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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Consultative Document: *Globally systemically important banks: Assessment methodology and the additional loss absorbency requirement*

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (the **Basel Committee**) July 2011 consultative document, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement* (the **Consultation Document** and, the proposed changes set forth therein, the **Proposal**).

ABA has consistently voiced strong support for ongoing regulatory reform efforts that aim to make international financial systems safer and more robust, with the broader goal of enhancing the ability of banks to serve customers. For those reasons, we have fundamental reservations regarding both the underlying concept of a significant additional capital surcharge on globally systemically important banks (**G-SIBs**) as well as the design of the indicator-based methodology described in the Consultation Document. We believe that as proposed they will in fact reduce the ability of the banking industry to serve customers. We do not accept the view that more capital is always the answer and strongly believe that excessive capital requirements are economically inefficient, permanently reducing the economic growth potential of the nation. Moreover, while they can inhibit the ability of banks[2] to support the economy, they can also create competitive discrepancies. Nor do we agree with the view that it is not feasible to end too-big-to-fail. We believe that it is possible and necessary to end the too-big-to-fail notion, a position that was also reinforced by the United States executive and legislative leaders at the time of the enactment of the Dodd-Frank Act.[3] We also note that the Financial Stability Board (the **FSB**) is currently working on a parallel effort to ensure that member nations adopt resolution protocols that clearly and effectively enable orderly liquidation of any failing institution without taxpayer support. This effort underscores the conclusion that the negative consequences associated with institutions perceived as too-big-to-fail can be effectively addressed without a punitive add-on capital requirement.

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees.
[2] The term "**banks**" here refers to both bank holding companies and depository institutions.
[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203 (2010).

The U.S. banking sector is well-capitalized by any regulatory definition, with capital ratios at historically high levels. The industry's three regulatory capital ratios— the leverage capital ratio, tier 1 risk-based capital ratio, and total risk-based capital ratio—were at all-time highs at the end of the 2nd quarter 2011.[4] This well-capitalized sector is in a position to aid the world's economic recovery if it is allowed to. Continual demands for banks to raise excess capital, significant regulatory policy uncertainty, and examination overkill in the U.S. have made it difficult for banks to lend. The proposed increase in required levels of capital is expected to result in a substantial reduction in the ability of large banks to perform their core intermediation functions and provide funding to the broader economy through loans, investments, and trading activities. This will impact large bank customers and counterparties through a reduction in available financial resources, reducing the pool of funds readily accessible for borrowing, investing, and trading and, thus, erode the ability of banks to serve as engines of economic recovery from the deep recession.

In view of recent national and international bank regulatory reform efforts, the uncertain benefits and potentially significant costs of an additional capital surcharge, and the significant flaws in the Proposal's concept and design, we believe that the Proposal is at best premature. This rushed proposal poses considerable risks to the international financial system and the global economy by requiring a major additional capital surcharge on G-SIBs. Furthermore, numerous and serious gaps in the Consultation Document prevent fully adequate analysis and comment on the Proposal at this time.

For these reasons, ABA strongly believes that the current proposal should be withdrawn and reconsidered. Any re-proposal should contain a transparent and empirically supported methodology; take into account the domestic regulatory environment in which banks operate, including resolution regimes; demonstrate that the benefits exceed the costs of reduced economic growth; and address other concerns highlighted in this letter. The current fragile condition of the global economy will not well tolerate such a risky experiment as that offered in the current proposal.

I. Policy Concerns

A. The Proposal creates a "black box" for calculating surcharges, rendering banks unable to determine their capital surcharge.

It would be essential that the determination of any surcharge be conducted in a transparent manner for at least two reasons. First, banks should have the information necessary to adjust their risk profiles and business models in order to adapt to the new regulatory capital regime. Second, without transparency, a cloud of uncertainty is created over each potential G-SIB, which adversely affects the market price for its securities and thereby affects the availability of capital. The Proposal, however, provides little if any transparency regarding the assessment and calculation of the surcharge. Instead, it effectively creates a "black box" for determining the surcharge, rendering a bank unable to calculate its own surcharge or to take steps to reduce its systemic importance scores, and thereby injecting substantial uncertainty into the capital

[4] FDIC's Quarterly Banking Profile, 2nd quarter 2011.

planning process. This additional uncertainty comes at a particularly inopportune time given the already acute uncertainty under which banks currently operate as a result of a multitude of new, complex rules adopted, and pending, following the financial crisis. ABA is deeply concerned that this uncertainty will have adverse consequences not just for banks but also for their customers, investors, and the general economy.

