort to Address Ring-Fencing**

The international framework that has emerged since the crisis under the auspices of the FSB is valuable not only for the quality of the reforms but also for driving the global financial system toward a common framework. In this regard, however, we are concerned by the current trend towards regulatory “ring-fencing,” which threatens to undermine and counteract the underlying stability gains from the harmonized global framework agreed at the FSB level. Key examples include certain jurisdictional actions, such as in the United States and in the European Union, to set internal TLAC requirements at the highest end of the 75%-90% range (a range that we believe is already too high); current U.S. resolution planning guidance relating to RLAP pre-positioning, under which firms must assume severe local and cross-jurisdictional ring-fencing actions; the Federal Reserve’s proposed imposition of liquidity and other new requirements on the IHCs of large non-U.S. banks (a structural requirement that is in itself already highly burdensome); and recent public discussion by the Federal Reserve about the possible application of standardized liquidity requirements to the U.S. branches and agencies of foreign banking organizations. The EU IHC/IPU structural mandate applied to large non-EU banks is another example of this phenomenon.

This multi-faceted tendency towards “ring-fencing” also is appearing in the supervisory sphere. The successful resolution of a G-SIB requires a coherent approach across jurisdictions. Supported by the FSB crisis management group framework, supervisory and resolution authorities in material host jurisdictions should work closely with other relevant authorities to develop a group-wide resolution plan approach that is fully integrated with the resolution strategy that has been developed for execution by the G-SIB’s home authorities. Where the home country resolution strategy is SPOE, the FSB should encourage host authorities to shape their local preparations and requirements to reflect the contours of the home country resolution strategy.

For instance, the FSB should devote particular attention to avoiding the inefficiencies and complications associated with “operational ring-fencing,” in which credible, resolution-resilient arrangements enabling the cross-border provision of critical shared services from a central service company have been put in place – but are effectively disregarded by local host country authorities who require the G-SIB group to establish redundant local capacity to provide the same services within the various host jurisdictions. A similar counterproductive dynamic may be created where a given host country requires a locally incorporated broker-dealer or investment firm to maintain the capability to execute a solvent wind-down in a manner that is predicated on unduly restrictive assumptions about continued ability to transact with group entities located outside the host jurisdiction. To the degree that such assumptions run contrary to a credibly developed home-country SPOE plan, they should be discouraged.

With respect to capital resources, supervisory ring-fencing may also take the form of an excessive calibration of the discretionary Pillar 2 capital requirements applicable to the local operations of a foreign G-

SIB.<sup>17</sup> Through such often non-public (and therefore non-transparent) means, host country supervisors can exacerbate the counterproductive effects that accompany calibration of an internal TLAC requirement at the highest end of the FSB range. The deleterious effects (described further below) of each of these varied forms of ring-fencing argue vigorously for greater FSB-led coordination to counteract the tendency toward such behavior.

The adverse impact of regulatory and supervisory ring-fencing extends well beyond the increased burden for regulated entities – as costly as it is. Ring-fencing reduces banks' ability to shift resources to the areas where they are most in demand in normal times and to where they are most needed in the event of financial stress. At the outset, these rigidities and redundancies impose a real economic impact upon the conduct of everyday operations, even before considering these ill effects in a crisis. Such measures reduce the ability of global firms to serve local clients efficiently, to the detriment of the competitiveness of local markets.

Ultimately even more damaging is the limitation on banks' flexibility to shift resources to where they would be needed in the event of financial stress. In the event of concentrated losses at a given subsidiary or branch, a banking group with a large central store of contributable resources should have sufficient resources to replace the losses and prevent the collapse of the subsidiary or branch. This would, at a minimum, cauterize the wound and limit the systemic impact. If, in contrast, jurisdictional ring-fencing measures require the bank's resources to be inflexibly allocated among various jurisdictional compartments – leaving the central store with far fewer resources – a global banking group will possess far-reduced capacity to deal with any losses that exceed the already-allocated resources. Widespread ring-fencing harms the resilience of the global banking group, and it is therefore in the best interest of home and host regulators to advance a more flexible system, balancing “*flexibility* for the parent bank and *certainty* for local stakeholders.”<sup>18</sup> Though some level of pre-positioning may be necessary to reinforce the proper alignment of incentives between home and host, regulators should be encouraged to cooperate across jurisdictions and consider adjusting local requirements to achieve this balance.<sup>19</sup> This will include taking under consideration contractual arrangements, such as the U.S. G-SIBs' secured support agreements discussed in Section III, that provide assurance that contributable resources will be made available to meet losses in host jurisdictions.

