Recent Developments Related to Capital

2. Daniel K. Tarullo Testimony to the Committee on Financial Services, June 16, 2011
3. Timothy Geithner Remarks to the International Monetary Conference, June 6, 2011
5. Final Rule: Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor
Regulating Systemically Important Financial Firms

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As the one-year anniversary of the Dodd-Frank Act approaches, there will be much discussion about the progress that has been made in reforming financial regulation. Today I would like to get a head start on this exercise, concentrating on Dodd-Frank’s requirement that the Federal Reserve Board establish special prudential standards for systemically important financial institutions or, as they are now generally known, “SIFIs.” My focus will be on the requirement for more stringent capital standards, which has generated particular interest.

Let me begin by placing this regulatory task in context. The financial crisis spawned or strengthened many reform agendas – among them consumer protection, securities and commodities market regulation, and traditional bank regulation. But a focus on systemic risk has been central to reform efforts, and fittingly so. It was, after all, a systemic financial crisis that we experienced and that led to the Great Recession that affects us still today. Regulatory reform in the wake of the crisis cannot be judged a success if it does not reduce the incidence and severity of future crises.

The pre-crisis regulatory regime had focused mostly on firm-specific or, in contemporary jargon, “microprudential” risks. Even on its own terms, that regime was not up to the task of assuring safe and sound financial firms. But it did not even attempt to address the broader systemic risks associated with the integration of capital markets and traditional bank lending, including the emergence of very large, complex financial firms that straddled these two domains, while operating against the backdrop of a rapidly growing shadow banking system.

A post-crisis regulatory regime must include a significant “macroprudential” component, one that addresses two distinct, but associated, tendencies in modern financial markets: First, the high degree of risk correlation among large numbers of actors in quick-moving markets, particularly where substantial amounts of leverage or maturity transformation are involved.
Second, the emergence of financial institutions of sufficient combined size, interconnectedness, and leverage that their failures could threaten the entire system.

In prior speeches I have discussed the correlated risks present in such areas as money market funds and repo markets.¹ This afternoon I turn to some of the issues surrounding regulation of SIFIs. Before doing so, it is important to underscore what is at stake here. For all the disagreements among legislators, policy officials, and the public over the right set of financial reform measures, I have noted one point on which there is near unanimity: No one wants another TARP program. Not those who thought TARP was the best of a bad set of options in the fall of 2008. Certainly not those who opposed it. Not the American people, many of whom saw the injection of billions of dollars of government capital into financial firms as more a bail-out of large banks than an imperative to stabilize the financial system. And not even, I suspect, most of the large financial firms that received the government capital.

In a period of financial stress, the disorderly failure of one or more SIFIs carries the potential for a devastating impact on the financial system. The fear elicited by that prospect led the Bush Administration to ask for TARP authority. That same fear led many members of Congress with no great love for large financial firms to vote for TARP. Those actions are further evidence for the proposition that, no matter what their general economic policy principles, government officials faced with a cascading financial crisis that threatens to bring down the national economy will usually support measures to rescue large banks. In order to avoid the need for a new TARP at some future moment of financial stress, the regulatory system must address now the risk of disorderly failure of SIFIs.
Rationale for Enhanced Capital Requirements

Last fall central bank governors and heads of supervision from countries represented on the Basel Committee on Banking Supervision agreed to the important package of reforms in capital regulation known as Basel III. The Basel III requirements for better quality of capital, improved risk weightings, higher minimum capital ratios, and a capital conservation buffer comprise a key component of the post-crisis reform agenda. But they are just that – a component. Although a few features of Basel III reflect macroprudential concerns, in the main it was a microprudential exercise. The new minimum equity capital ratio and conservation buffer were calibrated on the basis of an historical examination of the individual loss experiences of banks in the United States and six other countries.

A macroprudential perspective on capital requirements complements the microprudential orientation of Basel III. There would be very large negative externalities associated with the disorderly failure of any SIFI, distinct from the costs incurred by the firm and its stakeholders. The failure of a SIFI, especially in a period of stress, significantly increases the chances that other financial firms will fail, for two reasons. First, direct counterparty impacts can lead to a classic domino effect. Second, because losses in a tail event are much more likely to be correlated for firms deeply engaged in trading, structured products, and other capital market instruments, all such firms are vulnerable to accelerating losses as troubled firms sell their assets into a declining market.

A SIFI has no incentive to carry enough capital to reduce the chances of such systemic losses. The microprudential approach of Basel III does not force them to do so. The rationale for enhanced capital requirements for SIFIs is to take these costs into account, make SIFIs less prone to failure, and thereby to make the financial system safer. An ancillary rationale is that
additional capital requirements could help offset any funding advantage derived from the perceived status of such institutions as too-big-to-fail.

Of course, if a SIFI could be resolved in an orderly fashion, negative externalities could be greatly reduced. The special resolution regime in Dodd-Frank aims at just such an outcome. The FDIC is investing considerable time and talent into making that outcome more likely, and thus bringing a greater measure of market discipline to large financial firms more generally. Together with the FDIC, the Federal Reserve will be reviewing the resolution plans required of larger institutions by Dodd-Frank and, where necessary, seeking changes to facilitate the orderly resolution of those firms.

Still, we must acknowledge that we are some distance from achieving this goal. The legal and practical complexities implicated by the insolvency of a SIFI with substantial assets in many countries will make its orderly resolution a daunting task, at least for the foreseeable future.ii Similarly, were several SIFIs to come under severe stress, as in the fall of 2008, even the best-prepared team of officials would be hard-pressed to manage multiple resolutions simultaneously.

For these reasons, the special resolution mechanism of Dodd-Frank and the enhanced capital requirements called for by that same law should be regarded as complementary rather than as substitutes. Indeed, additional capital requirements would relieve some pressure on the insolvency regime. That regime, in turn, could over time induce additional market discipline so as to make more likely the chances that failure of a very large institution would be a manageable event.
Features of the Enhanced Capital Requirement

While Dodd-Frank mandates an enhanced capital requirement for SIFIs, it does not specify the form of that requirement. I would suggest five desirable characteristics.

First, in keeping with the macroprudential aims of SIFI regulation, an additional capital requirement should be calculated using a metric based upon the impact of a firm’s failure on the financial system as a whole. Size is only one factor to be considered. Of greater importance are measures more directly related to the interconnectedness of the firm with the rest of the financial system. Several academic papers try to develop this concept based on inferences about interconnectedness from market price data, using quite elaborate statistical models.iii Others have proposed using more readily observed factors such as intra-financial firm assets and liabilities, cross-border activity, and the use of various complex financial instruments.

Second, the metric should be transparent and replicable. In establishing the metric, there will be a trade-off between simplicity and nuance. For example, using a greater number of factors could capture more elements of systemic linkages, but any formula combining many factors using a fixed weighting scheme might create unintended incentive effects. On the other hand, using a small number of factors that measure financial linkages more broadly might reduce opportunities for unintended incentive effects, but at the cost of some sensitivity to systemic attributes of firms. Whatever the set of factors ultimately chosen, the metric must be clear to financial firms, markets, and the public.

Third, the enhanced capital standards should be progressive in nature. Dodd-Frank itself mandates that they “increase in stringency” with the systemic footprint of the firm, though the statute gives the Federal Reserve Board discretion in deciding how to realize this goal. There are good reasons for this requirement. Systemic importance is not a binary determination, but one of
degree. A related point is that it is generally better to avoid cliff effects, whereby significant regulatory consequences ensue based on relatively modest differences among firms. On this point, I would note that, while Dodd-Frank requires us to apply enhanced capital standards to all bank holding companies with more than $50 billion in assets, we would not want a big difference between the capital requirements for firms with assets just over that level and those just under that level. Thus the supplemental capital requirement for a $50 billion firm is likely to be very modest.

At the same time, it is important to build in constructive incentive effects. That is, the regulatory structure for SIFIs should discourage systemically consequential growth or mergers unless the benefits to society are clearly significant. There is little evidence that the size, complexity, and reach of some of today’s SIFIs are necessary in order to realize achievable economies of scale and scope.\textsuperscript{iv} Some firms may nonetheless believe there are such economies. For them, perhaps, the highest level of an additional SIFI capital charge may be worth absorbing. Others, though, may conclude in light of the progressive form of the capital requirement that changes in the size and structure of their activities would align better with their returns.

The implication of this point is that the enhanced capital requirements should increase based on the metric I discussed a few moments ago. As a theoretical matter, the ideal approach would be a continuous function, by which the percentage rate of the additional requirement would vary precisely with the measure of a firm’s systemic importance. An alternative would be a tiered structure, by which firms are divided into several groups on the basis of the systemic metric, with the rate of the additional requirement varying by group but the same for every firm in each group.
Fourth, it is important that an enhanced requirement be met with high-quality capital. Our presumption is that this means common equity, which is clearly the best buffer against loss and is what markets focused on during the crisis when evaluating the viability of financial firms. Some have suggested that a form of contingent capital instruments (“CoCos”) could be a partial or complete substitute for common equity. There is surely conceptual appeal in so-called “going concern” CoCos that convert from debt to equity early enough to forestall a run on a firm and keep it a viable financial intermediary even under stressed conditions. However, for all the attention paid to CoCos in the last few years, it is even now not clear as a practical matter that an instrument can be developed which would be cheaper than common equity but still structured so as to convert in a timely, reliable fashion. Furthermore, as the history of Tier 1 capital under the original Basel Accord teaches, there is considerable risk that once some form of hybrid is permitted, a slippery slope effect ensues, whereby national regulators approve increasingly diluted forms of capital under political pressures.

Fifth, U.S. requirements for enhanced capital standards should, to the extent possible, be congruent with international standards. The severe distress or failure of a foreign banking institution of broad scope and global reach could have effects on the U.S. financial system comparable to those caused by failure of a similar domestic firm. The complexities of cross-border resolution of such firms, to which I alluded earlier, apply equally to foreign-based institutions. For these reasons, we have advocated in the Basel Committee for enhanced capital standards for globally important SIFIs.

Achieving and implementing such standards would promote international financial stability while avoiding significant competitive disadvantage for any country’s firms. I would
note in this regard that it will be essential that any global SIFI capital standards, as well as Basel III, be rigorously enforced in all Basel Committee countries.

Work on this subject in the Basel Committee started a bit slowly, but it has picked up considerably in recent months. Although there is not yet consensus on some of the key elements, discussions have decidedly moved in that direction. I am hopeful that in the next several months we will be able to agree upon a proposal on which the Basel Committee can seek public comment. This international process would roughly coincide with a domestic notice and comment process on a proposed Federal Reserve rulemaking covering enhanced prudential standards for SIFIs. The parallelism of the international and domestic processes should facilitate the goal of congruence. Of course, we will in any case apply our enhanced standards, as required by Dodd-Frank, to foreign banking organizations operating in the United States.

**Calibrating the Enhanced Capital Standards**

As I mentioned earlier, the minimum and conservation buffer capital requirements of Basel III were calibrated by looking to the loss experience of larger banks. The intuition behind this approach was that historical loss experience provided the best basis for determining the amount of capital a bank would need in order to be regarded by counterparties as a viable financial intermediary. The minimum requirement was calculated by reference to the loss experiences of larger banks over several decades. The conservation buffer, intended to be the amount of capital necessary for a bank to withstand losses during a period of stress and still be above minimum required levels, was calculated by reference to the recent financial crisis.

A number of significant assumptions must be made in conducting analyses of this sort. For this reason, we found it more sensible to think in terms of ranges of capital requirements implied by this approach, rather than a specific number. Setting the final requirements still
required some judgment, not least on the question of how much we should try to minimize the chances of failure. The requirements ultimately agreed upon by the Basel Committee were within the range we had estimated, though at the lower end of that range. But the key point is that there was a single, reasonably persuasive approach to calibration around which regulators here and abroad converged.

When we move from the microprudential to macroprudential rationale for capital regulation, there is no such single accepted method for calibration. We do want to reduce further the probability that a SIFI might fail under stress. In that sense the exercise has some continuity with the microprudential approach – the percentage of required capital needs to be increased to achieve a smaller probability of failure based on the kind of loss history examined for Basel III purposes. But the macroprudential rationale for enhanced capital standards is the amount of harm a SIFI failure will inflict on the rest of the financial system, not the amount of loss its shareholders and creditors will incur. The calibration of the additional requirement needs to reflect this concern.

Several different methodologies have been considered by the Basel Committee. The “expected impact” approach tries to determine how much additional capital would be needed to reduce the probability of failure of a SIFI sufficiently to equalize the expected impact on the financial system of the failure of a SIFI and the failure of a banking firm just outside systemic status. For example, if the loss to the financial system from the failure of a SIFI would be five times that resulting from failure of the non-systemic firm, then the SIFI would have to hold additional capital sufficient to make the expected probability of failure one-fifth that of the non-SIFI. The enhanced capital requirement implied by this methodology can range between about
20% to more than 100% over the Basel III requirements, depending on choices made among plausible assumptions.

Another methodology uses macroeconomic models to estimate both the costs and benefits of higher capital requirements to the economy as a whole. The motivation for this “long-run economic impact” approach is still macroprudential, even though it differs from that informing the expected impact approach. However, isolating the effects of capital levels within a general macroeconomic model is a very challenging task and, perhaps for that reason, it produced lower implied increases in capital requirements than did the expected impact approach.

A third methodology tries to determine how much additional capital would be needed to offset any reduction in funding costs associated with the perceived too-big-to-fail status of SIFIs. The capital requirement increases implied by this approach were considerably higher than for the other two approaches. However, the results seemed even more sensitive to changes in reasonable initial assumptions than did the other two models. Moreover, while the possible moral hazard and competitive funding advantage associated with SIFIs are certainly of concern, they do not relate directly to the conceptual foundation for enhanced capital requirements, which lies in the negative externalities associated with a SIFI failure.

In reaching our final view on calibration, the Federal Reserve Board will consider all these approaches, though I note that the expected impact methodology has had the most influence on our staff’s analysis. We will also take account of observations from academics and financial institutions. We are certainly mindful of the uncertainties associated with these methodologies. But, at the same time, we cannot ignore the costs to society that the failures of SIFIs would cause the financial system and the economy more generally.
Objections to Enhanced Capital Standards

As we draw closer to the January 2012 statutory date for a rule on enhanced prudential standards for SIFIs, and as the Basel Committee makes progress on a SIFI surcharge, various objections have been raised to additional capital charges for SIFIs. Some have suggested that the statutory requirement for stricter capital requirements could be formally met by lowering capital requirements for banks with less than $50 billion in assets, or by modestly increasing the consequences of falling below the Basel capital buffer for banks with more than $50 billion in assets.

An examination of these objections does not, I believe, undermine the case for the type of SIFI capital standard I have described. On the contrary, some of these objections actually strengthen the case by revealing certain misplaced assumptions about the financial system that are embedded in the arguments of those who oppose a meaningful additional capital requirement.

A first objection is that equity is expensive - that the enhanced standard will force SIFIs to reduce their balance sheets because, with higher capital ratios, they cannot earn the rate of return that will be demanded by their investors. The purported result would be reduced intermediation, with consequent costs to the economy. This argument is conceptually incomplete, if not flawed, even when applied to generally applicable capital requirements. To the extent that equity investors demand higher rates of return from financial firms than from non-financial firms, it is largely because financial firms are so much more highly leveraged. Thus the risk of loss is greater, even as the prospect for outsized returns on the limited equity is improved. The lower leverage that would result from higher capital requirements should lead to at least some reduction in the required return on equity.
The argument is even weaker in the context of an additional charge limited to SIFIs. To the degree that systemically important institutions find the additional capital requirement makes some lending unprofitable, that lending could be assumed by smaller banks that do not pose similar systemic risk and thus have lower capital requirements. To be sure, there may not be perfect substitution, particularly not in the short term. In part for that reason, we contemplate a fairly generous transition period to the SIFI capital regime. In addition, though, it is worth recalling that not every additional dollar of lending or capital market activity is necessarily socially optimal. Just as monetary policy must at times induce higher credit costs in order to forestall the wider problems that high inflation would bring, so some checks on the scale of SIFIs are warranted to avoid a repeat of the financial crisis.