Because the G-SIB capital surcharge described in the Proposal effectively punishes size and global footprint, banks should have the ability to evaluate their structure and operations and proactively determine the potential magnitude of the applicable surcharge in order to manage and/or mitigate its potential impact. However, data for many of the indicators do not at present exist, as acknowledged by the Basel Committee, making it nearly impossible for banks to estimate the magnitude of the surcharge.[5] Creating a cross-jurisdictional uniform aggregated database that earns the confidence of the markets will involve substantial challenges that require addressing different business and reporting practices, different accounting regimes, and currency conversion. If this database is not successfully created, the surcharges will almost certainly be unreliable and inequitable.[6] The present lack of such a database obviously creates a great deal of uncertainty in the capital and business planning of banks potentially subject to the proposed surcharge.

Moreover, even if this database existed, a bank still could not determine its systemic importance score – and thus its surcharge – with any degree of accuracy over time because of two features of the Proposal's methodology for determining the surcharge. First, systemic importance scores are determined on a relative basis. As a result, in order for a bank to calculate its individual systemic importance score, it will need the ability to calculate and forecast not just the amount of each of the individual indicators for itself, but also the denominators of each of the respective indicators. However, the metrics chosen for the indicators are difficult to model even internally for an individual bank; modeling them for a subjective sample of 73 banks is not feasible. Second, even assuming a bank could accurately model the indicator values for itself and the 72 other banks and thereby estimate its systemic importance score with a reasonable amount of confidence, the thresholds for the buckets are adjusted every three to five years, making long-term capital planning nearly impossible.

The inability of a bank to estimate its surcharge with any accuracy frustrates bank management's ability to make fundamental business decisions on an informed basis and creates uncertainty regarding the amount of capital that must be held. In general, given the potentially severe supervisory consequences of holding too little capital, uncertainty regarding the magnitude of the

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[5] Consultation Document, ¶ 71 ("The Basel Committee acknowledges that the data used to construct the indicator based measurement approach currently may not be sufficiently reliable or complete. . . [T]he Basel Committee will address any outstanding data issues and re-run the indicator-based measurement approach using updated data well in advance of the implementation . . . This includes issues such as providing further guidance on the definition of the indicators, how to standardise further the reporting across the sample banks and how to address data that are currently difficult to collect or not publicly available"). Although rerunning the data and approach at a later date may prove helpful, it will be too late to mitigate the impact of the interim uncertainty.

[6] We strongly believe that the surcharge should not be implemented – whether formally or informally – prior to the completion of this database, regardless of whether this database is completed before the beginning of the proposed phase in period (*i.e.*, January 1, 2016).

regulatory surcharge will require banks to hold a much higher amount of capital in the form of an "uncertainty surcharge." Although this result may seem to some like an acceptable, or even desirable, regulatory outcome, capital is not free, and the incidence of the costs of holding more capital than is necessary or appropriate will not fall solely on banks, but also on customers of the banks and on the general economy. The lack of transparency surrounding the calculation of a bank's systemic importance score also makes the banking industry more difficult to understand for investors by introducing volatility and uncertainty in capital and associated profitability and investor return projections. Moreover, this lack of transparency seriously undermines the Proposal's credibility and hinders banks' ability to provide meaningful comment. Finally, it unnecessarily exposes regulators to the likelihood of public criticism for demonstrating presumed favoritism or acting punitively, undermining public credibility of the regulators.

B. The proposal should take into account the current regulatory environment and recent regulatory reforms.

Over the past two years, significant regulatory reforms have been introduced both by the Basel Committee and domestic regulators in order to address a wide variety of regulatory concerns, including capital adequacy, liquidity risk, loss absorbency, market risk, stress testing and resolution, and capital planning. Many of these measures will require, or have in practice already required, potential G-SIBs to make major changes to their capital structures, balance sheet composition, and liquidity and operational risk management functions, calling into question the need to impose an additional capital surcharge at this time.