As an international coordinating body, the FSB has a vital role to play in counteracting the tendency toward deleterious jurisdictional ring-fencing. We urge the FSB to place this objective as a top policy priority moving forward. Fundamentally, the ring-fencing phenomenon poses a challenge not merely

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<sup>17</sup> In the U.S., the multiplicity of requirements means that the large foreign banking organizations have effective requirements above 130% of the TLAC standard. See Institute of International Bankers, *FBO Tailoring Proposal Comment Letter* (June 21, 2019) at 17, available at <https://www.iib.org/news/457490/IIB-FBO-Tailoring-Proposal-Comment-Letter.htm>.

<sup>18</sup> Randal K. Quarles, *Trust Everyone—But Brand Your Cattle: Finding the Right Balance in Cross-Border Resolution* (May 16, 2018), available at <https://www.federalreserve.gov/newsevents/speech/quarles20180516a.htm> (stating that the U.S. “should consider whether the internal TLAC calibration for IHCs could be adjusted to reflect the practice of other regulators”).

<sup>19</sup> See *id.*

to full realization of the benefits of the TBTF reforms, but threatens to undermine them. Tremendous achievements have been realized as a result of the FSB's TBTF agenda over the past ten years, and it is crucial that the FSB now devote the same concerted effort to defending these achievements from erosion by means of individual and cumulative jurisdictional ring-fencing actions.<sup>20</sup> Such activity ends up benefitting no one – not even the jurisdictions that try to operate as first movers.<sup>21</sup>

Ideally, the current assessment of TBTF reforms could function as a kind of watershed or catalyzing event in which FSB member authorities conclusively demonstrate to the world, and to one another, the efficacy of the reforms that have been achieved – and proceed, as jurisdictional authorities, to demonstrate their acknowledgement of that reality by desisting from costly, redundant and counterproductive measures that seek to replicate in local miniature the requirements that function optimally at a worldwide group level. We recommend that the assessment work on TBTF reforms attempt further to analyze and quantify the harms that uncoordinated ring-fencing actions pose to underlying financial stability objectives, and the corresponding benefits of effective international coordination in this area.

## V. Adhering to an Analytically Rigorous Process

As the FSB itself has recently emphasized,<sup>22</sup> the approach to adopting regulatory standards can be as important as the substantive standard itself. A rush to impose fixes before a problem is fully identified and analyzed often results in unnecessary added burden and unintended consequences that cannot be justified. Where costs and benefits have not been carefully and objectively weighed up front, corrective action to achieve an appropriate balance can often be difficult and time-consuming, or even stymied altogether by the procedural realities of the regulatory process.<sup>23</sup> We believe that regular periodic review of

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<sup>20</sup> In this regard, we welcome the FSB's stated intention to focus on the distribution of intra-group resources within G-SIBs, as indicated in the recently published FSB report on the practical implementation of the TLAC standard. See Financial Stability Board, Review of the Technical Implementation of the Total Loss-Absorbing Capacity (TLAC) Standard (July 2, 2019), available at <https://www.fsb.org/2019/07/review-of-the-technical-implementation-of-the-total-loss-absorbing-capacity-tlac-standard/>.

<sup>21</sup> See, e.g., Wilson Ervin, Ring-Fencing: *Escape from the Prisoner's Dilemma*, Banking Perspectives (2018) (showing that, while a sole ring-fencer can gain an advantage, other jurisdictions will inevitably respond, shrinking a bank's pooled central reserve and increasing risk of bank failure).

<sup>22</sup> Randal K. Quarles, Chair, Financial Stability Board, *The Financial Stability Board: Beyond the Fog of Battle* (April 2, 2019), available at <https://www.fsb.org/wp-content/uploads/S020419.pdf> ("Stakeholders trust the FSB to undertake thoughtful, detailed work on emerging risks to financial stability. . . . To maintain that trust, we must be willing to make improvements when the evidence justifies it—to undertake rigorous analysis, before and after issuing new standards, and to follow that analysis where it leads.")