A second objection lodged by opponents is that what they characterize as the “punishment” of size and interconnectedness is shortsighted, because SIFIs are needed in a global financial system. But as earlier noted, while there are good reasons for firms to be big, there is little if any research showing that firms need to have balance sheets with the size and composition some do in order to achieve genuine economies of scope and scale. Moreover, a SIFI capital requirement would not prohibit the size and interconnectedness of today’s firms. Rather, it would incentivize firms to maintain those dimensions only if there are risk-adjusted returns for activities that require this scale. If research does establish some true economies for the largest, most interconnected firms, those benefits would need to be balanced with the societal risks associated with their potential distress or failure.

A third objection is that establishing SIFI metrics and capital requirements will actually increase, rather than mitigate, moral hazard by identifying which firms are considered too-big-to-fail. For those of us in the United States, Congress has already rejected this argument by its
creation of the requirement for enhanced prudential standards.\textsuperscript{vii} More fundamentally, the likelihood of systemic impact does not change regardless of whether firms have to meet enhanced capital standards. And moral hazard is already undermining market discipline on firms that are perceived to be too-big-to-fail. Higher capital standards will help offset the existing funding advantage for SIFIs.

A fourth objection is that a SIFI surcharge is unnecessary because Basel III and the Dodd-Frank Act have already put in place an adequate set of safety and soundness protections. I have already explained that Basel III is largely a microprudential tool, which does not fill the important macroprudential function of containing systemic risk. Provisions of Dodd-Frank such as the Volcker rule and the requirement for standardized derivatives to be centrally cleared are directed at specific activities believed by Congress to give rise to particular risks. It is important to recognize, first, that the diminution of such risks will carry some reduction in capital requirements and, second, that a crucial role of capital regulation is to provide a buffer against loss from all activities of a banking organization. As to the first, the cessation of proprietary trading and the limiting of private equity activities will directly reduce risk-weighted assets and thus capital requirements. Similarly, centrally cleared derivatives will carry lower capital charges.

As to the second point, the history of financial regulation over the last thirty years suggests that, when certain activities are restricted, firms will look for new areas in which to take more risk in the search for return. Capital regulation is the supplest and most dynamic tool we have to keep pace with the shifting sources of risk taken by financial firms. It is far from a panacea, subject as it is to arbitrage and dependent as it is on supervisory rigor. That is perhaps why Congress has also required enhanced prudential standards in other areas such as liquidity,
concentration of counterparty exposures, and risk management. But, I would say in conclusion, capital requirements are integral to both microprudential and macroprudential regulation. They are the foundation upon which much other regulation is built.

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Two examples of these complexities are that placing a financial firm into a resolution process in one country could trigger cross-default clauses or induce ring-fencing of assets in other jurisdictions.


As I have noted in prior speeches, there is a real need for a program of research into this question of the efficiencies of scope and scale in the financial services industry, as well as the relationship of industry structure to systemic risk.

The key problem revolves around the trigger for conversion. A trigger that was directly or indirectly exercised at the discretion of regulators would not necessarily be regarded by markets as predictable, but a trigger tied to a market measure could lead to a variety of unintended manipulative trading opportunities – including, in a worst case, a so-called death spiral.

In any case, it is absolutely clear that “bail-in” contingent capital – which converts at the point of non-viability of a firm in order to facilitate orderly resolution – would not be an acceptable substitute for common equity.

By setting the threshold for these standards at firms with assets of at least $50 billion, well below the level that anyone would believe describes a TBTF firm, Congress has avoided the creation of a de facto list of TBTF firms.
Statement by

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Chairman Bachus, Ranking Member Frank, and other members of the Committee, thank you for your invitation to testify today about capital and liquidity standards and their relationship to international competitiveness.

I will start by explaining how new international standards on regulatory capital and liquidity will foster global financial stability. Next, I will discuss several areas in which international work to enhance the resiliency of the financial system continues. Then I will turn to the agenda for implementation of these standards across national jurisdictions, as well as reforms in other areas such as derivatives markets and resolution regimes. In particular, I will address the need to expand the implementation agenda beyond assuring that the international standards are incorporated into national legislation and regulations. This is especially the case where the opaqueness of financial firms hinders observation of compliance with applicable standards, such as with minimum capital and liquidity requirements. Here it will be essential for international bodies of regulators to adopt effective oversight and monitoring mechanisms, in order to achieve the financial stability benefits that the minimum standards promise, to prevent the emergence of significant competitive disadvantages for internationally active firms, and promote international cooperation in addressing the technical and policy questions that will arise.

**Capital and Liquidity Standards**

The recent financial crisis exposed significant weaknesses in the regulatory capital requirements for large banking institutions in many parts of the world, including the United States. The amount of capital held by many banking institutions proved to be inadequate given the risks that had built up in the financial system. In some cases, especially for holdings of asset-backed securities in the trading books of the largest banks, it was evident that capital requirements were set far too low.
In addition, it became apparent that some of the instruments that qualified for regulatory capital purposes as tier 1 capital, which was the core measure of capital adequacy, were not truly loss absorbing, at least not in a way that permitted a financial firm to remain a viable financial intermediary. During the crisis, market assessments of the strength of financial firms focused on common equity, the most loss-absorbent form of capital. Many market participants questioned whether levels of common equity at the largest institutions would be sufficient to withstand potential losses. In conducting stress tests under the Supervisory Capital Assessment Program in the winter and early spring of 2009, we focused predominantly on common equity ratios. It was the disclosure of these ratios, along with our insistence that firms raise additional common equity to meet these ratios, that helped reassure financial markets of the continued viability of the nation’s nineteen largest bank holding companies.

The uncertainty about institutions’ financial strength had also contributed to severe liquidity problems at the height of the crisis. Investors and other counterparties were unwilling to extend credit of any sort in the absence of reliable information on the firms’ true capital positions. Institutions that substantially relied on short-term funding were unable to roll over this funding. Moreover, exacerbating this liquidity squeeze, many of the largest institutions were unable to unwind positions that they had assumed could be liquidated even in stressed markets.

The crisis thus revealed capital and liquidity shortfalls and confirmed that weaknesses in one group of internationally active firms could quickly be transmitted globally. In response, national prudential regulators represented on the Basel Committee on Banking Supervision have developed new standards to enhance the stability of the global financial system. In July 2009, the Basel Committee adopted more stringent regulatory capital standards for trading activities
and securitization exposures. Subsequently, in December 2010, the Basel Committee published its Basel III framework.

Basel III represents a major step forward for capital standards. Basel III not only promotes a higher *quantity* of capital by raising the minimum level of capital required at banking organizations. It also addresses the *quality* of capital by introducing for the first time a specific common equity capital requirement, thereby helping to ensure that a bank’s capital structure is composed of truly loss-absorbing forms of capital. In addition, Basel III enlarges the range of risks accounted for in the regulatory capital requirements and improves their measurement, particularly for the counterparty credit risk associated with over-the-counter (OTC) derivatives. The Basel agreement also adds for the first time an international leverage ratio as a complement to the long-standing Basel risk-based capital ratios.

Basel III likewise includes two sets of international standards for liquidity, the first efforts to develop quantitative standards for liquidity management. One standard, the Liquidity Coverage Ratio (LCR), is designed to ensure firms’ ability to withstand short-term liquidity shocks through adequate holdings of highly liquid assets. The other, the Net Stable Funding Ratio (NSFR), is intended to avoid significant maturity mismatches over longer-term horizons. These new standards are an important part of the global effort to enhance the financial system’s ability to withstand stresses comparable to those faced during the recent financial crisis.

**Areas for Continued International Work**

The risk-based capital requirements finalized in Basel III, and applicable to all internationally active banks, will be central to an effective framework for financial stability. There is an additional capital standard – along with the liquidity standards just mentioned – where the considerable work done to date still needs to be completed in the Basel Committee.
Global initiatives have also been started in two other areas covered by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), derivatives regulation, and resolution regimes, but a good deal remains to be done before we have agreement on appropriate international measures to promote global financial stability and to assure congruence between U.S. practices and those of other major financial centers.

An important capital policy initiative that has yet to be completed pertains to additional capital requirements for systemically important financial institutions (SIFIs). Section 165 of the Dodd-Frank Act directs the Federal Reserve to impose enhanced prudential standards, including capital requirements, on bank holding companies with consolidated assets of $50 billion or more. These requirements must be more stringent than those for firms that do not pose a similar risk to U.S. financial stability, and must increase in stringency based on the systemic footprint of the firm.

Last year, we proposed development of a comparable enhanced international capital requirement for SIFIs. Such a requirement would promote international financial stability while avoiding significant competitive disadvantage for any country’s firms. Work on the subject of SIFI capital surcharges in the Basel Committee started a bit slowly, but it has picked up considerably in recent months. Although there is not yet consensus, we are hopeful that in the next several months the Committee will agree upon a proposal and can seek public comment. This international process would roughly coincide with the domestic notice and comment process for rules proposed by the Federal Reserve covering enhanced prudential standards for SIFIs. The parallelism of the international and domestic processes should facilitate the goal of congruence between U.S. and international standards.
While the Basel III capital standards take effect during a transition period beginning in 2013, implementation of the two sets of liquidity standards will not begin until 2015 for the LCR and 2018 for the NSFR. The central bank governors and heads of supervision recognized that there may be a number of unintended consequences arising from the specifics of the LCR. For this reason, the Federal Reserve, supported by our counterparts from a number of other central banks, suggested a multi-year observation period before the LCR takes effect. During this period, the U.S. agencies and a Basel Committee working group will collect data, solicit comments from banks, analyze the effects of the new liquidity measures on financial markets and the broader economy, and determine whether the standards need to be amended to avoid adverse unintended consequences. With respect to the NSFR, while the Basel Committee countries are committed to having this standard in place in 2018, considerable technical work is still needed to refine this measure in the coming years.

In addition to these ongoing efforts regarding capital and liquidity, I would like to emphasize the importance of international cooperation on reforms to the derivatives market. In the United States, the market regulators and banking agencies are implementing the requirements of the Dodd-Frank Act to strengthen the infrastructure and regulation of the OTC derivatives market. This task includes enhancing the role of central counterparties, which can be an important tool for managing counterparty credit risk in the derivatives market, and introducing new margin requirements for certain derivatives activities that are not cleared with a central counterparty.

Even as these initiatives are underway in the United States, it is important that progress on reforming the OTC derivatives market continue at the international level. In 2009, the Group of Twenty (G-20) leaders set out commitments related to reform of the OTC derivatives markets...
that, when implemented by national authorities, will form a broadly consistent international regulatory approach.\(^1\) As work on the G-20 commitments is being pursued in a number of international groups, continued attention will be required to ensure that the convergence process continues in a timely fashion. In addition, there is need for agreement on a topic not covered by the G-20 declaration – that of global minimum margin requirements for derivatives not cleared through a central counterparty. Such an agreement would increase the stability of the financial system by reducing the likelihood of a race to the bottom in jurisdictions that do not implement equivalent standards.

A final issue that must remain on the international reform agenda is the development in major financial centers of effective resolution regimes for SIFIs. The Dodd-Frank Act gave the Federal Deposit Insurance Corporation (FDIC) authority to resolve failing financial firms where necessary to mitigate serious effects on financial stability. The efficacy of this mechanism and market discipline more generally will both be increased if other significant jurisdictions have parallel authority, with similar expectations for how SIFIs operating in multiple jurisdictions will be resolved. Work has been underway for some time at the Basel Committee and the Financial Stability Board to identify key attributes of effective regimes that will facilitate resolution of SIFIs while preserving critical market functions. In cooperation with our colleagues at the FDIC, we have encouraged these efforts, as well as an exploration of possible channels for avoiding impediments to successful resolution of firms with substantial operations in multiple jurisdictions.

Implementation of International Standards

The financial stability benefits of the Basel III reforms will be realized only if they are implemented rigorously and consistently across jurisdictions. In this regard, it is important to note that incorporating internationally acceptable standards into national legislation or regulations is only the first step in effective implementation. A second, critical step is ensuring that these standards are, in practice, rigorously enforced by national supervisors and observed by firms across all the Basel Committee countries.

In the United States, the Federal Reserve, FDIC, and Office of the Comptroller of the Currency (collectively, the banking agencies) are working to update and enhance risk-based capital standards, and introduce liquidity standards through a series of rulemakings. These rulemakings will be used to align U.S. capital and liquidity regulations with Basel III. In accordance with the internationally agreed-upon implementation timeframes, the banking agencies plan to issue a notice of proposed rulemaking in 2011 and a final rule in 2012 that would implement the Basel III reforms. We expect that other jurisdictions will be adopting regulations or, where necessary, legislation in a similar timeframe. The Basel Committee will review progress and identify any potential inconsistencies with the terms of Basel III.

Monitoring the incorporation of Basel agreements into national law is a fairly straightforward exercise, though no less important for that. It is also a familiar exercise in the Basel Committee. In this regard, the international leverage ratio the Basel Committee has adopted and is currently monitoring serves as an important backstop to risk-based ratios that rely extensively on banks’ models. It is notable that analysts that follow significant global financial institutions use a leverage ratio to gain insights into the credibility of banks’ average risk-
weighted assets. The Federal Reserve Board is fully committed to ensuring a robust leverage ratio remains in place for internationally active institutions.

Despite extensive sharing of information on supervisory practices, the Basel Committee has, over the years, found it difficult to achieve what I have characterized as the second critical step in the implementation of international capital accords – that is, rigorous and consistent application of those rules by supervisors and firms across countries, as reflected in reported capital levels and amounts of risk-weighted assets of individual banks. An international process for monitoring implementation on a bank-by-bank basis has become increasingly necessary as capital standards have relied to a greater extent on internal market-risk or credit-risk models, the parameters and operation of which are not transparent. This tendency has combined with the relatively opaque nature of bank balance sheets to complicate external efforts to assess how banks are meeting their capital requirements.

One area that has deservedly received attention of late is the potential for differences in the calculation of risk-weighted assets across banks, both currently and prospectively under the Basel III standards. In particular, market participants have focused on differences in measured risk exposure. Analysts have pointed out that large U.S. banks generally have markedly higher average risk weights, ratios of risk-weighted assets to total assets, and ratios of common equity to total assets, adjusted for differences in accounting, than some of their foreign competitors. These large disparities cannot be easily explained away through differences in risk profiles, which are largely similar within the business lines of competing banks.

Indeed, with regard to capital for trading activities, where a commonly disclosed measure of risk is one-day value-at-risk (VaR), U.S. trading banks appear to hold multiples of the capital

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2 A value-at-risk approach measures the potential gain or loss in a position, portfolio, or organization that is associated with a price movement of a given probability over a specified time period.
non-U.S. trading banks hold per unit of VaR. Precisely because of the opacity of bank balance sheets and their internal risk models, we do not yet fully understand the reasons for these disparities. Some observers have suggested that U.S. stringency in application of the rules and standards may be a factor. Gaining insight into these differences and taking action to more closely align capital requirements for similar risk exposures across countries will take concerted work within the Basel Committee.

The Basel Committee leadership has acknowledged that failing to implement Basel III in a globally consistent manner could lead to a competitive race to the bottom and increase risks to the global financial system. The Committee must take action to avoid this outcome, specifically through the Committee’s Standards Implementation Group (SIG). The SIG is initiating this year a peer review process, through which teams of experts will assess the extent to which countries have implemented Basel Committee standards. While these reviews will focus initially on standards other than capital, such as stress testing, the process should nevertheless provide insight into how approaches and outcomes related to the implementation of Basel III can be meaningfully monitored and compared.