Late last year, the Basel Committee finalized the Basel III capital requirements. Basel III dramatically increased minimum common equity capital requirements in three ways: by more than tripling the required ratio of common equity to risk-weighted assets; by significantly reducing the types of capital that would count as common equity; and by significantly increasing the risk-weights for certain types of assets. The net effect was to quadruple (or more) the required level of common equity for most large banks, which have since raised enormous amounts of capital (and in many cases shed assets) to begin complying with the new rules. In light of the Basel III requirements, and the current capital levels of large banks, ABA believes the surcharge is unnecessary for the purpose of ensuring adequate capital positions.

The imposition of significant additional capital surcharges on G-SIBs is premised on the assumption that these higher requirements are necessary to address the negative externalities and moral hazard costs associated with institutions with perceived implicit guarantees of governmental support.[7] As a logical matter, therefore, the need for such a capital surcharge

[7] *See, e.g.*, Consultation Document, ¶¶ 2, 3 ("The rationale for adopting additional policy measures for G-SIBs is based on the cross-border negative externalities created by systemically important banks which current regulatory policies do not fully address. . . . The negative externalities associated with institutions that are perceived as not being allowed to fail due to their size, interconnectedness, complexity, lack of substitutability or global scope are well recognized. In maximizing their private benefits, individual financial institutions may rationally choose outcomes that, from a system-wide level, are sub-optimal because they do not take into account these externalities. Moreover, the moral hazard costs associated with implicit guarantees derived from the perceived expectation of government support may amplify risk-taking, reduce market discipline and create competitive distortions, and further increase the probability of distress in the future.")

would be mitigated to the extent that such negative externalities and moral hazard costs are eliminated or reduced.

The U.S., for example benefits from the Federal Deposit Insurance Corporation's robust and tested bank resolution scheme. The very existence of this resolution regime informs the market place that depository institutions can fail. This resolution regime is unmatched in any other jurisdiction and it is funded by the industry. In addition, new orderly liquidation authorities we enacted pursuant to Title II of the Dodd-Frank Act. The U.S. has supplemented this regime with numerous other rules designed to limit financial institutions' risk taking and reduce systemic risk, including regular stress tests, living wills, concentration limits on expansion, the migration to centrally cleared swaps and related margin and capital requirements, the ability to require the prudential supervision of systemically important non-bank financial entities, new regulations on securitizations markets (including enhanced disclosures and risk retention requirements), reforms of credit rating agencies, and the establishment of the Financial Stability Oversight Council to coordinate detection of and response to systemic risks. While none of these measures are without fault or controversy, they are an important part of the context in which the Proposal must be considered, particularly with regard to their intention of reducing systemic and individual bank risk as well as their likely impact on bank costs and ability to serve customers.

The very logic behind the imposition of a significant capital surcharge on G-SIBs rests on the existence of substantial negative externalities and moral hazards. Regulatory reforms which reduce such problems and otherwise decrease systemic risk must be taken into account in order for such a proposal to be consistent with its foundational goals. Nevertheless, and quite paradoxically, the Consultative Document indicates that such considerations should not play a role in the G-SIBs' additional capital surcharge equation.[8]

We strongly believe that this doubling up of approaches for G-SIBs – both (i) reforms intended to address systemic and individual bank risk, which inherently involve substantial additional costs; and (ii) a significant capital surcharge – is not only excessive but deeply taints the logic of the whole Proposal. Indeed, the very failure to recognize, or otherwise take into account the existence of, such reforms when determining whether to impose a G-SIB surcharge, and in what amount, is indicative of a fundamental analytical flaw and internal logical incoherence in the assumptions underlying the imposition of a significant capital surcharge on G-SIBs as outlined in the Consultation Document.

