16 May 2011

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

RE: Discussion Note on SIFI Loss Absorbency Proposals Submitted to the FSB Standing Committee on Supervisory and Regulatory Cooperation

To the Financial Stability Board,

Introduction

1. The Global Financial Markets Association (GFMA) and its members fully accept that any institution, regardless of its size, complexity, or interconnectedness should be allowed to fail and that taxpayers should not be called upon to support such institutions to prevent their failure. Members also acknowledge the need for a policy framework that both lessens the probability that systemically important banks, or SIFIs[1], will fail, and reduces the risk of significant disruption to the wider financial system and economic activity should the failure of a SIFI occur. We very much appreciate being invited to discuss these issues with the Financial Stability Board (FSB) Standing Committee on Supervisory and Regulatory Cooperation.

2. GFMA applauds the work being done by the FSB and the Basel Committee on Banking Supervision (BCBS) to achieve an appropriate, workable, and sustainable regime for SIFIs that promotes financial stability. However, we also strongly believe that in contemplating additional changes, policymakers should consider carefully the aggregate impact of both existing and prospective prudential requirements, to ensure that the expected benefits which they aim to deliver are at least commensurate with the costs that they impose.

3. This discussion note focuses on the proposals under consideration by the FSB and the BCBS relating to the establishment of additional loss absorbing capacity for SIFIs. The FSB's 20 October 2010 paper, *Reducing the moral hazard posed by systemically*

[1] We use the term "SIFI" throughout this note to refer to large, complex and interconnected financial institutions, recognizing that there is no agreed definition and that other terms have been used in various public documents.

important financial institutions, describes the concept by noting that policymakers should develop:

> …a requirement that SIFIs and initially in particular global SIFIs (G-SIFIs) have higher loss absorbency capacity to reflect the greater risks that these institutions pose to the global financial system.[2]

4. We strongly believe that significant progress towards this objective has been made through the many initiatives that have already been adopted. These not only reflect and mitigate the greater risks that SIFIs pose to the global financial system, but go a long way in reducing the likelihood and impact of serious financial distress at large, systemically significant institutions. We urge the FSB to take stock of those initiatives before deciding to impose any additional capital charge on SIFIs. In particular we believe that before adding further requirements on banks it is necessary to evaluate fully the cumulative impact of the numerous new regulations they are facing, especially on their ability to serve their customers and contribute to economic recovery. For these reasons, which we will elaborate upon below, we feel that the need for an additional SIFI capital buffer is unsupported.

Summary

5. **GFMA and its members do not think a SIFI capital buffer should be adopted.** Any additional capital requirements in excess of those already imposed by Basel III should be carefully considered against the potential negative economic consequences of lower credit availability and a higher cost of capital for the financial system as a whole. Numerous significant steps have been taken, in addition to the Basel III capital rules, to reduce the systemic risk of SIFIs, including enhanced supervision, recovery and resolution plan requirements, and strengthened regulatory authority to implement orderly resolutions of SIFI failures.

Increasing SIFI Capital Requirements Comes with a Cost

6. Instituting a SIFI capital buffer would come with a cost, which may not have fully offsetting benefits. First, the additional required capital buffer will have an adverse effect on economic growth and lending availability, particularly given already-higher capital requirements. Second, added costs are likely to either be passed on to customers, or to drive SIFIs to take on more risk in a search for revenue. Neither of these are good outcomes, particularly considering the added costs imposed by many other new requirements, such as compliance costs, fees, risk management staff, and

[2] FSB – "*Reducing the moral hazard posed by systemically important financial institutions: FSB recommendations and timelines*", 20 October 2010, p. 2.

the like.[3] And, while some of these initiatives will be phased in over time in order to address the cost burden as well as the regulations' impact on the capacity of banks to make credit available, it is important that the FSB and BCBS recognize that in many cases the market is putting pressure on banks to achieve much earlier progress toward the implementation of new requirements than those set forth in the agreed timetables.

7. This would appear to be particularly the case for some of the larger institutions and will inevitably further constrain the supply of credit and suppress growth in GDP. Indeed the Macroeconomic Group's Final Report[4] last December "assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements" recognized that the impact of new requirements on GDP would be dependent on the extent to which banks sought to implement new capital requirements ahead of the transition schedule set by supervisors. The shorter the implementation period the more negative the impact on GDP, with such effects accentuated to the degree that banks chose to hold an additional voluntary equity capital buffer above the new standards.