The SIG has already begun sharing information on the status of Basel III implementation by member countries and is in the early stages of planning comparative work on risk-weighted assets across jurisdictions and banks to promote consistent implementation.

As the Basel Committee moves into this next phase, we will urge the Committee to take a comprehensive approach to monitoring processes that includes three elements. First, the Committee should begin work as soon as possible to develop mechanisms to implement effective

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cross-country monitoring. Second, this process should go beyond traditional stocktaking exercises to include a careful assessment of the methodologies national regulators use to determine the appropriateness and acceptability of bank practices. Third – and here is where the real work will lie – the Committee must develop a mechanism to validate the actual risk-weighted assets calculated by individual banks under international capital standards.

There are several possibilities for conducting this work. One that has been discussed in the Basel Committee would be to use tools such as benchmarks and test portfolios, in order to provide an accurate, quantifiable comparison of standards implementation across jurisdictions. Another, more far-reaching option would be to use validation teams working under the auspices of the Basel Committee itself to verify the methodologies used at individual banks to ensure their compliance with international standards. They could use expertise gained through horizontal reviews of institutions to make assessments of individual banks in different jurisdictions. A less far-reaching variant of this option would entail national supervisors collaboratively participating in examinations of specific institutions.

As a result of these monitoring and validation processes, outliers (i.e., banks whose risk weights for comparable assets differ materially from those of other banks) could be identified so that national supervisors might perform more in-depth analyses of their banks’ processes and outcomes. This would lead to a greater understanding of the disparity in results for certain institutions or jurisdictions based on their assumptions, data, or risk profiles. There can be legitimate reasons that banks may have different risk estimates for similar portfolios. Where disparities are identified, however, national supervisors of outlier banks should be called upon to explain the results to their fellow supervisors, as well as steps they are taking to address
situations in which differences may arise from systematic underestimation of risk or manipulation of capital ratios to achieve desired outcomes.

Any of these options would require the Basel Committee, international supervisors, and banking organizations to work together to address confidentiality concerns, as well as other jurisdictional issues. Some options will surely prove more feasible than others. While we do not prejudge which will prove to be most effective, we do maintain that something of this sort is necessary in order to assure that the benefits for financial stability promised by international capital standards are in fact being realized, as well as to prevent some banks from enjoying competitive advantage through lax application of these standards. At the same time, any of these options will give banking supervisors from the countries represented on the Basel Committee an opportunity to work together to address the many issues of implementation, interpretation, and evasion that will surely arise under Basel III.

Thank you for your attention. I would be pleased to answer any questions you might have.
Thank you, Rick, for that introduction. It’s good to be here at this conference and to have this opportunity to speak to you today about the state of global financial reform.

Nearly a year ago the President signed into law the most significant financial reforms since the Great Depression. These reforms are essential to making our system stronger and more resilient.

As we move forward, however, we face a series of consequential choices that will determine the true success of these reforms.

It has been more than three years since the start of the financial crisis that led to those reforms. And we are now in the midst of a fundamental reshaping of the financial system of the United States.

Based on the changes already achieved and those now underway, we will be able to accomplish what few people would have thought possible at the beginning of 2009. We can remake the American financial system so that it emerges from this crisis not only transformed but in much stronger shape, with the best mix of protections available in the world for investors and consumers and the best opportunities for businesses to raise capital.

If we succeed in achieving this goal, it will not be because of good fortune. It will happen as a direct result of the tough choices we made to fundamentally restructure the system as we were fighting the financial fires of 2008 and 2009. And it will be because we put in place the reforms necessary to preserve those changes, with a better balance of stability and innovation.

But as we work towards the goal of a stronger financial system, there are risks.

We have a very complicated regulatory structure with multiple agencies, with closely related and sometimes overlapping missions and roles. We must bring a more coordinated and integrated approach across these agencies to write sensible rules and to demonstrate more agility in response to an ever changing financial marketplace, in order to meet this challenge.

We live in a global financial marketplace, with other financial centers competing to attract a greater share of future financial activity and profits. As we strengthen the protections we need in the United States, we have to reduce the chance that risk just moves outside the United States. Allowing that would not just weaken the relative strength of U.S. firms and markets, it would also leave the world economy vulnerable to future crises.
The challenges of designing and enforcing new rules in this more complicated and dangerous world of finance will require a very substantial increase in the quality and scale of resources we deploy in financial oversight. If we don’t have the resources to attract, retain, and train the human talent necessary to make better regulatory judgments in the future, then we place these achievements at risk.

I want to review the main challenges ahead of us as we work to achieve this renewal of the American financial system. But I want to start by reviewing what we have achieved to date.

The American financial system has already been changed in far-reaching ways. But the extent and significance of these changes are not well understood. Many wonder whether anything has changed, or even whether we have left the system more vulnerable.

So let me describe why we are in a much stronger position today, and where we still have a lot of work to do.

The weakest parts of the U.S. financial system – the firms that took the most risk – no longer exist or have been significantly restructured. That list includes Lehman Brothers, Bear Stearns, Merrill Lynch, Washington Mutual, Wachovia, GMAC, Countrywide, and AIG.

Of the 15 largest financial institutions in the United States before the crisis, only nine remain as independent entities.

Those that survived did so because they were able to raise capital from private investors, significantly diluting existing shareholders. We used stress tests to give the private market the ability – through unprecedented disclosure requirements and clear targets for how much capital these institutions needed – to distinguish between those institutions that needed to strengthen their capital base and those that did not.

The 19 firms that we put through that process have together increased common equity by more than $300 billion since 2008.

The average level of common equity to risk weighted assets across these institutions is now 10 percent, much higher than before the crisis. The average level of total leverage in these institutions has fallen substantially from $16 of assets for every dollar of common equity to $11.

These firms are now funded more conservatively, so that they are much less vulnerable to a loss of liquidity during a future downturn. Debt maturing in one year or less at these institutions, as a share of total liabilities, has declined dramatically to roughly 40 percent of the pre-crisis level.

Outside these institutions, the risk in the so-called “shadow banking system” – the financial firms that operated outside of the protections and constraints we imposed on banks – has fallen substantially.

Assets in the “shadow banking system” are roughly half the level seen in 2007. Funding through tri-party repurchase agreements has fallen 40 percent from its peak in 2007, and asset-backed commercial paper outstanding – which was often used to fund leveraged off-balance sheet vehicles – is a third of where it was in 2007.

The vast majority of large financial companies that received government support have repaid it, with a total return to the taxpayer from investments in banks of $12 billion dollars in profit to date. Just two years ago, hundreds of billions in losses were projected on those investments.

We now have the authority to subject all major financial institutions operating in the United States to comprehensive, consolidated limitations on risk taking. That represents a dramatic change from before the crisis,
when more than half of the financial activity in the nation that was involved in “banking” from the investment banks to large finance companies, AIG, and Fannie Mae and Freddie Mac, operated outside those limits.

And the markets where firms came together – like the over-the-counter derivatives markets – will now be subject to oversight, once regulators finalize and implement new rules authorized by Dodd-Frank. We now have much stronger tools to limit the risk that one firm’s failure could cascade through markets to weaken the rest of the system.

Overall, and this is the most important test of crisis response, the U.S. financial system is now in a position to finance a growing economy and is no longer a source of risk to the recovery.

Now, it is important to recognize that even with these achievements, we have a lot of repair work still ahead of us. The housing finance system is still broken and completely dependent on the government. Small banks in many parts of the country are still under a lot of pressure. Credit is still hard to get for many small businesses and individuals.

Some argue that the U.S. financial system is too concentrated, which could promote systemic risks. But the U.S. banking system today is less concentrated than that of any other major economy. And total banking assets in the United States today are only about the size of U.S. GDP – much lower than in other developed economies.

The three largest U.S. banks account for 32 percent of total banking assets in the United States, in comparison to 46 percent for the three largest in Japan, 58 percent in Canada, 63 percent in the UK, 65 percent in France, 70 percent in Germany, 71 percent in Italy, and 76 percent in Switzerland.

And total banking assets are 461 percent of GDP in the UK, 178 percent in Germany, and 820 percent in Switzerland.

The actions we took to restructure and strengthen the financial system were extraordinary. Together with the Federal Reserve and the FDIC, we provided liquidity where it was necessary, not just to the entire banking system, but to those markets that were as critical to the broader economy. Those actions, taken together, helped prevent a second Great Depression, and have produced billions in profit to the taxpayer, on top of the profits earned from the direct investments we placed in individual institutions.

Any successful financial rescue carries with it the risk that the actions necessary to protect the economy from financial failure will create the potential for future crises, by encouraging investors to take too much risk in the future in the hope they will be protected from failure.

We were exceptionally careful to design our emergency strategy to minimize that risk of moral hazard. We let the weakest firms fail. We forced the equity holders of those that survived to absorb losses on a scale proportionate to the mistakes of their companies.

Where we had to step in and provide exceptional levels of support, we did so to diffuse the risk of catastrophic failure. We chose, in the case of Fannie and Freddie, to replace management and the boards of directors, wipe out equity holders, and wind down the institutions, a process that is still underway.

To preserve the gains we have achieved, to minimize the risk of moral hazard, and to reduce both the risk of and the damage from future crises, we have to put in place the comprehensive reforms, those legislated in the Dodd Frank Act, and those still ahead of us in the housing finance system.

* * *

Financial reform involves far-reaching changes to investor and consumer protection, the structure of the housing finance market, resolution authority for failing firms, as well as the design of more conservative limits on risk-
taking. I am going to focus my remarks today on two areas of reform that are most important to reducing systemic risk.

The central challenge in reducing future risk in financial systems has two dimensions. It requires reforms to reduce the risk of failure of large institutions and reforms to limit the damage any failure could impose on the broader economy.

This involves tougher rules to limit risk and leverage in individual institutions, but also changes in how we govern the markets where firms come together, such as the derivative markets and the funding markets. These are shock absorbers that are critical to limiting catastrophic risk in modern financial systems.

This is a complicated endeavor. It requires judgments about the costs and benefits of too much or too little capital and the tradeoffs between innovation and stability. It requires employing the power of disclosure and market discipline to reinforce the constraints and incentives we establish through regulation. It requires better supervision, because no system of rules can anticipate all sources of risk. And it requires better ways of managing the inevitable failures that will happen in competitive markets, by adapting bankruptcy type processes to handle the unique difficulties in unwinding large, leveraged financial institutions.

And because of technology and the much tighter integration of national financial systems, the challenge of reducing the risk of contagion from a financial crisis requires much more global coordination internationally than has ever been the case.

Foremost among the many challenges of reform ahead of us are those that relate to capital or leverage requirements and derivatives. It is on these two pillars that the prospect of a truly level global playing field most squarely rests.

* * *

Let me begin by discussing the new global standards on capital.

Last year, central banks and supervisors reached agreement on the core elements of a new global capital standard, known as Basel III. As a result of this agreement, banks will have to hold substantially more capital in the form of common equity against the risks they take.

These requirements are critical to making the financial system more stable and more resilient. They were set at a level designed to allow institutions to absorb a level of losses comparable to what we faced at the peak of this crisis and still be able to operate without special government support.

The agreement was designed to allow banks to meet these heightened standards gradually, so that they can continue to perform their essential function of providing credit to households and businesses. Many institutions, and almost all the largest U.S. firms, have already reached the new minimum levels, years ahead of schedule. And the U.S. is committed to implementing the full Basel III agreement on schedule.

This agreement was the foundation of a comprehensive new capital framework, but it left open several areas to negotiation, including the size and composition of additional capital requirements to impose on the largest global institutions, how to refine the provisional liquidity requirements, and how to bring more compatibility to the risk-weighting of assets.

We are now at the point where it is important to resolve these open questions, provide clarity about the rules going forward, and allow supervisors to turn their attention to how to enforce these new requirements.

It is our hope that the central banks, supervisors, and finance ministries of the major economies working together will resolve these outstanding issues this summer.
Whether they are able to so will depend on the extent to which they can find consensus on a strong agreement with reasonable terms.

This will require decisions in three important areas.

First is the question of the size of the additional requirements to be imposed on the largest institutions, which is commonly referred to as the systemic surcharge.

There is a very strong case for requiring the largest firms, those whose failure could cause the greatest damage to the economy, to hold more capital relative to risk, than smaller institutions. I have long supported this approach. We made it a key part of our proposals for reform in the United States. And it was incorporated into law in the United States and embraced by the G-20.

The question is how much. In making this judgment, the central banks and supervisors need a balance between setting capital requirements high enough to provide strong cushions against loss but not so high to drive the re-emergence of a risky shadow banking system. They also need to look at the full impact of other reforms in the system that have the effect of reducing both the probability of failure of large institutions and the ability of the rest of the financial system to absorb or contain or diffuse those losses. Among these other reforms are the new liquidity requirements on these institutions, limits on leverage, concentration limits, activity restrictions, the forthcoming margin rules for derivatives, the stronger financial cushions being built in central counterparties, the tougher requirements on tri-party repos and securities lending.

In short, capital requirements cannot bear the full burden of protecting the system against risk, and they should be considered in the context of the reinforcement provided by these other reforms.

A second question is to distinguish between what all countries commit to require as a minimum, and what measures some countries may choose to retain the discretion to impose on top of those requirements.

In the United States, we will require the largest U.S. firms to hold an additional surcharge of common equity. We believe that a simple common equity surcharge should be applied internationally. The strength of a common equity surcharge also reduces the need for an excessive surcharge. But given the other protections available here, including our resolution authority, we do not need to impose on top of that requirement any of the three other proposed forms of additional capital – convertible, bail in, contingent capital instruments, or counter cyclical capital requirements.

And third, we need to make sure that we provide a much stronger set of protections to ensure a level playing field in the application of the new Basel III requirements and the additional systemic surcharge.

This means, among other things, a uniform and mandatory minimum leverage ratio, safeguards to ensure the consistent applications of the new risk weightings by national supervisors, sufficiently broad application of the systemic surcharge to major institutions around the world, and restrictions on the amount of discretion available to national supervisors to relax the application of these requirements to their own banks.

If we can achieve consensus on these terms, we will have a strong agreement, which will give all the major countries the confidence they need that the requirements will be implemented fairly and evenly across institutions and markets.

* * *

These new global requirements on capital are critical to reducing the risk of failure of institutions. We need to lay the foundation for the same type of global approach to constraining risk in markets, particularly in the derivative markets.
In U.S. reforms, we are building a comprehensive framework of oversight for the over-the-counter derivatives market, which now has an estimated $600 trillion in gross exposures.

A core element of this framework is to require standardized derivatives to be centrally cleared. This replaces the exposures of an exceptionally complex web of millions of bilateral trades with a central counterparty that has strong financial safeguards and comprehensive oversight.

All derivatives contracts that are appropriate for central clearing will be cleared and traded on an exchange or other regulated trading platform. At the same time, the law makes provisions for economically essential contracts that are not suitable for central clearing – for example, trades by non-financial end users or certain complex, illiquid or otherwise highly customized derivatives.

For uncleared derivatives transactions, the Dodd-Frank Act requires new margin standards that reflect the nature and risk of these contracts. Regulators have recently proposed rules to implement this requirement. These margin requirements are critical to promoting the safety and soundness of the dealers and lowering the risk of the financial system. Imposing appropriate margin requirements on uncleared swaps will also help create incentives for market participants to use centralized clearing and standardized contracts so that they do not needlessly externalize risks to the financial system by avoiding central clearing. New margin requirements will also mitigate the increased risks presented by derivatives that are appropriately executed outside of central clearing, and therefore do not benefit from the protections of a central counterparty.