C. G-SIB capital surcharges reduce economic and job growth.

Imposing higher capital requirements on G-SIBs is not a cost-free proposition. The trade-off between safety and growth is well recognized, primarily in the form of increased capital holdings resulting in reduced credit availability and banking activity. The Basel Committee has itself recognized these potentially negative consequences. The Consultative Document sets forth a provisional estimate, based on earlier work done by the Committee's Macroeconomic Assessment Group (**MAG**) in the context of Basel III, that the proposed surcharge would dampen growth during its phase-in period. While the provisional estimate shows only a modest

[8] *See* Consultation Document, ¶ 56.

reduction in growth,[9] that minimalist estimate is not empirically supported, because the MAG's full analysis of the projected impact of the surcharge will not be completed and published until September– after the public comment period has expired with respect to the Consultative Document.

Given the critical importance of this issue, ABA strongly believes that the Basel Committee should withdraw the proposal until it has better understanding of the economic impact. It is important that the Committee benefit from public comment on the potential impact of the proposed surcharge before finalizing its views. ABA makes these requests based on the conviction that the risk to growth from the surcharge is likely to be significant. ABA has serious concerns about the potential macroeconomic impact of the Proposal over the long run, and deep worries about its short-term impact given the current state of the economies of the nations most affected by it. A precipitous increase in required levels of capital would be expected to result in an immediate, substantial, and enduring reduction in the ability of banks to perform their core intermediation functions and provide capital to the broader economy through loans, investments, trading activities, and other banking services. This will impact bank customers and counterparties through higher costs of borrowing, investing, and trading. These increased costs and the lower supply of bank intermediation activities will translate into lower levels of domestic and global economic growth, reducing the growth potential for the economies affected for as long as the requirements remain in effect.

Finally, we believe the MAG should evaluate the economic impact as if the surcharge were applied immediately and without a transition period. If the reaction to the Basel III requirements is any guide, banks will be pressured by markets (which demand immediate financial recognition of planned regulatory mandates) to adjust to the new standards quickly, at exactly the same time that the financial system is adjusting to an unprecedented number of regulatory initiatives, further undermining the fragile economic recovery.

D. There are significant uncertainties in the theoretical and policy foundations of a G-SIB surcharge, including the appropriate calibration of such surcharge. Given these uncertainties, the imposition of a G-SIB surcharge could have unintended consequences and risks that are not readily apparent.

Even accepting, for argument's sake, the appropriateness of a G-SIB surcharge, there are significant uncertainties and open questions concerning the theoretical and policy foundation of a G-SIB surcharge, including, as the Basel Committee itself readily acknowledges, questions regarding the appropriate method to calibrate such a surcharge.[10] Depending on the assumptions

[9] Based on the MAG's earlier work, "a one percentage point increase in capital applied to G-SIBs would dampen growth by an additional 0.08 to 1.46 basis points per year for an eight year implementation period. For a four year implementation period, the range of impacts is 0.17 to 3.17 basis point per year on average over the transition." Consultative Document, p.16 (¶ 78). The Document acknowledges that this amount could be higher or lower depending on several factors. *Id*., n.24.

[10] *See* Basel Committee on Banking Supervision, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirements* (July 2011), at 23 (regarding its empirical analysis undertaken in support of the assessment of the magnitude of additional loss absorbency that "[i]t is important to note that there is no single correct approach that is reliable enough to inform the assessment of the magnitude of additional loss absorbency . . . . All the approaches suffer from data gaps and the results are sensitive to assumptions made . . . . The estimates of the magnitude of additional loss absorbency based on the expected impact approach, assessment of

selected and measurement method chosen, the "systemic importance" of a bank can vary widely. The empirical measurement of systemic importance is in its infancy, and academic commentators pursuing this research regularly caution against directly adopting their work as part of a regulatory framework.[11] There has been limited research regarding capital surcharges affecting only the largest institutions. The majority of research focuses on the impact of Basel III or system-wide optimal capital levels. Finally, and perhaps most significantly, the full potential combined impact of the current financial-services regulatory reforms has not yet been comprehensively analyzed.[12] The cumulative effects of these complex rules could have economic costs and other unintended consequences and risks that are not readily apparent but nevertheless significant.

E. A capital surcharge on G-SIB's could encourage the growth of the unregulated shadow banking system and therefore serve to increase systemic risk by feeding regulatory inconsistencies and anomalies.