<sup>23</sup> One example of the rush to adopt a policy without the benefit of such prior analysis – or consultation in an international venue such as the FSB – is the U.S. Volcker Rule. There was no evidence adduced that the now prohibited "proprietary trading" had in any way contributed to the Financial Crisis, and no study of the contribution of this trading activity to the profitability or resilience of banks. Yet, the trading prohibition has undeniably increased the regulatory burden for the banking industry (and until recently on even the smallest U.S. banks), and there are studies indicating that the absolute proprietary trading ban has caused a loss of market liquidity. See, e.g., Jack Bao, Maureen O'Hara and Alex Zhou, *The Volcker Rule and Market-Making in Times of Stress*, Finance and Economics Discussion Series 2016-102, Washington: Board of Governors of the Federal Reserve System (September 2016), available at <https://doi.org/10.17016/FEDS.2016.102>. The prohibition on investments in "covered funds" is, if anything, even less sustainable as a response to the Financial Crisis.

the coherence and calibration of the SIB prudential framework – including in the areas of capital, liquidity and broader TBTF reforms – is an advisable practice that will help identify future areas for tailoring and adjustment as the banking system evolves.

## VI. Assessment of Capital and Liquidity Standards

In connection with the FSB's evaluation of TBTF reforms, we believe it would be valuable for the FSB and the BCBS to assess the comprehensive effects of post-crisis bank capital requirements on the broader economy, focusing on identifying and examining areas of duplication and conflict that do not enhance safety and soundness, and taking into consideration the costs – including in terms of lending capacity and economic growth – of maintaining unnecessary capital regulations or unnecessarily high calibrations of existing standards. As part of this evaluation, we strongly believe that the calibration of the G-SIB surcharge could be reconsidered for downward adjustment without affecting the resilience or resolvability of G-SIBs because of substantial reinforcements in other aspects of the regulatory regime since its initial introduction. These include, most notably, the set of resolution-related reforms (including TLAC) and liquidity enhancement measures (including LCR) that have dramatically reduced the systemic impact resulting from a G-SIB failure.

In addition, the FSB and BCBS should re-evaluate the need for the Net Stable Funding Ratio particularly in light of the anticipated substantial net costs to the broader economy of its implementation. Firms have come into compliance with numerous jurisdictional liquidity requirements since the BCBS finalized its NSFR standard in 2014, which overlap substantially with the objectives and purposes of the NSFR. Prudence therefore dictates that a detailed review of already adopted standards in this area is warranted before proceeding with implementation of the NSFR. In connection with such review, the FSB and BCBS should consider the potential economic impacts of the NSFR on bank lending to the nonfinancial sector, as well as the potential impact on market liquidity and functioning from the increase in cost to banks of providing short-term credit to financial sector institutions. We believe the degree to which the estimated costs of the NSFR are likely to exceed its benefits needs to be considered as part of the assessment of TBTF reforms.

## VII. Additional Areas for Evaluation and Policy Attention

In addition to carrying out the present evaluation of TBTF reforms, we believe there are two areas that merit additional focus by the FSB and regulatory agencies in relevant jurisdictions. The first relates to financial institutions that compete with banks, whether without bank charters or with special bank charters (*e.g.*, so-called “challenger banks” and “shadow banks”). It is essential that they be closely monitored so that “regulatory arbitrage” does not give rise to systemic risk or an un-level regulatory playing field that undermines the franchise value, earning potential and, ultimately, the safety and soundness of banks.<sup>24</sup>

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<sup>24</sup> As the FSB has noted, non-bank financing may “become a source of systemic risk, both directly and through its interconnectedness with the banking system, if it involves activities that are typically performed by banks, such as maturity/liquidity transformation and the creation of leverage.” FSB, *Global Monitoring Report on Non-Bank Financial Intermediation 2018*, at 4 (February 4, 2019), available at <https://www.fsb.org/2019/02/global-monitoring-report-on-non-bank-financial-intermediation-2018/>.

Second, a number of resolution regimes – including the U.S. bank resolution regime under the Federal Deposit Insurance Act and the Orderly Liquidation Authority under the Dodd-Frank Act – incorporate a “bridge bank” concept, but there is only limited experience in carrying out actual resolutions of a large institution, particularly across jurisdictions pursuant to a bridge bank or bridge financial company strategy.<sup>25</sup> We applaud the FDIC’s efforts to develop strategies to execute a resolution using the bridge technique if called upon as a backup and believe that the FSB should continue to support resolution authorities’ efforts at coordination and cooperation to facilitate cross-border resolution.

\* \* \*

Thank you for the opportunity to present these views and recommendations in written form. We would welcome the opportunity to participate in future stakeholder workshops and meetings as part of the assessment work being undertaken.

Sincerely,

A handwritten signature in black ink that reads "John Court". The signature is written in a cursive, slightly stylized font.

John Court  
Senior Vice President and General Counsel

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*See FSB, Thematic Review on Bank Resolution Planning, Peer Review Report (April 29, 2019).*