In practice, the combination of central clearing for many transactions and margin requirements for most uncleared transactions, in conjunction with trading on exchanges or other regulated platforms, will not only reduce risk in the system, but also encourage increased standardization of derivatives, and thus additional central clearing and exchange trading. Central clearing and trading, in turn, along with increased post-trade transparency mandated by Dodd-Frank, will provide increased market liquidity, tighten spreads, reduce transaction costs, and facilitate the evolution of a more transparent market.

The United States has taken an important leadership role in comprehensive reform of the over-the-counter derivatives market. Alignment with Europe and Asia is essential.

The focus of that remaining work towards alignment with our European counterparts lies in a few key areas: scope of standardized derivatives contracts, central clearing and mandatory trading of standardized derivatives contracts, fair and open access to qualified participants for central counterparties of swaps, electronic trading platforms, reporting to data repositories, the scope of any exceptions or exemptions – for example, end-user exemptions and intra-group exemptions – and, finally, capital and margin requirements.

Likewise, progress in Asia on derivatives is essential. We urge our Asian counterparts to meet G-20 commitments to central clearing, mandatory trading, and reporting of standardized over-the-counter derivatives by the end of 2012. Recently, Deputy Treasury Secretary Neal Wolin traveled to Asia to discuss these issues, as part of a series of efforts to make progress on derivatives reforms in the region. He will be making that trip again.

Now, as we work with our international counterparts on this range of issues, we need to develop a global margin standard.

Just as we have global minimum standards for bank capital – expressed in a tangible international agreement – we need global minimum standards for margins on uncleared derivatives trades.

Without international consensus, the broader cause of central clearing will be undermined. Risk in derivatives will become concentrated in those jurisdictions with the least oversight. This is a recipe for another crisis.
A global approach to margin will help prevent regulatory arbitrage and a “race to the bottom.” It will make our global financial system safer and stronger.

Both banking and market regulators are now in the process of laying the groundwork to set an international effort in motion, by asking the FSB and the international standard setting bodies to undertake analysis and recommendations. The United States will take a leading role in this effort, and I expect there will be support for it in Europe and in the G-20 more broadly.

* * *

In the meantime, we still have work to do at home. Regulators have been busy proposing rules to implement the Dodd-Frank Act, and many of these rules still need to be finalized. To build a strong regulatory framework that can serve as a model for international efforts, it is critical that the rules put in place by these regulators are as consistent as possible.

The regulators are independent agencies, with independent mandates. Where Congress has given them the room to adopt common approaches, they need to do so, both so that we reduce the chance of risk shifting among institutions subject to their different jurisdictions, but also so that we improve the chances of promoting a uniform global approach that does not damage U.S. firms.

Congress decided in designing our financial reforms to preserve a system of specialized, functional supervision, with different regulators responsible for consumer protection, for investor protection and market integrity, for supervision of banks, and for deposit insurance and bank resolution. And Congress brought these regulators together in a Council with a mandate to encourage a more system-wide and coordinated approach to critical regulatory questions that affect the financial system as a whole.

This framework has a lot of strength, but it adds to the complexity of designing reforms that work across institutions and markets. Small differences in approach will create opportunities for risk to move around the system and to hide in the dark, which is part of what made our crisis so severe.

I am very encouraged by the first year of experience in seeing these regulators work more closely together. It gets harder from here, and even more important that we achieve a common approach.

* * *

I want to conclude with a few comments on the third of the challenges I started with: the challenge of strengthening the resources we need to make these reforms work.

In the years before this crisis, Washington allowed the financial system to outgrow the framework of protections that we put in place after the Great Depression and refined in the decades that followed. We allowed the emergence of a parallel or “shadow” financial system outside of the constraints we place on banks. The rules on banks fell behind the pace of innovation in markets. The resources in terms of numbers of bank examiners and enforcement officials and their expertise fell behind the growth in our markets and the increased complexity of the system.

The success of the Dodd Frank Act will depend on a sustained effort to improve the level of expertise in the regulators charged with oversight and to ensure there are enough “cops on the street” that can look into the seams and shadows of the financial system and more effectively deter fraud and manipulation.

This is not a new challenge, but we face two new risks in addressing it. One is the effort by politicians and groups that oppose financial reform to starve the regulatory agencies of the resources they need to carry out their new responsibilities. The second is to use the confirmation process to block appointments.
Those in the U.S. financial community who are supporting these efforts to block resources and appointments are looking for leverage over the rules still being written. There is a long tradition of similar efforts. They will not be successful in undermining the core elements of reform, but they will risk causing a different type of damage.

Over time, they will make it less likely that there will be enough capable people in the regulatory bodies to bring the care and judgment necessary for the new rules to work. The firms that will suffer most from weak regulators are the strongest and best managed firms, for they will find themselves spending more time on compliance and will be potentially placed at a greater disadvantage with respect to their international competitors. And they will create the conditions again for a situation in which the weak and poorly-managed risk bringing down the financial system again. We can’t allow loopholes, gaps, and weaknesses to take hold and undermine the fundamental strength of our reforms. We’ve been down that road before, and it led us to the edge of the abyss. We won’t allow that to happen again.

Those of you here today who are leaders of the major U.S. financial institutions should be champions, not opponents of getting strong capable people to lead and staff the oversight bodies.

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We are committed to building a more level playing field internationally, as we move ahead with reforms in the United States.

We don’t want to see another race to the bottom around the world. As we act to contain risk in the U.S., we want to minimize the chances that it simply moves to other markets around the world.

The United Kingdom’s experiment in a strategy of “light touch” regulation to attract business to London away from New York and Frankfurt ended tragically. That should be a cautionary note for other countries deciding whether to try to take advantage of the rise in standards in the United States.

But it is important to note that the strength of the United States financial system in the decades that followed the Great Depression was that we had the highest standards for disclosure and investor protection, we had the strongest protections for depositors and against money laundering, and we had the best exchanges. We did not lower our sights to match the more limited ambitions of others. We knew we would be more vulnerable if we did.

So we will do what we need to do to make the United States financial system stronger. We will do so carefully. And as we do it, we will bring the world with us.
Joint Press Release

For immediate release June 14, 2011

Agencies Adopt a Final Rule to Establish a Risk-Based Capital Floor

Three federal banking regulatory agencies adopted a final rule that establishes a floor for the risk-based capital requirements applicable to the largest, internationally active banking organizations. The rule, finalized by the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, is consistent with the requirements of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

A banking organization operating under the agencies' advanced approaches risk-based capital rules is required to meet the higher of the minimum requirements under the general risk-based capital rules and the minimum requirements under the advanced approaches risk-based capital rules.

The rule also provides limited flexibility to establish appropriate capital requirements for certain low-risk exposures that, in general, are not held by insured depository institutions, but may be held by depository institution holding companies or nonbank financial companies supervised by the Federal Reserve Board.

The final rule will be effective 30 days after publication in the Federal Register; publication is expected soon.

Attachment (99 KB PDF)

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DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 3
Docket No. -2010-0009
RIN Number 1557-AD33

FEDERAL RESERVE SYSTEM
12 CFR Parts 208 and 225
Regulations H and Y; Docket No. R-1402
RIN No. 7100-AD62

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 325
RIN 3064-AD58

Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II;
Establishment of a Risk-Based Capital Floor

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors
of the Federal Reserve System; and the Federal Deposit Insurance Corporation.

ACTIONS: Final rule.

SUMMARY: The Office of the Comptroller of the Currency (OCC), Board of
Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance
Corporation (FDIC) (collectively, the agencies) are amending the advanced risk-based
capital adequacy standards (advanced approaches rules) in a manner that is consistent
with certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection
Act (the Act), and the general risk-based capital rules to provide limited flexibility
consistent with section 171(b) of the Act for recognizing the relative risk of certain assets
generally not held by depository institutions.
DATES: This final rule is effective [INSERT DATE 30 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER.]

FOR FURTHER INFORMATION CONTACT:

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  Board: Anna Lee Hewko, (202) 530–6260, Assistant Director, or Brendan Burke, (202) 452–2987 Senior Supervisory Financial Analyst, Division of Banking Supervision and Regulation, or April C. Snyder, (202) 452–3099, Counsel, or Benjamin W. McDonough, (202) 452–2036, Counsel, Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), (202) 263–4869.

  FDIC: George French, Deputy Director, Policy, (202) 898-3929, Nancy Hunt, Associate Director, Capital Markets Branch, (202) 898-6643, Division of Risk Management Supervision; or Mark Handzlik, Counsel (202) 898-3990, or Michael Phillips, Counsel (202) 898-3581, Supervision and Legislation Branch, Legal Division.

SUPPLEMENTARY INFORMATION

I.  Background

A.  Overview of the requirements of the Act

  Section 171(b)(2) of the Act\(^1\) states that the agencies shall establish minimum risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies, and nonbank financial companies

supervised by the Federal Reserve (covered institutions). In particular, and as described in more detail below, sections 171(b)(1) and (2) specify that the minimum leverage and risk-based capital requirements established under section 171 shall not be less than the “generally applicable” capital requirements, which shall serve as a floor for any capital requirements the agencies may require. Moreover, sections 171(b)(1) and (2) specify that the Federal banking agencies may not establish leverage or risk-based capital requirements for covered institutions that are quantitatively lower than the generally applicable leverage or risk-based capital requirements in effect for insured depository institutions as of the date of enactment of the Act.

B. Advanced approaches rules

On December 7, 2007, the agencies published in the Federal Register a final rule to implement the advanced approaches rules, which are mandatory for banks and bank holding companies (collectively, banking organizations) meeting certain thresholds for total consolidated assets or foreign exposure. The advanced approaches rules


3 On March 8, 2011, in an NPR that paralleled the agencies’ rulemaking, the Office of Thrift Supervision (OTS) issued a notice in which OTS proposed to amend 12 CFR part 567, which sets forth the capital regulations applicable to savings associations. 45 FR 12,611 (March 8, 2011). OTS received one comment on its proposal. The Act specifies that the regulatory authority and other functions of OTS will transfer to OCC on the transfer date provided in the Act, which is expected to be July 21, 2011. Given that the OTS’s parallel rulemaking is subject to a 90 day review by the Office of Management and Budget pursuant to Executive Order 12866, it would be impracticable for OTS to issue a final rule before the transfer date. The OTS and OCC anticipate that OCC would issue a final rule to amend the capital regulations applicable to savings associations, after the transfer date.

4 12 CFR part 3, Appendix C (OCC); 12 CFR part 208, Appendix F and 12 CFR part 225, Appendix G (Board); and 12 CFR part 325 Appendix D (FDIC).

5 72 FR 69288 (December 7, 2007). Subject to prior supervisory approval, other banking organizations can opt to use the advanced approaches rules. Id. at 69397.
incorporate a series of proposals released by the Basel Committee on Banking
Supervision (Basel Committee or BCBS), including the Basel Committee’s
comprehensive June 2006 release entitled “International Convergence of Capital

To provide a smooth transition to the advanced approaches rules and to limit
temporarily the amount by which a banking organization’s risk-based capital
requirements could decline relative to the general risk-based capital rules, the advanced
approaches rules established a series of transitional floors over a period of at least three
years following a banking organization’s completion of a satisfactory parallel run.7
During the transitional floor periods, a banking organization’s risk-based capital ratios
are equal to the lesser of (i) the organization’s ratios calculated under the advanced
approaches rules and (ii) its ratios calculated under the general risk-based capital rules,
with tier 1 and total risk-weighted assets as calculated under the general risk-based
capital rules multiplied by 95 percent, 90 percent, and 85 percent during the first, second,
and third transitional floor periods, respectively.8 Under this approach, a banking

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6 The BCBS is a committee of banking supervisory authorities established by the central
bank governors of the G-10 countries in 1975. The BCBS issued the New Accord to
modernize its first capital accord (“International Convergence of Capital Measurement
and Capital Standards” or “Basel I”), which was endorsed by the BCBS members in 1988
and implemented by the agencies in 1989. The New Accord, the 1988 Accord, and other
documents issued by the BCBS are available through the Bank for International

7 12 CFR part 3, Appendix A (OCC); 12 CFR parts 208 and 225, Appendix A (Board);
12 CFR part 325, Appendix A (FDIC).

8 Under the advanced approaches rules, the minimum tier 1 risk-based capital ratio is 4
percent and the minimum total risk-based capital ratio is 8 percent. See 12 CFR part 3,
Appendix C (OCC); 12 CFR part 208, Appendix F and 12 CFR part 225, Appendix G
(Board); and 12 CFR part 325 Appendix D (FDIC).
organization that uses the advanced approaches rules is permitted to operate with lower minimum risk-based capital requirements during a transitional floor period, and potentially thereafter, than would be required under the general risk-based capital rules. To date, no U.S.-domiciled banking organization has entered a transitional floor period and all U.S-domiciled banking organizations are required to compute their risk-based capital requirements using the general risk-based capital rules.

C. Requirements of section 171 of the Act

Section 171(a)(2) of the Act defines the term “generally applicable risk-based capital requirements” to mean: “(A) the risk-based capital requirements, as established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action regulations implementing section 38 of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure; and (B) includes the regulatory capital components in the numerator of those capital requirements, the risk-weighted assets in the denominator of those capital requirements, and the required ratio of the numerator to the denominator.” Section 171(b)(2) of the Act further provides that “[t]he appropriate Federal banking agencies shall establish minimum risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Board of Governors. The minimum risk-based capital requirements established under this paragraph shall not be less than the generally applicable risk-based capital requirements, which shall serve as a floor for any capital requirements that the agency may require, nor quantitatively lower than the generally applicable risk-based
capital requirements that were in effect for insured depository institutions as of the date of enactment of this Act.”

In accordance with section 38 of the Federal Deposit Insurance Act, the Federal banking agencies established minimum leverage and risk-based capital requirements for insured depository institutions for prompt corrective action (PCA) rules. All insured institutions, regardless of their total consolidated assets or foreign exposure, must compute their minimum risk-based capital requirements for PCA purposes using the general risk-based capital rules, which currently are the “generally applicable risk-based capital requirements” defined by Section 171(a)(2) of the Act.

D. The proposed rule

By notice in the Federal Register dated December 30, 2010, the agencies issued a notice of proposed rulemaking to modify the advanced approaches rules consistent with section 171(b)(2) of the Act. In particular, the agencies proposed to revise the advanced approaches rules by replacing the transitional floors in section 21(e) of the advanced approaches rules with a permanent floor equal to the tier 1 and total risk-based capital requirements of the generally applicable risk-based capital rules (“permanent floor”). Under the proposal, each quarter, each banking organization subject to the advanced approaches rules would be required to calculate and compare its minimum tier 1 and total risk-based capital ratios as calculated under the general risk-based capital rules with the same ratios as calculated under the advanced approaches risk-based capital rules. The banking organization would then compare the lower of the two

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10 75 FR 82317 (December 30, 2010).
tier 1 risk-based capital ratios and the lower of the two total risk-based capital ratios to
the minimum tier 1 ratio requirement of 4 percent and total risk-based capital ratio
requirement of 8 percent in section 3 of the advanced approaches rules\textsuperscript{11} to determine
whether it meets its minimum risk-based capital requirements.\textsuperscript{12}

For bank holding companies subject to the advanced approaches rule, the proposal
stated that in calculating their risk-based capital ratios, these organizations must calculate
their floor requirements under the general risk-based capital rules for state member
banks.\textsuperscript{13} However, in accordance with the Act, they may include certain debt or equity
instruments issued before May 19, 2010 as described in section 171(b)(4)(B) of the
Dodd-Frank Act. The agencies also proposed to eliminate the provisions of the
advanced approaches rules relating to transitional floor periods and the interagency study
of any material deficiencies in the rules.\textsuperscript{14} If the proposed permanent floor were
implemented, these provisions of the advanced approaches rules would no longer serve a
purpose.