Demand in the economy for the products and services that G-SIBs are no longer willing or able to provide because of the higher costs imposed by a G-SIB surcharge will not, of course, simply evaporate. The provision of some of these products and services is likely to shift to the unregulated shadow banking sector.[13] The Proposal particularly exacerbates this problem by imposing a surcharge on certain banks well in advance of even considering the imposition of a similar surcharge on other systemically important financial institutions. In view of the unregulated shadow banking system's role in events leading up to the recent financial turmoil,[14] a migration of financial activity and market share to those market participants would do little to ward off future systemic problems.[15] In addition, the unregulated shadow banking system can exhibit volatile and intermittent flows compared with the traditional banking system's credit intermediation function. This lack of reliability as a source of funding would subject borrowers

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the long-term economic impact and too-big to-fall [*sic*]. . . subsidies are based on imperfect models and involve numerous assumptions and judgments.").

[11] *Cf.* John B. Taylor, Systemic Risk in Theory and Practice, at 51 (stating that systemic risk is still not well defined and that reform proposals relying on systemic risk to determine in advance whether a firm should be deemed systemically significant "are not ready for prime time") (2010), http://www.stanford.edu/~johntayl/Onlinepaperscombinedbyyear/2010/Defining_Systemic_Risk_Operationally.pdf.

[12] Public sector officials have acknowledged that the aggregate impact of the current financial-services regulatory reforms in the U.S., including the Dodd-Frank Act and Basel III, have not yet been fully analyzed. *See, e.g.*, Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke's Speech on the U.S. Economic Outlook (June 7, 2011) (transcript available at http://video.cnbc.com/gallery/?video=3000026289) (noting that no one had yet done an analysis of the impact of the recent financial reform on credit and stating, "It's just too complicated. We don't really have the quantitative tools to do that.").

[13] This transfer of business to the shadow banking sector is of course already underway. *See, e.g.*, Kate Berry and Jeff Horwitz, *Regs Push MetLife Out of Banking, into Shadow System*, American Banker (July 2011) (discussing MetLife's decision to sell its bank but to continue writing mortgages).

[14] *See* Financial Stability Board, *Shadow Banking: Scoping the Issues*: *A Background Note of the Financial Stability Board* (April 12, 2011), at 3, available at http://www.financialstabilityboard.org/publications/r_110412a.pdf.

[15] *Cf.* Zoltan Pozsar, Tobias Adrian, Adam Ashcraft and Hayley Boesky, *Federal Reserve Bank of New York Staff Reports: Shadow Banking*, Staff Report no. 458, at 69 (July 2010) (questioning whether the economically viable parts of the shadow banking system "will ever be stable through credit cycles in the absence of official credit and liquidity puts").

and investors to marketplace vagaries. Both of these outcomes would actually increase systemic risk – quite the opposite of the ultimate goal of the Proposal.

F. The G-SIB surcharge will lead to unjustified competitive inequities among firms.

Imposing a significant capital surcharge on G-SIBs will lead to competitive inequities both between G-SIBs and other large nonbank financial institutions and between G-SIBs and other large banks that are not subject to the surcharge. Under the Proposal, only 28 of the 73 presumably large international banks selected for analysis (and whose data is aggregated for purposes of the denominator used for the indicator-based approach) will be subject to a capital surcharge. In addition, the 28 G-SIBs themselves will be subject to differentiated surcharges based on the yet to be defined buckets to which they ultimately are assigned. Although we do not yet know the cut-off scores for surcharge versus no surcharge or for the various surcharge buckets, inherent in the very nature of a formula-based approach, such as the Proposal, is the probability that such scores will have arbitrary effects among banks, especially those whose scores are just below and just above a particular cut-off score. Nevertheless, fine numerical distinctions on the Proposal's normalized scale could have dramatically different effects on institutions with essentially very similar risk profiles in practice. This will necessarily lead to unjustified competitive inequities among firms, where small statistical differences substantially increase a firm's capital requirements in relation to those of its competitor or competitors under the Proposal by way of regulatory fiat rather than genuine risk realities.