8. A third potential negative outcome from the imposition of additional SIFI buffers is that it may encourage the migration of certain activities from the regular banking system towards the "shadow banking" system, thereby creating opportunities for regulatory arbitrage that undermine effective supervision and giving rise to systemic risk beyond the regulatory perimeter.

Benefit of SIFI Capital Buffer is Unclear

9. As noted, GFMA members do not think there is compelling evidence in favor of a SIFI buffer and believe that a buffer should not be instituted. We have not yet seen any convincing evidence of the benefit that would accrue, and indeed it would be difficult to estimate the effectiveness of such a buffer when so many other capital requirements have been adopted but not yet implemented, and other highly significant regulatory changes are also underway.

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[3] Under the Dodd Frank Act, large U.S. banks will have higher deposit insurance assessments, new fees charged by the Financial Stability Oversight Council, new ceilings on debit interchange fees, and many other cost pressures. In the EU, a number of initiatives are being considered by the Commission including the introduction of resolution levies, and amendments to the Deposit Guarantee Directive are being negotiated.

[4] FSB and BCBS, *Final Report – Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements* – December 2010.

10. Global banks are already facing steep increases in their capital requirements, which have not yet been fully implemented.

- First, banks already face significant increases in both the quality and quantity of capital they will be obliged to hold under the new Basel III standards announced in December 2010, the key features of which are:
  - Minimum capital levels are raised – the core equity tier one ratio (CET1) is more than doubled to 4.5% (excluding the impact of a new capital conservation buffer described below), and the total tier one ratio is increased by half to 6%.
  - Eligible capital is redefined such that common equity is the predominant form of capital.
  - Common equity is defined more strictly:
    - Regulatory capital deductions have to be taken from common equity rather than from Tier 1 or Tier 2 capital as is currently the case.
    - The deductions from common equity are significantly more stringent.
- Second, the Basel III framework adds two buffers above the minima:
  - A capital conservation buffer, which provides that if banks do not stay above the stipulated buffer, they will have to restrict the amount of dividend and bonus payments they make.
  - A countercyclical buffer of up to 2.5% of RWAs, which will be deployed when supervisors deem there to be excess credit growth.
- Third, banks establish internal targets to hold capital buffers above their regulatory minima, due to several factors:
  - Operational considerations, to ensure that capital levels do not go below required minima and possibly engender a regulatory consequence.

- Market considerations, since analysts and investors typically expect banks to operate above regulatory minima, and

- Regulatory considerations, since under the Pillar 2 ICAAP process, supervisors stipulate that banks should build in a cushion in their own capital objectives.

11. In addition to higher capital requirements, there have been numerous changes to prudential standards, supervisory architecture, and market infrastructure in the wake of the financial crisis. Some of these changes are national, such as the Dodd Frank Act in the U.S., while others are international, such as the FSB and BCBS initiatives on liquidity, credit practices and derivatives reforms, to name just a few. Many of these regulatory changes, while not specifically targeted at SIFIs, will disproportionately impact large, interconnected banks. Elements of Basel III, for example, will result in higher capital requirements for securitization exposures and derivative exposures.

12. New institutions have also been established that will elevate and focus work on systemic risk, including the European Systemic Risk Board, the UK Financial Policy Committee, and the U.S. Financial Stability Oversight Council. Additional steps in the EU and the U.S. include risk-reducing provisions such as mandatory clearing of certain OTC derivatives on exchanges or with central counterparties, mandated increased utilization of trade repositories and higher capital requirements for non-centrally cleared contracts.

13. It is important to understand the aggregate effect of these new requirements on the systemic risk posed by SIFIs in advance of adding an additional requirement into the mix. Moreover, concerns are already being raised in some jurisdictions with respect to the potentially uneven implementation of requirements under Basel II and III, for example, in relation to the calculation of risk weighted assets. GFMA and its members recognize that harmonized implementation is a priority for the BCBS and the FSB and welcome the work being done, including peer reviews, to ensure equivalence between jurisdictions. At present, an additional capital requirement for SIFIs could further exacerbate distortions, without first ensuring a level playing field in the implementation of Basel II and III.