\textsuperscript{11} 12 CFR part 3, Appendix C, section 3 (OCC); 12 CFR part 208, Appendix F, section 3
and 12 CFR part 225, Appendix G, section 3 (Board); and 12 CFR part 325, section 3
Appendix D (FDIC).

\textsuperscript{12} Banking organizations that use the advanced approaches rules are subject to the same
minimum leverage requirements that apply to other banking organizations. That is,
advanced approaches banks calculate only one leverage ratio using the numerator as
calculated under the generally risk-based capital rules. Accordingly, the agencies did not
propose any change to the calculation of the leverage ratio requirements for banking
organizations that use the advanced approaches rules.

\textsuperscript{13} 12 CFR part 208, appendix A.

\textsuperscript{14} Supra, section 21(e)(6) Interagency study. For any primary Federal supervisor to
authorize any institution to exit the third transitional floor period, the study must
determine that there are no such material deficiencies that cannot be addressed by then-
existing tools, or, if such deficiencies are found, they are first remedied by changes to this
appendix.
The proposal also included a modification to the general risk-based capital rules to address the appropriate capital requirement for low-risk assets held by depository institution holding companies\textsuperscript{15} or by nonbank financial companies supervised by the Board pursuant to a designation by the Financial Stability Oversight Council (FSOC), in situations where there is no explicit capital treatment for such exposures under the general risk-based capital rules. The agencies proposed that such exposures receive the capital treatment applicable under the capital guidelines for bank holding companies under limited circumstances. The circumstances are intended to allow for an appropriate capital requirement for low-risk, nonbanking exposures without creating unintended new opportunities for depository institutions to engage in capital arbitrage. Accordingly, the agencies proposed to limit this treatment to cases in which a depository institution is not authorized to hold the asset under applicable law other than under the authority to hold an asset in connection with the satisfaction of a debt previously contracted or similar authority, and the risks associated with the asset are substantially similar to the risks of assets that otherwise are assigned a risk weight of less than 100 percent under the general risk-based capital rules.\textsuperscript{16}

\section*{II. Comments Received}

A. Overview

\textsuperscript{15} Section 171 of the Act defines “depository institution holding company” to mean a bank holding company or a savings and loan holding company (as those terms are defined in section 3 of the Federal Deposit Insurance Act) that is organized in the United States, including any bank or savings and loan holding company that is owned or controlled by a foreign organization, but does not include the foreign organization. See section 171 of the Act, 12 U.S.C. 5371.

The agencies collectively received 16 comments from both domestic and international trade associations and from individual financial institutions, including insurance companies. Groups representing large banking organizations generally argued against the proposed permanent floor. These commenters asserted that it would place large U.S. banking organizations at a disadvantage relative to their international competitors, increase their costs, and undermine the risk sensitivity of the advanced approaches capital rules. In contrast, a trade organization for community banks and a financial reform advocacy organization supported the proposal.

Commenters representing insurance companies generally supported the proposed revisions to the general risk-based capital rules for selected nonbank assets, arguing that insurance companies have different risk profiles and their liabilities and assets are of different durations compared to banks. These commenters said it would not be appropriate to mechanically apply bank capital regulations to insurance companies.

B. Impact on banking organizations that use the advanced approaches rules

In response to the agencies’ question on how the proposal would affect U.S. banking organizations that use the advanced approaches rules, several commenters, mostly representing the largest U.S. financial institutions, expressed strong concerns about the proposed permanent floor, while acknowledging that the agencies were acting in response to a statutory requirement.17 These commenters generally asserted that the proposal exceeds the requirements of the Act, and would undermine the risk sensitivity of the risk-based capital rules, encourage banking organizations to invest more in higher risk assets, and distort decisions regarding capital allocation. These commenters also

17 Id. at 82319.
contended that the proposal would put U.S. banks at a disadvantage relative to their foreign competitors. Some of these commenters expressed a preference for alternative approaches to implement section 171 of the Act, including a Pillar 2 supervisory approach under the New Accord.

Some of the commenters who opposed the permanent floor also criticized the proposal for retaining two regulatory capital regimes, causing confusion, and diverting significant resources into developing systems to comply with the advanced rules, without a corresponding reduction in capital costs due to the imposition of the proposed permanent floor. These commenters also expressed concern and asked the agencies to clarify how the proposal would interact with Basel III\(^\text{18}\) (particularly, the Basel III leverage ratio and capital conservation buffer), prompt corrective action, and other Dodd-Frank Act provisions relating to capital adequacy, such as those required by section 165.\(^\text{19}\) In particular, these commenters expressed concern about what they viewed as negative consequences of maintaining a Basel I-based floor after full implementation of Basel III.

In contrast, one commenter representing community banks and another representing a financial reform advocacy organization expressed strong support for modifying the advanced approaches rules by replacing the transitional floors with the permanent floor. These commenters asserted that it is not appropriate for the agencies to allow large banking organizations to determine their capital requirements based on

\(^{18}\) The term “Basel III” refers to the new comprehensive set of reform measures developed by the BCBS to strengthen the regulation, supervision, and risk management of the banking sector. These releases are available on the BIS website, [www.bis.org](http://www.bis.org).

\(^{19}\) See section 165 of the Act; 12 U.S.C. 5365.
internal models because it may allow them to reduce their capital levels and give them a competitive advantage over community banks, and could also increase negative procyclical outcomes.

C. Effect on applications by foreign banking organizations

The preamble to the proposed rule noted that in approving an application by a foreign banking organization to establish a branch or agency in the United States or to make a bank or nonbank acquisition, the Board considers, among other factors, whether the capital of the foreign banking organization is equivalent to the capital that would be required of a U.S. banking organization.20 In addition, in approving an application by a foreign banking organization to establish a federal branch or agency, the OCC must make a similar capital equivalency determination.21 Similarly, in order to make effective a foreign banking organization’s declaration under the Bank Holding Company Act (BHC Act) to be treated as a financial holding company (FHC), the Board must apply comparable capital and management standards to the foreign banking organization “giving due regard to the principle of national treatment and equality of competitive opportunity.”22 National treatment generally means treatment that is no less favorable

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20 See 12 U.S.C. 1842(c); 1843(j); and 3105(d)(3)(B), (j)(2).
22 12 U.S.C. 1843(l)(3). A foreign bank that operates a branch, agency or commercial lending company in the United States and any company that owns such a foreign bank, is subject to the BHC Act as if it were a bank holding company. The BHC Act, as amended by the Gramm-Leach Bliley Act, provides that a bank holding company may become an FHC if its depository institutions meet certain capital and management standards. See 12 U.S.C. 1843(l)(1); 12 CFR 225. Under section 606 of the Act, this requirement will be modified to require the bank holding company to be well capitalized and well managed. See the Act, section 606.
than that provided to domestic institutions that are in like circumstances. The agencies have broad discretion to consider relevant factors in making these determinations.

The Board has been making capital equivalency findings for foreign banking organizations under the International Banking Act and the BHC Act since 1992 pursuant to guidelines developed as part of a joint study by the Board and Treasury on capital equivalency.23 The study acknowledged the Basel Committee on Banking Supervision’s 1988 Accord (Basel I) as the prevailing capital standard for internationally active banks and found that implementation of Basel I was broadly equivalent across countries. Until 2007, the agencies had generally accepted as equivalent the capital of foreign banking organizations from countries adhering to Basel I within the bounds of national discretion allowed under the Basel I framework. For foreign banking organizations that have begun operating under the New Accord’s capital standards, the agencies have evaluated the capital of the foreign banking organization as reported in compliance with the New Accord, while also taking into account a range of factors including compliance with the New Accord’s capital requirement floors linked to Basel I, where applicable. In some countries, Basel I floors are no longer in effect, or are expected to be phased out in the near term.

The NPR sought commenters’ views on how the proposed rule should be applied to foreign banking organizations in evaluating capital equivalency in the context of applications to establish branches or make bank or nonbank acquisitions in the United States, and in evaluating capital comparability in the context of foreign banking

organization FHC declarations. In raising this question, the agencies recognized the challenge of administering capital equivalency determinations where the foreign banking organization is not subject to the same floor requirement as its U.S. counterpart.

In responding to this question, most commenters asserted that extending U.S. capital requirements to a foreign banking organization operating outside of the United States would not be appropriate and would be inconsistent with the Board’s supervisory practice regarding the recognition of home country capital regulations. Several commenters noted that subjecting a foreign banking organization to the proposed rule contradicts the language of the Act, which excludes foreign banking organizations from the requirements of section 171. Several commenters supported applying the proposed rule to the U.S. operations of foreign banking organizations operating in the United States to be consistent with requirements for domestic banking organizations.

Some commenters noted that foreign banking organizations operating under the advanced approaches rules would receive a competitive advantage over U.S. banking organizations subject to the proposal’s permanent floor requirement. In addition, several commenters expressed concern that the applying the proposed floor to foreign banking organizations may incentivize home country supervisors to impose reciprocal arrangements for U.S. banking organizations operating abroad.

The agencies acknowledge that section 171, by its terms, does not apply to foreign banking organizations. Rather, the question on capital equivalency and comparability determinations was intended to seek views on practical ways to administer such determinations in the context of certain foreign bank organization applications to enter or expand operations within the United States given the proposal’s requirements
and longstanding supervisory practice. One of the agencies’ supervisory objectives is to establish a consistent means for making capital equivalency determinations in the context of foreign banking organization applications to establish branches or to acquire banks or nonbanks in the United States, and in evaluating capital comparability in the context of foreign banking organization FHC declarations. The agencies recognize the challenges of establishing a consistent process for evaluating capital equivalency in cases where, among other things, the foreign banking organization applicant operating under advanced approaches no longer has the Basel I floor in place in its home country, and therefore no longer produces financial information based on Basel I requirements. The agencies believe that it is important to take into consideration the competitive issues highlighted by commenters. The agencies will continue to evaluate equivalency issues on a case-by-case basis taking into consideration the comments received.

D. Proposed capital requirements for certain nonbanking exposures

In the NPR, the agencies sought comment on whether the proposed treatment of nonbanking exposures described above was appropriate, whether this treatment was sufficiently flexible to address the exposures of depository institution holding companies and nonbank financial companies supervised by the Board, and, if not, how the treatment should be modified. Most commenters generally supported allowing flexibility for the capital treatment of nonbanking assets and agreed with the agencies’ observation that automatically assigning such assets to the 100 percent risk weight category because they are not explicitly assigned to a lower risk weight category may not always be appropriate based on the economic substance of the exposure. One commenter broadly agreed with

24 Id. at 82320.
the proposal but stated that the proposed treatment needed further clarification. Another commenter noted that the rule also should provide for higher capital requirements, particularly for those exposures that are impermissible for banks. One commenter noted that the proposal’s limited flexibility to allow certain assets to receive the capital treatment applicable under the capital guidelines for bank holding companies should not include the condition that the asset be held under debt previously contracted or similar authority. This commenter stated that assignment to a risk category should be based on the risk of the asset and not on the underlying authority to own the asset.

The agencies received substantial comments from insurance companies about the capital requirements for these entities in general as well as on the proposed modifications to the general risk-based capital rules to address certain nonbank assets. These commenters argued that it would not be appropriate to apply capital requirements applicable to banking organizations to insurance companies because their risk profiles, balance sheet characteristics, and business models fundamentally differ. Several of these commenters were concerned that applying capital requirements for banking organizations to insurance companies without taking these differences into account is overly simplistic and may lead to distorted incentives, undermine efficient use of capital, curtail insurance underwriting capacity, and negatively impact insurance markets.

Some commenters suggested that significant adjustments to the risk weights applicable to banking organizations’ exposures would be necessary when considering applicability to insurance companies’ exposures. Other commenters suggested that adjustments to risk weights alone would be insufficient. Several commenters suggested that the agencies recognize and incorporate established insurance capital standards into
any new capital regime that may apply to insurance companies. Some commenters suggested that the agencies use a principle of equivalence to evaluate insurance companies’ capital adequacy similar to the practice used by the Board to determine if the capital of a foreign bank is equivalent to the capital required of a U.S. banking organization. Certain insurance industry commenters provided specific examples of exposures that should be given consideration for a lower risk weight under the general risk-based capital rules, including non-guaranteed separate accounts based on the rationale that the insurance policyholder and not the institution bears the investment risk associated with the contract. Other assets for which commenters suggested consideration regarding the capital treatment included guaranteed separate accounts, corporate debt, and private placements.

Some commenters expressed concern that the Board may require insurance companies to use U.S. generally accepted accounting principles for preparing financial statements instead of the statutory accounting principles applicable to insurance companies. These commenters noted the burden and costs associated with using two accounting systems.

E. Quantitative methods for comparing capital frameworks

The NPR sought comment on how the agencies should, in the future, evaluate changes to the general risk-based capital requirements to ensure they are not quantitatively lower than the “generally applicable capital requirements” in effect as of the enactment of section 171 of the Act. Commenters generally supported looking at industry-wide aggregate capital levels, in order to conduct the analysis, rather than basing

25 75 FR at 82320-21.
the calculation on an item-by-item comparison of capital requirements for each class of exposures. These commenters asserted that this approach would allow individual organizations to adjust their business models appropriately while satisfying the test. One commenter suggested that in comparing proposed changes to the generally applicable capital requirements, the agencies should assume a stable risk profile within the industry while assessing levels of capital. This commenter points out maintaining reliable comparative data over time could make quantitative methods for this purpose difficult. For example, evaluating asset categories with current and historic data would be difficult if banks have not maintained consistent tracking methods, or common definitions over time. This commenter also suggested that it would be misguided to compare future capital requirements without regard to risk.

F. Costs and benefits and other comments

Several commenters were concerned about the operational expense and burden associated with determining compliance with two sets of capital rules. One stated that requiring two sets of capital rules would result in permanently higher operating costs for banking organizations under the advanced approaches rules. This commenter also suggested that the proposed risk-based capital floor will reduce the incentive for banking organizations considering whether to undertake the expense and effort necessary to adopt the advanced approaches rules if minimum capital levels are determined by a less risk-sensitive capital framework. Some commenters also expressed concerns about the cost of continuing to implement the advanced approaches rules. One said that banks already have spent hundreds of millions of dollars on implementing the advanced approaches rules, and the proposal would eliminate the opportunity for banks to realize cost savings
from potentially lower capital requirements under the advanced approaches rules.

Another commenter suggested the agencies consider exempting from the permanent floor requirement any banking organization whose risk-weighted assets in the trading book exceeded a certain percent of total risk-weighted assets. This commenter also suggested ways of reducing the cost of compliance under the advanced approaches rules by, for example, raising the materiality standards to exempt small, relatively low-risk portfolios to save significant time and money at minimal cost in terms of lessened risk sensitivity.

Commenters generally indicated that keeping track of two sets of capital regulations (the advanced approaches rules and the generally applicable risk-based capital rules then in effect) was preferable to tracking three capital rules (the above two capital regimes and the general risk-based capital rules in effect on July 21, 2010).

Two commenters also suggested that because the FSOC has not designated any systemically important nonbank financial companies, potential designees were not provided sufficient notice and opportunity to comment on the proposal.

G. Analysis of Comments

As described in the preceding section, a number of the commenters expressed opinions about the appropriateness of the policy underlying section 171 of the Act. The agencies note that they are required by law to comply with the Act and sought comment in the NPR on the manner in which the agencies proposed to implement certain requirements of section 171, and on ways to mitigate banking organizations’ burden in meeting the proposed requirements.