In addition, the G-SIB surcharge will exacerbate competitive inequities arising from jurisdictional differences in accounting, definitions of capital, and the calculation of risk-weighted assets;[16] further affecting G-SIBs based in jurisdictions with more conservative accounting and supervision standards.

G. Capital should serve as a buffer in case banks suffer unexpected losses; it should not be set at levels and assessed pursuant to a methodology where business decisions are effectively made for G-SIBs by regulatory fiat or formula.

The combination of the Proposal's indicator-based methodology and the high capital charges it imposes would mean that asset allocation and business mix decisions will be dictated to a significant degree by the potential assessment of regulatory capital charges. Thus, fundamental decisions regarding which businesses to conduct and assets to hold, as well as organic growth or other expansion, will to some degree be made by regulators. We do not believe that this is desirable or appropriate or economically efficient; capital should serve as a buffer in case banks suffer unexpected losses; it should not be set at levels and assessed pursuant to a methodology where business decisions are effectively made for G-SIBs by regulatory fiat or formula.

[16] It is unclear how U.S. regulators will adopt portions of the Basel Accord in light of section 171 (which establishes a risk based capital floor) and section 939A (which requires the removal of regulatory references to ratings) of the Dodd-Frank Act. As a result, it is unlikely that capital requirements will be harmonized across jurisdictions in the near future.

H. Numerous aspects of the Proposal's indicator-based methodology are seriously flawed.

ABA generally agrees with the Basel Committee that no measurement approach will perfectly measure systemic importance across all global banks,[17] and perfection should not be demanded of any methodology. Nevertheless, we have serious concerns with numerous aspects of the Proposal's indicator-based methodology, including the following:

1. The Proposal's indicator-based methodology should not be a relative measure.

ABA is concerned that the scores for each bank are derived on a relative basis to the other banks in the sample. As a result, it is not clear what would occur if the average scores for all the banks change – in either direction. It is also not clear how and when the sample of 73 banks will change. In this sense, the proposed test would not reward risk reduction because it "grades on a curve." That is, an institution would be rewarded only if it materially decreased its risk *relative to* other G-SIBs. To the extent the entire industry evenly reduces a risk factor measured by the proposal, no G-SIB's score is reduced. As a result, the proposal as written does not incentivize major, industry-wide risk reduction.

Moreover, well-managed banks would be disadvantaged by rising scores if, by virtue of their safety and soundness, they maintain or grow their market shares during periods when the industry shrinks, regardless of how well-managed the growth was or how it may have added to the safety of the institution. Additionally, if such well-capitalized and managed institutions should engage in loan growth or stabilizing acquisitions during times of distress, they could be penalized for doing so. We do not believe it is at all sensible to penalize these banks under such circumstances.

2. The Proposal does not account for the benefits of diversification. Instead it punishes banks that diversify their assets across jurisdictions and business lines.

All else held equal, an undiversified portfolio of assets is riskier than a diversified portfolio. The Proposal, however, not only fails to provide any offsetting benefits for banks with diversified assets but actually penalizes banks for diversifying their assets geographically and across business lines. This approach is inherently flawed, because it fails to accord recognition to the risk mitigations of geographic and business line diversification. That approach is inconsistent with best risk management practices.

3. Basing the "size" indicator on the Basel III leverage ratio total exposure measure aggravates existing industry concerns.

[17] *See* Consultation Document, ¶ 13.

Under the Proposal, the "size" category is measured using total "exposure" as defined in the denominator of the Basel III leverage ratio. ABA believes that this exposure test would provide a seriously inaccurate evaluation of size unless it is adjusted to address the concerns already voiced by the industry in other comments.[18] These concerns include (i) the inclusion of gross "sold" credit derivative positions without recognition of off-setting hedges and (ii) the failure to use reasonable conversion factors for off-balance sheet commitments (*e.g.*, an assumed 100% draw-down on liquidity facilities and trade finance commitments, which is not justified by the available empirical data). Until these issues are resolved, the Basel III definition of exposure is an aberrant indicator of size.

4. Contrary to best risk management practices, the cross-jurisdictional indicators encourage banks to fund foreign claims with home country liabilities.