Other SIFI Policy Work should Continue

14. GFMA recognizes that the FSB and BCBS are working diligently towards addressing the risks posed by SIFIs. We strongly support the work stream aimed at ensuring

that SIFIs are subject to a robust supervisory framework that meets the FSB enhanced supervision standards for SIFIs[5]. These standards are designed to ensure supervisors have the capacity, tools and skills to effectively deal with the risks posed by SIFIS and will make them less susceptible to failure, including:

- An early intervention framework;
- Supervisors having:
    - Operational independence,
    - Sufficient resources,
    - A full suite of supervisory powers, and
    - Improved assessment and analysis techniques.
- Supervisory structures that adequately allow for consolidated and continuous supervision;
- Cross-border coordination; and
- Effective macroprudential approaches and appropriate and efficient outsourcing.

15. In addition, under Pillar 2 of the BCBS capital framework, SIFIs are required to have a robust, forward-looking Pillar 2 process to assess and maintain the adequacy of their capital. The BCBS Pillar 2 guidance stipulates that bank management should identify all of the bank's risks and determine, through stress testing and various other means, how much capital it should hold on a going-forward basis. The BCBS has made clear that it expects bank management to build in a cushion above the quantitative capital minima it faces, through the Pillar 2 process. The FSB should evaluate the rigor with which supervisors are implementing Pillar 2 through its peer review program.

16. Finally, we support the critically important efforts underway on addressing resolution of SIFIs and other large financial institutions. The FSB's work to ensure the presence of SIFI-specific cross-border cooperation agreements is essential. The national progress toward recovery and resolution plan requirements mentioned earlier is being supported by various FSB work streams, including the effort to

[5] For the enhanced supervision standards, please see BCBS "*Intensity and Effectiveness of SIFI Supervision: Recommendations for Enhanced Supervision*", 2 Nov 2010.

review and report on the progress toward SIFI implementation of recovery and resolution plans.

17. The benefits of the recovery and resolution planning process in meeting the objectives of reducing the likelihood and impact of SIFI failure should not be underestimated. The recovery portion is aimed directly at reducing the likelihood of SIFI failure by ensuring that SIFIs develop enhanced processes for managing through stress, including contingency funding planning, capital planning, stress testing, and strategic planning. The resolution planning process directly addresses lessening the impact of a SIFI failure by identifying and removing obstacles to an orderly failure such as inadequate information on legal entities and counterparty exposures, while plans for core businesses to continue.

18. National implementation of enhanced resolution regimes is moving forward as well. For example, in the U.S., the orderly resolution provisions in Title II of the Dodd Frank Act and the FDI Act are flexible enough to be used to recapitalize the systemically important or other viable parts of a failed institution by exchanging debt in the failed institution for equity in a newly recapitalized, restructured institution. This can be done in a manner that minimizes losses, maximizes the going concern value of the failed institution, mitigates or avoids a severe destabilization or collapse of the financial system, and ensures any and all losses are ultimately borne by shareholders and creditors rather than taxpayers. Elsewhere, in the UK, the Banking Act 2009 put in place a permanent special resolution regime providing the FSA, Bank of England and Her Majesty's Treasury with tools to protect financial stability by effectively resolving failing banks. These improved resolution processes, which allow authorities to apportion losses to existing creditors, are a significant step towards minimizing the impact of the failure of large financial institutions by maximizing firm value and reducing moral hazard. Like the widely discussed notion of a bail-in regime, they effectively provide authorities with additional loss-absorbing capacity at the point of failure.

19. Work on SIFI supervision, Pillar 2 implementation, recovery and resolution planning, and resolution regimes offers significant potential for addressing the regulatory challenges posed by large or interconnected firms. These initiatives entail considerable cost to the industry but the benefits are more evident than implementing yet another capital buffer directed at SIFIs.

Conclusions

20. GFMA and its members are fully supportive of the need to establish a policy framework to reduce the probability and impact of SIFI failures. It is important that

any framework pays due regard to the extensive regulatory changes that are already underway and the cumulative impact that they are likely to impose on SIFIs, as well as on the broader financial sector and wider economy. Understandably, precise quantification of such impacts is impossible at this stage. This argues for proceeding with caution if regulators are to ensure that the economic consequences of any new regulation are properly understood.

21. To these ends, we strongly encourage the FSB and the BCBS to recognize the many significant changes that have already been adopted that will reduce the probability and impact of the failure of SIFIS, as well as the important initiatives underway that will further this goal. GFMA strongly recommends that these many recent and pending regulatory changes and supervisory efforts underway, many of which have been crafted by the FSB and the BCBS, have a chance to take effect before considering whether to institute additional capital requirements.

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Again, we thank the FSB Standing Committee on Supervisory and Regulatory Cooperation for its invitation to this meeting and for its work on these challenging issues.

Respectfully submitted,

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