In response to comments on the burden of maintaining two systems to calculate capital requirements under both the risk-based capital rules and the advanced approaches
rules, the agencies note that banking organizations in parallel run are currently reporting their capital requirements under both sets of rules. The agencies recognize that reporting capital calculations under two capital frameworks beyond the transitional floor arrangement was not expected at the onset of the advanced approaches rules. However, as discussed above, the agencies are issuing the final rule to be consistent with the requirements under section 171(b)(2) of the Act.

Generally commenters supported the proposal’s amendment to the general risk-based capital rules to address the appropriate capital requirement for low risk assets that non-depository institutions may hold and for which there is no explicit capital treatment in the general risk-based capital rules. This change was focused on providing limited flexibility for future changes to the risk-based capital rules applicable to bank holding companies following an evaluation of the exposures of covered institutions that may not previously have been subject to consolidated risk-based capital requirements applicable to banking organizations. Several commenters provided specific examples of assets that warrant consideration for a risk weight lower than 100 percent. The Board will consider the risk characteristics for such assets on a case-by-case basis as it considers potential changes to the risk-based capital rules applicable to bank holding companies.

One commenter recommended that the agencies remove from this treatment the condition that the bank holds the asset in connection with the satisfaction of a debt previously contracted or similar authority. This commenter suggests that the assignment to a risk category should be based on the risk of the asset, not an authority to own the asset. The agencies agree that in the cases where this limited treatment is used, the assignment of a capital requirement in this situation would be based on an evaluation of
the asset’s risk profile. The condition related to legal authority is intended to limit the scope for assignments of capital requirements under this provision to assets not typically held by depository institutions, whose risks and characteristics were not contemplated when the general risk-based capital rules were developed.

Insurance-related commenters noted that some large insurance companies which engage predominantly in insurance activities have depository institution subsidiaries or affiliates that represent a relatively small portion of the consolidated entity. These commenters highlighted fundamental differences in risk profiles, balance sheet characteristics, and business models between insurance companies and banking organizations. In response to these comments, the agencies note that section 171(b)(2) of the Act does not take into account the size or other differences between a holding company and its subsidiary depository institution(s). Consistent with this section of the Act, the “generally applicable” capital requirements serves as a floor for any capital requirements the agencies may require.

Some commenters suggested that foreign banking organizations operating under the advanced approaches rules could hold less capital and therefore, receive a competitive advantage compared to U.S banking organizations. The agencies agree that without the proposal’s floor requirement, a banking organization that uses the advanced approaches rules could theoretically operate with lower minimum risk-based capital requirements than would be required under the general risk-based capital rules. The agencies will consider these competitive equity concerns when working with the BCBS and other supervisory authorities to mitigate potential competitive inequities across jurisdictions, as appropriate.
In explaining their concern about how the proposal would interact with Basel III, a number of commenters focused on the proposed rule and future changes to regulatory capital requirements, including those related to U.S. implementation of Basel III. These commenters stated that it is not possible to understand the consequences of implementing section 171 without addressing the broader range of changes in capital regulations, such as changes to the leverage ratio and PCA provisions.

The agencies agree that implementing section 171 will require careful consideration and diligence over time, as the agencies propose and implement various enhancements to the regulatory capital rules. Consistent with the joint efforts of the U.S. banking agencies and the Basel Committee to enhance the regulatory capital rules applicable to internationally active banking organizations, the agencies anticipate that their capital requirements will be amended, establishing different minimum and “generally applicable” capital requirements. These amendments would reflect advances in risk sensitivity and potentially other substantive changes to international agreements on capital requirements and capital policy changes generally.

Thus, the “generally applicable” capital requirements as defined under section 171 will evolve over time, and as they evolve, continue to serve as a floor for all banking organizations’ risk-based capital requirements. Section 171 also requires that the minimum capital requirements established under section 171 not be “quantitatively lower” than the “generally applicable” capital requirements in effect for insured depository institutions as of the date of the Act.

The agencies anticipate performing a quantitative analysis of any new capital framework developed in the future for purposes of ensuring that future changes to the
agencies’ capital requirements result in minimum capital requirements that are not “quantitatively lower” than the “generally applicable” capital requirements for insured depository institutions in effect as of the date of enactment of the Act. By performing such an analysis, the agencies would ensure that all minimum capital requirements established under section 171 meet this requirement, including minimum requirements that become the new “generally applicable” capital requirements under section 171.

The agencies are currently considering how that analysis may be performed for anticipated changes to the capital rules. As some commenters noted, comparing capital requirements on an aggregate basis is an effective way of conducting the “quantitatively lower” analysis and the agencies expect to propose this method as appropriate in future rulemakings. The agencies anticipate that before proposing future changes to their capital requirements, the agencies will consider the implications for the capital adequacy of banking organizations, the implementation costs, and the nature of any unintended consequences or competitive issues. The agencies note that section 171 does not require a “permanent Basel-I based floor” as some commenters have suggested. The agencies also note that they do not anticipate proposing to require banking organizations to compute two sets of generally applicable capital requirements from current and historic frameworks as the generally applicable requirements are amended over time.

In addition, the agencies agree with commenters that the relationship between the requirements of section 171 and other aspects of the Act, including section 165, must be considered carefully and that all aspects of the Act should be implemented so as to avoid imposing conflicting or inconsistent regulatory capital requirements.
III. Final Rule

A. Implementation of a risk-based capital floor.

The agencies have considered the comments received on the NPR, and continue to believe that the rule as proposed is consistent with the requirements of section 171 of the Act with respect to risk-based capital requirements. Therefore, the agencies have decided to implement the rule as proposed, effective [INSERT DATE 30 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

Thus, each organization implementing the advanced approaches rules will continue to calculate its risk-based capital requirements under the agencies’ general risk-based capital rules, and the capital requirement it computes under those rules will serve as a floor for its risk-based capital requirement computed under the advanced approaches rules. The agencies note that the effect of this rule on banking organizations is to preclude certain reductions in capital requirements that might have occurred in the future, absent the rule and absent any further changes to the capital rules. The agencies also note that in practice, the rule will not have an immediate effect on banking organizations’ capital requirements because all organizations subject to the advanced approaches rules are currently computing their capital requirements under the general risk-based capital rules.

For bank holding companies subject to the advanced approaches rule, as noted above, the final rule provides that they must calculate their floor requirement under the general risk-based capital rules for state member banks.26 However, in accordance with the Act, these organizations may include certain debt or equity instruments issued before

26 12 CFR part 208, appendix A.
May 19, 2010 as described in section 171(b)(4)(B) of the Act. The agencies expect the phase-in of restrictions on the regulatory capital treatment of the debt or equity instruments described in section 171(b)(4)(B) of the Act will be addressed in more detail in a subsequent rule. As indicated in the proposal, other aspects of section 171 are not addressed in this final rule.

B. Capital requirements for certain nonbanking exposures.

Commenters generally supported the agencies’ proposed treatment of certain low-risk, nonbanking exposures. The agencies believe the proposed treatment provides flexibility to address situations where exposures of a depository institution holding company or a nonbank financial company supervised by the Board not only do not wholly fit within the terms of a risk weight category applicable to banking organizations, but also impose risks that are not commensurate with the risk weight otherwise specified in the generally applicable risk-based capital requirements. Therefore, the final rule retains the proposed rule’s treatment for these assets without modification.

As a general matter, the Board and the other federal banking agencies retain a reservation of authority to assign alternate risk-based capital requirements if such action is warranted.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the regulatory flexibility analysis otherwise required under section 604 of the RFA is not required if an agency certifies that the rule will not have a significant economic impact on

27 5 U.S.C. 605(b).
a substantial number of small entities (defined for purposes of the RFA to include banks with assets less than or equal to $175 million) and publishes its certification and a short, explanatory statement in the Federal Register along with its rule.

The final rule would affect bank holding companies, national banks, state member banks, and state nonmember banks that use the advanced approaches rules to calculate their risk-based capital requirements according to certain internal ratings-based and internal model approaches. A bank holding company or bank must use the advanced approaches rules only if: (i) it has consolidated total assets (as reported on its most recent year-end regulatory report) equal to $250 billion or more; (ii) it has consolidated total on-balance sheet foreign exposures at the most recent year-end equal to $10 billion or more; or (iii) it is a subsidiary of a bank holding company or bank that would be required to use the advanced approaches rules to calculate its risk-based capital requirements.

With respect to the changes to the general risk-based capital rules, the final rule has the potential to affect the risk weights applicable only to assets that generally are impermissible for banks to hold. These changes are, accordingly, unlikely to have a significant impact on banking organizations. The agencies also note that the changes to the general risk-based capital rules would not impose any additional obligations, restrictions, burdens, or reporting, recordkeeping or compliance requirements on banks including small banking organizations, nor do they duplicate, overlap or conflict with other Federal rules.

The agencies estimate that zero small bank holding companies (out of a total of approximately 2,499 small bank holding companies), one small national bank (out of a total of approximately 664 small national banks), one small state member bank (out of a
total of approximately 398 small state member banks), and one small state nonmember bank (out of a total of approximately 2,639 small state nonmember banks) are required to use the advanced approaches rules. In addition, each of the small banks that is required to use the advanced approaches rules is a subsidiary of a bank holding company with over $250 billion in consolidated total assets or over $10 billion in consolidated total on-balance sheet foreign exposures. Therefore, the agencies believe that the final rule will not result in a significant economic impact on a substantial number of small entities.

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28 All totals are as of December 31, 2010.
OCC Unfunded Mandates Reform Act of 1995 Determinations

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104-4 (UMRA) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector of $100 million or more (adjusted annually for inflation) in any one year. If a budgetary impact statement is required, section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC has determined that its final rule will not result in expenditures by state, local, and tribal governments, or by the private sector, of $100 million or more. Accordingly, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

Paperwork Reduction Act

In accordance with the requirements of the Paperwork Reduction Act of 1995, the agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. Each of the agencies has an established information collection for the paperwork burden imposed by the advanced approaches rule. This final rule would replace the transitional floors in section 21(e) of the advanced approaches rule with a permanent floor equal to the tier 1 and total risk-based capital requirements under the current generally applicable risk-based capital rules. The

29 44 U.S.C. 3501-3521

30 See Risk-Based Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework, FFIEC 101, OCC OMB Number 1557-0239, Federal Reserve OMB Number 7100-0319, FDIC OMB Number 3064-0159.
proposed change to transitional floors would change the basis for calculating a data element that must be reported to the agencies under an existing requirement. However, it would have no impact on the frequency or response time for the reporting requirement and, therefore, does not constitute a substantive or material change subject to OMB review.

**Plain Language**

Section 722 of the Gramm-Leach-Bliley Act (Pub. L. 106-102, 113 Stat. 1338, 1471) requires the agencies to use plain language in all proposed and final rules published after January 1, 2000. In light of this requirement, the agencies have sought to present the final rule in a simple and straightforward manner.

**List of Subjects**

12 CFR Part 3

Administrative practice and procedure, Banks, Banking, Capital, National banks, Reporting and record keeping requirements, Risk.

12 CFR Part 208

Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and record keeping requirements, Risk.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and record keeping requirements, Securities.

12 CFR Part 325

Administrative practice and procedure, Banks, banking, Capital Adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.
Authority and Issuance

For the reasons stated in the common preamble, the Office of the Comptroller of the Currency amends part 3 of chapter I of Title 12, Code of Federal Regulations as follows:

PART 3- MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

1. The authority citation for part 3 continues to read as follows:

   Authority: 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

2. In Appendix A to part 3, in section 3, add new paragraph (a)(4)(xi) as follows:

APPENDIX A TO PART 3—RISK-BASED CAPITAL GUIDELINES

Section 3. Risk Categories/Weights for On-Balance Sheet Assets and Off-Balance Sheet Items

(xi) Subject to the requirements below, a bank may assign an asset not included in the categories above to the risk weight category applicable under the capital guidelines for bank holding companies,31 provided that all of the following conditions apply:

31 See 12 CFR part 225, appendix A.
(A) The bank is not authorized to hold the asset under applicable law other than debt previously contracted or similar authority; and

(B) The risks associated with the asset are substantially similar to the risks of assets that are otherwise assigned to a risk weight category less than 100 percent under this appendix.

3. In Appendix C to part 3:
   a. Revise Part I, section 3 to read as set forth below.
   b. Remove section 21(e).

APPENDIX C TO PART 3—CAPITAL ADEQUACY GUIDELINES FOR BANKS: INTERNAL RATINGS-BASED AND ADVANCED MEASUREMENT APPROACHES

Part I. General Provisions

* * * * *

Section 3. Minimum Risk-Based Capital Requirements

(a) (1) Except as modified by paragraph (c) of this section or by section 23 of this appendix, each bank must meet a minimum:

(i) Total risk-based capital ratio of 8.0 percent; and

(ii) Tier 1 risk-based capital ratio of 4.0 percent.

(2) A bank’s total risk-based capital ratio is the lower of:

(i) Its total qualifying capital to total risk-weighted assets; and

(ii) Its total risk-based capital ratio as calculated under Appendix A of this part.

(3) A bank’s tier 1 risk-based capital ratio is the lower of:

(i) Its tier 1 capital to total risk-weighted assets; and

(ii) Its tier 1 risk-based capital ratio as calculated under Appendix A of this part.
(b) Each bank must hold capital commensurate with the level and nature of all risks to which the bank is exposed.

(c) When a bank subject to 12 CFR part 3, Appendix B, calculates its risk-based capital requirements under this appendix, the bank must also refer to 12 CFR part 3, Appendix B, for supplemental rules to calculate risk-based capital requirements adjusted for market risk.

* * * * *

Federal Reserve System

12 CFR CHAPTER II

Authority and Issuance

For the reasons set forth in the common preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are amended as follows:

PART 208 – MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

4. The authority citation for part 208 continues to read as follows:


5. In Appendix A to part 208, revise section III.C. 4.a and add section III.C. 4.e to read as follows:
Appendix A to Part 208—Capital Adequacy Guidelines for State Member Banks:

Risk-Based Measure

* * * * *

III. Procedures for Computing Weighted Risk Assets and Off-Balance Sheet Items

* * * * *

C. Risk Weights

* * * * *

4. Category 4: 100 percent. a. Except as provided in section III.C. 4.e, all assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

* * * * *

e. Subject to the requirements below, a bank may assign an asset not included in the categories above to the risk weight category applicable under the capital guidelines for bank holding companies, provided that all of the following conditions apply:

i. The bank is not authorized to hold the asset under applicable law other than under debt previously contracted or other similar authority; and

ii. The risks associated with the asset are substantially similar to the risks of assets that are otherwise assigned to a risk weight category of less than 100 percent under this appendix.

* * * * *

6. In Appendix F to part 208:

32 See 12 CFR part 225, appendix A.
a. Revise section 3 to read as set forth below; and

b. Remove section 21(e).

Appendix F to Part 208—Capital Adequacy Guidelines for Banks: Internal Ratings-Based and Advanced Measurement Approaches

Part I. General Provisions

Section 3. Minimum Risk-Based Capital Requirements

(a) (1) Except as modified by paragraph (c) of this section or by section 23 of this appendix, each bank must meet a minimum:

(i) Total risk-based capital ratio of 8.0 percent; and
(ii) Tier 1 risk-based capital ratio of 4.0 percent.

(2) A bank’s total risk-based capital ratio is the lower of:

(i) Its total qualifying capital to total risk-weighted assets, and
(ii) Its total risk-based capital ratio as calculated under Appendix A of this part.

(3) A bank’s tier 1 risk-based capital ratio is the lower of:

(i) Its tier 1 capital to total risk-weighted assets, and
(ii) Its tier 1 risk-based capital ratio as calculated under Appendix A of this part.

(b) Each bank must hold capital commensurate with the level and nature of all risks to which the bank is exposed.