The focus of the cross jurisdictional activity category is to capture the "global footprint" of banks, and it is based on the assumption that the "greater the global reach of a bank, the more difficult it is to coordinate its resolution and the more widespread the spillover effects from its failure."[19] Contrary to sound risk management practices, the proposed methodology actually promotes funding structures that could result in a more complicated resolution process and hence entail higher resolution risk. This methodology creates an incentive for banks to fund local assets with home country liabilities, rather than with local liabilities – an objectively riskier practice in view of exchange rate and exchange control risks, interest rate risks, ring fencing, and other regulatory mandates that could prevent the transfer of local currency assets to home country liability holders in the event of an insolvency. To illustrate this issue, consider the following hypothetical bank structures:

- Structure 1: A U.S. bank holding company with subsidiaries or branches in 25 countries. Each subsidiary or branch has local currency assets funded entirely by local currency liabilities.
- Structure 2: A U.S. bank holding company with subsidiaries or branches in 25 countries. Each subsidiary or branch has local currency assets funded by U.S. liabilities.

Assume the size of the local currency assets in each of the 25 branches or subsidiaries are identical in structures 1 and 2. All else held constant, Structure 2 would be the riskier and more difficult structure of the two to resolve. However, according to the methodology for determining a G-SIB's score for the cross jurisdictional activity, Structure 2 would have the smaller indicator score, because in Structure 2 the bank holding company does not have any "cross-jurisdictional liabilities" for purposes of this indicator.[20] In other words, the proposed methodology would penalize a G-SIB for funding locally held assets with local liabilities, and instead encourage it to

[18] See, letter to the Basel Committee, from the ABA, dated April 15, 2010. Available at http://www.aba.com/NR/rdonlyres/DC65CE12-B1C7-11D4-AB4A-00508B95258D/66804/cl_BCBS_2010Apr15.pdf.
[19] Consultation Document, ¶ 18.
[20] Structure 1 and Structure 2 are equivalent with respect to the other individual indicator for this category – cross-jurisdictional claims.

fund those assets with liabilities in its home country, even though match funding with local liabilities is far less risky. Thus, the methodology would incentivize cross-border funding of foreign operations, a practice that is objectively riskier as described above.

5. The indicators' failure to account for the risk of assets, derivatives, or exposures held by a bank is inconsistent with the stated aim of the Proposal to reduce the probability of failure of G-SIBs.

Each of the cross-jurisdictional activity, size, interconnectedness, and complexity categories contains an indicator or indicators that attempt to quantify the amount of assets, derivatives, or other exposures held by a bank. None of these indicators, however, takes into account the risk profile of those assets, derivatives, or exposures for purposes of determining a bank's indicator-score. This failure to account for the riskiness of the assets, derivatives, and other exposures of G-SIBs is not consistent with the goal of reducing the probability of default of G-SIBs, another serious flaw in the Proposal's methodology.

6. A bank's score for the wholesale funding ratio is erroneously inflated, because it does not measure the term of the wholesale funding.

The wholesale funding ratio is flawed in that it does not consider the term of wholesale funding. Longer-term funding generally puts less pressure on capital than does short-term funding. In a crisis, if an institution has wholesale funding with a term, for instance, of three years, then the roll-over risk is much further out and at a time, potentially, when the crisis will have been resolved. We therefore believe that the term of a bank's funding is a more relevant factor to systemic risk in a crisis than the source of its funding (*i.e.*, whether it is from retail or wholesale sources). Although the Basel Committee notes its concern about the risk inherent in short-term financing, the wholesale funding ratio indicator does not address this concern, because it does not measure the term of the wholesale funding, and as a result it inflates the indicator.

7. A gross notional measure of OTC derivatives overstates the risks associated with holding such derivatives.

The OTC derivatives indicator in the complexity category calculates the value of OTC derivatives on a gross notional basis. Most OTC derivatives activity is conducted, however, pursuant to legally enforceable netting arrangements. As a result, the exposure of such derivatives is limited to a net obligation. The Proposal's failure to recognize legally enforceable netting arrangements overstates the risks associated with holding such derivatives. It also effectively penalizes the banks that spent the time and resources to establish such netting arrangements, by failing to take account of the success of efforts to reduce risk. For example, if one were to assume two banks with 1000x of gross notional exposure on the same book of business and one has netted down to 10x and the other to 1x, the OTC indicator would treat the 10:1 difference in risk as between the two banks in this example as non-existent—clearly an absurd result from a risk perspective.