(c) When a bank subject to [the market risk rule] calculates its risk-based capital requirements under this appendix, the bank must also refer to [the market risk rule] for supplemental rules to calculate risk-based capital requirements adjusted for market risk.
PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK
CONTROL (REGULATION Y)

7. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8),
1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909; 15 U.S.C. 6801 and
6805.

8. In Appendix G to part 225:

a. Revise section 3 to read as set forth below; and

b. Remove section 21(e).

Appendix G to Part 225—Capital Adequacy Guidelines for Bank Holding
Companies: Internal Ratings-Based and Advanced Measurement Approaches
Part I. General Provisions
* * * * *

Section 3. Minimum Risk-Based Capital Requirements

(a)(1) Except as modified by paragraph (c) of this section or by section 23 of this appendix, each bank holding company must meet a minimum:

(i) Total risk-based capital ratio of 8.0 percent; and

(ii) Tier 1 risk-based capital ratio of 4.0 percent.

(2) A bank holding company’s total risk-based capital ratio is the lower of:

(i) Its total qualifying capital to total risk-weighted assets, and

(ii) Its total risk-based capital ratio as calculated under 12 CFR part 208, appendix A, as adjusted to include certain debt or equity instruments issued before May 19, 2010 as described in section 171(b)(4)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).
(3) A bank holding company’s tier 1 risk-based capital ratio is the lower of:

(i) Its tier 1 capital to total risk-weighted assets, and

(ii) Its tier 1 risk-based capital ratio as calculated under 12 CFR part 208, appendix A, as adjusted to include certain debt or equity instruments issued before May 19, 2010 as described in section 171(b)(4)(B) of the Dodd-Frank Act.

(b) Each bank holding company must hold capital commensurate with the level and nature of all risks to which the bank holding company is exposed.

(c) When a bank holding company subject to [the market risk rule] calculates its risk-based capital requirements under this appendix, the bank holding company must also refer to [the market risk rule] for supplemental rules to calculate risk-based capital requirements adjusted for market risk.

* * * * *

Federal Deposit Insurance Corporation

12 CFR Chapter III

Authority for Issuance

For the reasons stated in the common preamble, the Federal Deposit Insurance Corporation amends Part 325 of Chapter III of Title 12, Code of the Federal Regulations as follows:

PART 325 – CAPITAL MAINTENANCE

9. The authority citation for part 325 continues to read as follows:

10. Amend Appendix A to part 325 as follows:

a. In section II.C, revise the first sentence of the introductory text;

b. In sections II.D, and II.E, redesignate footnotes 45 through 50 as footnotes 46 through 51.

c. In section II.C, Category 4, add new paragraph (d) and a new footnote 45.

APPENDIX A TO PART 325 – STATEMENT OF POLICY ON RISK-BASED CAPITAL

II. PROCEDURES FOR COMPUTING RISK-WEIGHTED ASSETS

C. Risk Weights for Balance Sheet Assets (see Table II)

The risk based capital framework contains five risk weight categories—0 percent, 20 percent, 50 percent, 100 percent, and 200 percent. Category 4 – 100 Percent Risk Weight.
(d) Subject to the requirements below, a bank may assign an asset not included in the categories above to the risk weight category applicable under the capital guidelines for bank holding companies, provided that all of the following conditions apply:

(1) The bank is not authorized to hold the asset under applicable law other than debt previously contracted or similar authority; and

(2) The risks associated with the asset are substantially similar to the risks of assets that are otherwise assigned to a risk weight category less than 100 percent under this appendix.

* * * * *

11. In Appendix D to part 325:

a. Revise section 3 to read as set forth below; and

b. Remove section 21(e).

APPENDIX D TO PART 325—CAPITAL ADEQUACY GUIDELINES FOR BANKS: INTERNAL RATINGS-BASED AND ADVANCED MEASUREMENT APPROACHES

Part I. General Provisions

* * * * *

Section 3. Minimum Risk-Based Capital Requirements

(a) (1) Except as modified by paragraph (c) of this section or by section 23 of this appendix, each bank must meet a minimum:

(i) Total risk-based capital ratio of 8.0 percent; and

(ii) Tier 1 risk-based capital ratio of 4.0 percent.

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33 See 12 CFR part 225, appendix A.
(2) A bank’s total risk-based capital ratio is the lower of:

(i) Its total qualifying capital to total risk-weighted assets, and

(ii) Its total risk-based capital ratio as calculated under appendix A of this part.

(3) A bank’s tier 1 risk-based capital ratio is the lower of:

(i) Its tier 1 capital to total risk-weighted assets, and

(ii) Its tier 1 risk-based capital ratio as calculated under appendix A of this part.

(b) Each bank must hold capital commensurate with the level and nature of all risks to which the bank is exposed.

(c) When a bank subject to appendix C of this part calculates its risk-based capital requirements under this appendix, the bank must also refer to appendix C of this part for supplemental rules to calculate risk-based capital requirements adjusted for market risk.

* * * * *
Dated: June 14, 2011

John Walsh (signed)

John Walsh,
Comptroller of the Currency
By order of the Board of Governors of the Federal Reserve System, June 14, 2011

Jennifer J. Johnson  (signed)
Jennifer J. Johnson
Secretary of the Board.
Dated at Washington, D.C., this 14th day of June 2011.
By order of the Board of Directors.
Federal Deposit Insurance Corporation.

Robert E. Feldman (signed)
Robert E. Feldman,
Executive Secretary
Release Date: June 10, 2011

For immediate release

The Federal Reserve Board is seeking comment on a proposal to require top-tier U.S. bank holding companies with total consolidated assets of $50 billion or greater to submit annual capital plans for review.

The aim of the capital plan review, which builds on the Comprehensive Capital Analysis and Review (CCAR) conducted earlier this year, is to ensure that institutions have robust, forward-looking capital planning processes that account for their unique risks and that permit continued operations during times of economic and financial stress. Institutions would be expected to have credible plans to have sufficient capital so that they can continue to lend to households and businesses, even under adverse conditions. Boards of directors of the institutions would be required each year to review and approve capital plans before submitting them to the Federal Reserve.

The Federal Reserve would evaluate institutions' plans to make capital distributions, such as increasing dividend payments or repurchasing or redeeming stock, as part of the capital plan reviews. In some cases, such as when institutions' capital plans have been rejected by the Federal Reserve, firms would be required to receive approval from the Federal Reserve before making capital distributions.

The proposal would institutionalize the recently completed CCAR exercise. The CCAR involved a forward-looking analysis of the capital plans at the 19 largest U.S. bank holding companies. The CCAR followed the Supervisory Capital Assessment Program (SCAP), a standardized stress test led by the Federal Reserve in 2009.

As of March 31, the most recent available data, 35 U.S. bank holding companies had assets of at least $50 billion. According to the proposal, the level of detail and analysis expected in each institution's capital plan would vary based on the company's size, complexity, risk profile, and scope of operations. The Federal Reserve plans to finalize the proposal later this year and to begin the annual capital plan reviews in early 2012.

The proposed capital plans would complement a number of components of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including the development of enhanced prudential standards for large firms and required stress tests. As the Federal Reserve implements the Dodd-Frank Act, it is expected that the company-run Dodd-Frank stress tests will serve as one component of institutions' capital plans.

The Federal Reserve requests comments on the capital plan review proposal, which will be published soon in the Federal Register, by August 5, 2011.

For media inquiries, call 202-452-2955.

Federal Register notice: HTML | 224 KB PDF

Comments: Submit | View
Supervisory Oversight of Capital Plans and Capital Distributions at Large Banking Organizations
Speech by Patrick Parkinson
Director, Division of Banking Supervision and Regulation
Exchequer Club Luncheon
June 15, 2011

I would like to thank the Exchequer Club for the opportunity to offer a few remarks today. I plan to discuss something that I believe is on many people’s minds right now: supervisory oversight of capital at large banking organizations. The recent crisis demonstrated quite vividly that most large banking organizations (and, indeed, most large financial institutions generally) underestimated the amount and quality of capital required for them to sustain stressful circumstances and continue as viable entities. As a result, since the onset of the crisis the Federal Reserve has led a series of initiatives to strengthen the capital positions of large, complex banking organizations, including working with the firms to bolster their internal processes for assessing capital needs. The most recent of these initiatives is a proposal released last week that would require certain large firms to submit annual capital plans to the Federal Reserve. The Federal Reserve would review those plans and could in certain circumstances object to a firm’s capital plan, as well as its planned capital distributions to shareholders through dividends, share repurchases, or other transactions.

To begin, I would like to place this most recent initiative in context by describing the steps leading up to it and how it fits within our broader efforts to enhance large bank supervision.

Key Lessons Informing Recent Supervisory Policies

Our efforts to enhance large bank supervision are based on what we see as the key lessons from the recent financial crisis. I will briefly mention some of those lessons that are most relevant for understanding our capital plan proposal. Chairman Bernanke and other
members of the Federal Reserve Board have provided more comprehensive discussions of
lessons learned in testimony and speeches over the last several years.

When it comes to capital planning and capital adequacy, clearly one of the most
important lessons is that firms’ processes were not sufficiently comprehensive and forward-
looking. For one, leading up to the crisis many firms underestimated the risks inherent in their
exposures and activities— which generally led to a corresponding underestimation of capital
needs. Probably the most prominent example of this was firms’ insufficient appreciation of the
risks associated with subprime mortgages and certain structured products, especially the impact
that declines in housing prices would have on both their loan and trading portfolios.

Having a satisfactory internal process for assessing capital adequacy, which takes into
account capital needs under a variety of potential adverse scenarios, is vital to confirming that a
bank’s level and composition of capital is indeed adequate to withstand outcomes that are worse
than anticipated. Additionally, firms now understand much better that they cannot focus solely
on meeting the minimum requirements of regulators but must also maintain the level and
composition of capital needed to assure investors, counterparties, and providers of funding that
the firm can remain a viable entity in the face of a particularly adverse operating environment.
For example, during the crisis many providers of wholesale funding focused on common equity
ratios as their measure of bank soundness, giving little or no credit to hybrid capital instruments
that satisfied regulatory requirements.

Among the most striking examples of pre-crisis shortsightedness are the significant
distributions of capital made by many large firms, in the form of stock repurchases and
dividends. These distributions resulted in a substantial outflow of capital from the banking
system even after it was apparent that the economy was starting to weaken and that financial
markets were stressed. As an example, the 19 largest banking organizations paid out more than $43 billion in dividends in 2007, plus an additional $39 billion in 2008. In retrospect, it seems clear that firms made these distributions without due consideration of the effects that a prolonged economic downturn and severe financial market distress could have on their capital adequacy and on their ability to continue to operate and meet the credit needs of their clients. And, quite frankly, these capital distributions were not given sufficient attention by bank supervisors, including the Federal Reserve.

We are going to be paying very careful attention to capital distributions going forward, and we will expect banks’ boards of directors and senior management, who have primary responsibility for such decisions, to do the same. Part of the Federal Reserve’s responsibility is to counter overoptimism among firms, which is why our recent initiatives and the proposed capital plan rule entail supervisory oversight of the manner in which firms estimate their capital needs and resources, as well as their capital distribution plans. This oversight may require us to deliver some blunt and unwelcome communications to firms’ boards of directors and senior management and to follow up forcefully to ensure that issues are being properly resolved. But that is our job.

**Oversight of Capital Adequacy at Large Organizations since the Onset of the Crisis**

Now I will discuss some of the specific steps we have taken since the onset of the crisis to improve capital adequacy at large banking organizations. While we have obviously undertaken other steps to improve capital positions at regional and community organizations, special attention has been given to large firms because financial distress at these firms can have a broad impact on the financial system and the economy. I will begin with two initiatives undertaken in early 2009 during the depths of the crisis.
Supervisory Capital Assessment Program and Supervisory Guidance on Capital Adequacy

As most of you know, one of the most effective steps taken in response to the crisis was the Supervisory Capital Assessment Program, or SCAP. The SCAP covered all domestic bank holding companies with at least $100 billion in assets at the end of 2008, in total 19 firms collectively representing about two-thirds of U.S. banking assets. Notably, prior to the SCAP market participants were losing confidence in banking organizations not only because those market participants expected steep losses on banking assets, but also because the range of estimated potential losses, and thus the impact on future earnings and capital, was exceptionally wide. The SCAP was designed both to ensure that firms would have enough capital in the face of potentially large losses and to reduce the uncertainty about potential losses and earnings prospects. Importantly, the SCAP was not a solvency test; rather, the exercise was intended to determine whether the tested firms would have sufficient capital remaining to continue to function as sources of credit and other financial services, even after potential losses that could result from a worse-than-anticipated weakening of the economy.

In many respects, the SCAP was a milestone not only in the financial crisis but also in our approach to banking supervision. Since then we have been building on the tools and approaches that we developed for the SCAP to further enhance our supervisory process in ways intended to reduce the likelihood and mitigate the potential impact of future financial crises.

Around the same time as the SCAP was being conducted, the Federal Reserve issued supervisory guidance to provide direction to firms on their declaration and payment of dividends and capital repurchases in the context of their capital planning processes. To a large extent, this guidance was the precursor to elements of the proposed regulation just recently published.
Although the 2009 supervisory guidance largely reiterated longstanding Federal Reserve policies, it also heightened the expectation that a firm will inform and consult with Federal Reserve supervisory staff sufficiently in advance of making capital distributions that would result in a net reduction of capital. That guidance also underscored the longstanding expectation that organizations should generally operate with capital positions well above the minimum regulatory capital ratios, with the amount of capital held by a banking organization corresponding to its unique firm-wide risk profile. Thus, an organization’s internal process for assessing capital adequacy should reflect a full understanding of all of the organization’s risks and should ensure that its capital is commensurate with those risks. The guidance also underscored the importance of the quality of a firm’s capital, with heightened focus on the importance of common equity. Finally, it stated that firms should guard against the risk that potential losses in adverse economic and financial conditions could result in losses that, while not fully depleting capital, could lead providers of funding and counterparties to financial transactions to pull away from the firm and thereby threaten its viability.

Enhancements to Regulatory Capital Requirements

Greater attention to capital distributions is also an element of “Basel III” – a comprehensive and far-reaching reform package for internationally active banking organizations issued by the Basel Committee on Banking Supervision in December. Its overarching goal is to increase the resiliency of the banking system by strengthening global capital and liquidity regulations. The Basel III framework seeks to address the lessons of the recent financial crisis by, among other things, increasing the level and quality of firms’ capital.

Basel III would increase the quantity and quality of the regulatory capital base in several ways. Importantly, it would establish a new minimum common equity tier 1 to risk-weighted
assets ratio of 4.5 percent. Also included is a capital conservation buffer (comprised of common equity tier 1) of 2.5 percent of risk-weighted assets that would sit on top of the minimum capital requirements. The purpose of this buffer is to enable firms to withstand losses during a downturn and still maintain capital levels above the minimum requirements. Organizations that fall below the capital conservation buffer would be subject to constraints on their capital distributions. And such distribution constraints would become more stringent as a firm’s capital ratios get closer to the minimum capital requirements. There are also enhancements in Basel III to the risk weights for certain types of exposures, again reflecting lessons from the crisis.

In addition, Basel III would introduce an international leverage ratio designed to contain the buildup of excessive on- and off-balance sheet leverage in the banking system, and to safeguard against attempts to game the risk-based capital requirements. Notably, adoption of an international leverage ratio should help to put U.S. banking organizations on a more level playing field with their foreign peers, since U.S. institutions have been subject to minimum leverage ratio requirements for nearly 30 years.

The Federal Reserve strongly supports such efforts to increase the level and quality of regulatory capital for our internationally active banking organizations, but fully understands that these organizations need sufficient time to implement the new requirements in full. Thus, Basel III includes transitional arrangements, phasing in the new requirements through January 1, 2019.