Moreover, basing the OTC derivatives indicator in the complexity category on the gross notional amount also fails to take into account important differences which exist within the derivative markets. For example, the primary risk in FX transactions is settlement risk, a concern largely addressed via the development and use of a well-functioning international settlement process, namely Continuous Link Settlement (**CLS**). In order to ensure consistency in the treatment of FX transactions within the G-SIB framework, we recommend that transactions executed via CLS should be excluded from the definition of OTC derivatives notional value. Similarly, OTC derivatives that are centrally cleared should be excluded from the measure.

8. The Proposal appears to assume custody accounts would become inaccessible to customers as a result of failure.

The Proposal states that the failure of a large custodian bank holding assets on behalf of customers could disrupt the operation of financial markets. The Proposal thus appears to assume that assets held under custody at a failed bank would become inaccessible to the customers as a result of the failure. We do not believe that assumption is warranted. To the extent there is uncertainty regarding the status of assets upon a custodian's failure, the Basel Committee should undertake the research necessary to establish the systemic significance of custodial relationships. We do not believe that assets under custody is inherently indicative of systemic importance.

II. Other Concerns and Requests for Clarification

A. ABA would appreciate additional information on the methodology used to determine that 28 banks will initially be designated as G-SIBs.

The Proposal states that based on the result of applying the indicator-based methodology, the Basel Committee determined that the number of G-SIBs will initially be 28. No criteria or other explanation was provided for how the Basel Committee arrived at this number, other than noting that one bank was added based on the supervisory judgment of its home country supervisor. ABA believes that a transparent process requires additional information regarding the criteria the Basel Committee used to determine that 28 banks would initially be designated as G-SIBs.

B. ABA requests that the Basel Committee clarify how often the denominator used to calculate the systemic importance score will be updated.

The Proposal notes that "bank scores will be updated annually based on new data applied to the numerator in calculating the score."[21] However, the Proposal does not state whether the denominator will also be updated at that time. This omission could be interpreted to imply that the denominator will be updated every three to five years, at the time the threshold scores are updated. ABA would appreciate the Basel Committee clarifying how often the denominator will be updated. ABA also requests clarity about the long term engagement the Basel Committee will have with national regulators to ensure internationally consistent application.

C. ABA requests that the Basel Committee clarify its use of the term "weighting" as it applies to the determination of a bank's indicator scores.

[21] Consultation Document, ¶ 69.

We note that the Proposal states that the score for a particular indicator is calculated by "dividing the individual bank amount by the aggregate amount summed across all banks in the sample for a given indicator. The score is then weighted by the indicator weighting within each category."[22] However, when giving an example of this calculation, the Proposal states that if the size indicator for a bank accounts for 10% of the sample aggregate size variable, it will contribute 0.10 to the total score for the bank, and does not multiply the .10 by 20%[23] – that is, it fails to multiply the score by the weighting of the indicator, but rather appears to be multiplying the indicator score by a fraction equal to one over the number of indicators in the category (which in the case of the size indicator equals 1) and adding that to the total systemic importance score. ABA would appreciate the Basel Committee clarifying its use of the term "weighting" and providing additional examples regarding how the indicator scores are supposed to be calculated.

III. Conclusion

ABA strongly believes that the current proposal should be withdrawn and reconsidered. Any re-proposal should contain a transparent and empirically supported methodology; take into account the regulatory environment in which banks operate, including resolution regimes; demonstrate that the benefits exceed the costs (particularly the costs of reduced economic growth); and address other concerns highlighted in this letter.

Thank you for the opportunity to comment. If you have any questions or need additional information, please contact the undersigned at 202.663.5324 or via email at hcarney@aba.com.

Sincerely,

Hugh Carney
Senior Counsel

[22] Consultation Document,¶ 17.
[23] Consultation Document,¶ 17.