While not part of Basel III, another important international initiative regarding capital adequacy is the so-called “SIFI surcharge.” The idea is that certain systemically important financial institutions (SIFIs) should be subject to enhanced capital requirements in order to reduce the likelihood of their failure, since such a failure would impose additional costs on the financial system as a whole. This issue was discussed in a recent speech by Governor Tarullo, so
I will only touch on a few key points here. First, the size of such an enhanced requirement for a particular firm should be calibrated to the impact the firm’s failure would have on the financial system. Second, the requirement should be transparent to firms and the public so that firms have incentives to alter the activities that pose a systemic risk and market discipline can be brought to bear on those activities. Third, the additional requirement should be met with high-quality capital that can reliably absorb losses and allow the institution to remain a going concern. Finally, we want to ensure that such SIFI capital requirements are broadly consistent across countries, to maintain a level playing field and avoid creating adverse incentives.

Comprehensive Capital Analysis and Review

I will now turn to another important domestic supervisory initiative related to capital. Building on SCAP and other supervisory work coming out of the crisis, the Federal Reserve initiated the Comprehensive Capital Analysis and Review (CCAR) in late 2010. This was an evaluation of the internal capital planning processes of large, complex bank holding companies, including of their proposals for capital actions. The same 19 firms involved in SCAP were required to submit comprehensive capital plans and additional supervisory information. These submissions were evaluated across three main areas: capital assessment and planning processes, including capital distribution policies; ability to absorb losses under several scenarios; and plans for addressing the expected impact of Basel III and the Dodd-Frank Act.

The major innovation in the CCAR, compared to the SCAP, was to have firms submit formal capital plans describing their forward-looking strategies for managing capital over a two-year horizon, and for supervisors to conduct in-depth reviews of those plans. There were several key components to these capital plans, which are also included as requirements in the proposed capital plan rule. One was a description of the firm’s current regulatory capital base, including
key contractual terms of its capital instruments and any management plans to retire, refinance, or replace the instruments over the planning horizon. Another component was a description of all planned capital actions (including dividends, share repurchases, and issuance), as well as anticipated changes in the firm’s risk profile, business strategy, or corporate structure over the planning horizon.

So while the SCAP was an evaluation of potential stressed capital levels, the CCAR assessed the processes used by the firms to manage and assess their risks and capital adequacy on an ongoing and forward-looking basis, using stress test results as inputs. In this respect, the CCAR was a broader supervisory exercise. Notably, however, the CCAR did not involve supervisors conducting full-fledged supervisory stress tests; rather, we developed sensitivity analyses of the firms’ stress test results and in some key areas developed independent assessments to inform our evaluation of firms’ capital plans. As in the SCAP, we conducted our evaluations of individual firms’ capital plans and the analysis supporting them simultaneously, allowing the process to be informed by a horizontal perspective – which was particularly helpful in identifying outliers deserving additional attention.

Consistent with the overall supervisory goals of the CCAR, the Federal Reserve’s stress scenario analysis focused on assessing the sensitivity of the firms’ own projections of capital under the adverse scenario provided by the Federal Reserve, to alternate assumptions and estimates. As part of CCAR, the Federal Reserve further developed its ability to make independent supervisory estimates of firms’ potential future losses and revenues, even though – as I just noted – we did not conduct full supervisory stress tests. Use of such independent estimates will continue to be a central part of our supervision, including in our evaluation of any stress testing performed by firms as part of their capital plans or to meet any other regulatory
requirements, as well as in efforts to further develop our own independent supervisory stress tests.

**Proposed Requirements for Capital Plans**

So that brings us to the proposed rule for capital plans, released for comment last week. In the next few minutes I plan to outline some of the details of this proposal, which would create a formal requirement for carrying out CCAR-like exercises on an annual basis. I note that the proposal is out for public comment, meaning that we are soliciting feedback on the proposed rule and its impact. I am sure we will receive useful comments and can assure you that we will consider them carefully before issuing any final rule.

Put simply, the proposal would require certain large bank holding companies to submit capital plans to the Federal Reserve on an annual basis and would require such firms to provide prior notice to the Federal Reserve under certain circumstances before making capital distributions. The proposed rule generally would apply to every top-tier bank holding company in the United States that has $50 billion or more in total consolidated assets, about three dozen firms according to the most recent data. Under the proposal, nearly all of these firms would be required to submit a capital plan in January 2012.

So what specifically do we expect to see in a capital plan? In the proposal, a capital plan is defined as a written presentation of a firm's capital planning strategies and capital adequacy processes that includes three main elements: (1) an assessment of the expected uses and sources of capital over a two-year forward-looking planning period, assuming both expected and stressful conditions; (2) a detailed description of the firm's processes for assessing capital adequacy; and (3) the firm's analysis of the effectiveness of these processes.
Importantly, the discussion of sources and uses of capital would be required to include estimates of projected revenues, losses, reserves, and pro forma capital levels, under expected and adverse environments. The capital plans should include an assessment of a firm’s post-stress capital positions relative to several key capital ratios. These include existing regulatory capital requirements, and a pro forma tier 1 common ratio of five percent (based on current regulatory risk weights) until January 1, 2016, which is roughly when the Basel III common equity tier 1 ratio would be expected to become binding on firms subject to the proposal. Also relevant would be any other capital requirements that the firm concluded it needed to satisfy for it to remain a viable entity. The organizations covered by this rule would be required to make these projections using scenarios provided by the Federal Reserve and at least one stress scenario developed by the firm itself, appropriate to its business model and portfolios. The capital plan would also include a description of all planned capital actions over the period.

A firm’s board of directors or its designated committee would be required at least annually to review the effectiveness of the firm’s processes for assessing capital adequacy, ensure that any deficiencies in its processes for assessing capital adequacy are appropriately remediated, and approve its capital plan. After the capital plan is approved by the board of directors, the firm would be required to submit its complete capital plan to the Federal Reserve each January and the Federal Reserve would provide feedback to the firm about its capital plan by March 15.

In connection with its submission of a capital plan to the Federal Reserve, a firm would be required to provide certain data on its exposures, activities, and capital strategies. To the greatest extent possible, the data templates, and any other data requests, would be designed to minimize burden on the firm and to avoid duplication, particularly duplication with potential new
reporting requirements arising from the Dodd-Frank Act. Data required by the Federal Reserve would include, but not be limited to, information regarding the organization’s financial condition, structure, assets, risk exposures, policies and procedures, liquidity, and management.

So how do we plan to evaluate these capital plans? In general, we would evaluate the rigor and comprehensiveness of the analysis in the capital plan. This would start with leveraging off our safety and soundness evaluations of a firm’s risk-management practices that support the firm’s capital plan. If a firm cannot effectively identify and measure its risks, it cannot credibly estimate its uses and sources of capital over its planning period.

In addition, we would of course make an evaluation of each firm’s capital levels and composition given its capital plan submission, again building off existing supervisory work. This would include a supervisory assessment, informed by our own independent estimates of a firm’s potential losses and resources, of the firm’s ability to maintain capital above minimum regulatory requirements, as well its ability to maintain a tier 1 common ratio of five percent on a pro forma basis under stressful conditions throughout the planning horizon.

In the event that the Federal Reserve objected to a bank holding company’s capital plan, the bank holding company would be required to provide the Federal Reserve with prior notice of any capital distributions. Even if the Federal Reserve did not object to the bank holding company’s capital plan, the bank holding company still would be required to provide prior notice to the Federal Reserve before making capital distributions if, after the capital distribution, the bank holding company would not meet all minimum regulatory capital ratios and until January 1, 2016, a tier 1 common equity ratio of 5 percent. Prior notice would also be required if the Federal Reserve determined that earnings were materially underperforming projections or had other evidence that the capital distribution would result in a material adverse change to the
organization’s capital or liquidity structure. Finally, a firm would also have to give prior notice if the dollar amount of the capital distribution would exceed the amount described in the capital plan approved by the Federal Reserve or if the distribution would occur during the period that the Federal Reserve is reviewing the company’s capital plan.

The proposal also describes circumstances under which the Board may disapprove a proposed capital distribution, including the firm’s continued inability to resolve material supervisory issues or to remediate unreasonable assumptions or analytical weaknesses in its capital plan. The Board could also disapprove if a firm is unable to maintain capital above each minimum regulatory capital ratio, and until January 1, 2016, a pro forma tier 1 common ratio of 5 percent under adverse conditions. Finally, the Board could disapprove if the distribution would constitute an unsafe or unsound practice.

Before concluding, I would like to take a moment to discuss how the capital plan proposal relates to certain requirements for large organizations in the Dodd-Frank Act. Under section 165 of the Dodd-Frank Act, the Federal Reserve Board is required to impose enhanced prudential standards on bank holding companies with total consolidated assets of $50 billion or more, as well as non-bank SIFIs designated by the Financial Stability Oversight Council. Among others, these enhanced standards include requirements for stress testing, and higher standards for capital, liquidity, and risk management. The capital plan proposal would complement these requirements and in particular the stress testing standards. As the Board implements these requirements, it is expected that firms subject to the capital plan proposal would use their Dodd-Frank stress test results for purposes of meeting the stress testing requirements of the proposed capital planning rule. Thus, results of firms’ stress testing requirements in Dodd-Frank would be a helpful input to firms’ capital plans by helping them
understand the potential impact of adverse outcomes as they evaluate possible capital needs and resources over the next two years. In addition, an important aspect of Dodd-Frank is for supervisors to conduct their own, independent supervisory stress tests for the same set of companies submitting capital plans, which would allow us to better evaluate the firms’ own tests and how they fit into their capital plans.

The Dodd-Frank Act also requires the Federal Reserve Board to impose early remediation requirements, including limits on capital distributions, on large holding companies. We are required to issue final rules for Dodd-Frank early remediation by January 2012, and we will ensure these rules dovetail with other regulatory and supervisory efforts related to capital distributions. Under the early remediation requirements, a firm experiencing financial distress must take specific remedial actions in order to reduce the probability that it will become insolvent and to minimize the potential harm of such insolvency to the U.S. financial system. These early remediation requirements must impose limitations on capital distributions when a firm is in the initial stages of financial decline, and they must increase in stringency as the financial condition of the firm worsens. For institutions whose financial condition is deteriorating, early remediation requirements imposed under the Dodd-Frank Act may result in specific limits on a company’s capital distributions.

Conclusion

As I close, let me underscore the key themes of my remarks. First, the recent financial crisis highlighted the need to change how we supervise our largest firms, particularly with respect to capital and risk management. In response, we have been making enhancements to supervision of large firms, including several initiatives that have focused on increasing the overall level and quality of capital, as well as on improving firms’ internal processes for
assessing capital adequacy. The most recent milestone in this regard is a proposed rule on
capital plans and capital distributions that would codify much of the work we have done to date.
That proposed rule is intended to help prevent a repetition of the events of 2007 and 2008, when
capital distributions greatly diminished the banking system’s capacity to absorb losses – thereby
magnifying the adverse effects on the financial system and on the broader economy. We will
continue to seek to enhance the supervision of large organizations, mindful that the financial
crisis has demonstrated that when such firms encounter financial difficulties the impact on the
financial system and the economy can be severe.
June 15, 2011

The Honorable Timothy F. Geithner,
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The Honorable Ben S. Bernanke,
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The Honorable Sheila C. Bair,
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Mr. John G. Walsh,
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
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Re:  Application of Surcharges to Systemically Important Financial Institutions in the United States

Dear Sir or Madam:

The Clearing House Association L.L.C. ("TCH"), an association of major commercial banks, is deeply interested in U.S. and international initiatives to reform capital and liquidity regulation and, more broadly, in the overall debate over financial institution regulatory and resolution reform. In this regard, we are writing to express concern with respect to the direction and the potential application of a capital surcharge to systemically important financial institutions ("SIFIs") in the U.S., in the context of both the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and the ongoing international cooperative efforts under the auspices of the Financial Stability Board (the “FSB”) and the Basel Committee on Banking Supervision (the “Basel Committee”).

Public statements from the academic and official sectors have included consideration of the imposition of a significant capital surcharge on some U.S. banking institutions in an amount potentially as large as 100% of the combined Common Equity Tier 1 ("CET1") ratio (minimum plus macroprudential conservation buffer) required under the Basel Committee’s recently finalized global capital and liquidity standards commonly referred to as “Basel III.” Because banking institutions are likely to maintain some “cushion” above required regulatory ratios to offset unexpected developments (and to accommodate the volatility introduced by Basel III’s requirement that accumulated other comprehensive income (“AOCI”) not be filtered out of Tier 1 capital calculations), as a practical matter, banks will maintain CET1 ratios at levels that exceed the amount required to satisfy the required effective CET1 ratio plus any applicable surcharge for SIFIs.

To be clear, TCH strongly supports ongoing regulatory reform efforts that aim to make the U.S. and international financial systems safer and more robust—both from a firm-specific microprudential and, to the extent applicable in the context of a particular firm, a broader systemic
macroprudential risk perspective. As a key element of enhanced regulation, TCH supports strong capital and liquidity ratios and the U.S. bank regulatory agencies’ objectives of minimizing systemic risk and preventing future financial crises. We believe that the financial crisis demonstrated a direct correlation between the risk of failure and the level of a bank’s capital. That correlation, however, was most evident with banks that maintained capital levels far below the more strongly capitalized banks.

The imposition of any significant capital surcharge on U.S. SIFIs is premature in view of the substantial capital increases, and other regulatory enhancements, that in practice are being imposed on U.S. SIFIs earlier than on most non-U.S. SIFIs. We also believe that it would be imprudent to rely on academic models and theories, to the extent untested, to conclude that considerably higher capital requirements will not have significant adverse consequences on U.S. banks’ capacity to support a still fragile economic recovery.

We believe that a measured, transparent and deliberate course should be pursued in connection with determining the U.S. approach to a SIFI surcharge. A presumptive rush to judgment that “more is always better” when it comes to capital should be avoided given the uncertainties and complex questions regarding the analytical underpinnings and calibration, as well as the at best uncertain marginal benefits, of a SIFI capital surcharge when compared to the risks to U.S. economic growth and jobs and the international competitiveness of U.S. banking institutions.

I. Executive Summary

As further detailed in this letter, TCH believes:

- A decision to impose a capital surcharge on U.S. SIFIs must be informed by the robust increase in capital levels already mandated by Basel III (and Basel II.5). As a result of the imposition of Basel III’s quantitative, qualitative and risk-weighting requirements, the 7% minimum combined CET1 ratio under Basel III is nearly triple the amount of Tier 1 common equity currently required by the U.S. banking agencies for an institution to meet the “well-capitalized” requirements under their prompt corrective action regulations (that is, an implicit 4.5% Tier 1 common equity requirement under those regulations compared to a 13% Tier 1 common requirement, which approximately equates to a 7% CET1 ratio under Basel III).

- The significant macroprudential reforms introduced by the Dodd-Frank Act, including orderly-liquidation authority, living wills, regular stress tests, and the migration to centrally cleared swaps, provide U.S. regulators with strong tools to minimize systemic risk and must also inform the amount and composition of any SIFI surcharge.

- The marginal utility of significant capital surcharges for SIFIs is minimal at best because the Basel III requirements, including the capital conservation buffer, in and of themselves would very likely be effective in preventing both microprudential risks to financial institutions and macroprudential risks to the global economy.
• Capital stringency should be evaluated in the context of the entire framework of capital regulation, including Basel II, the market-risk rule revisions in Basel II.5 and possible differences in the application of parts of the Basel III standards to SIFIs and other large banks versus the banking industry as a whole.

• Empirical analysis demonstrates that the marginal macroprudential benefits, if any, of a significant surcharge may be minimal given the fact that financial institutions that had capital levels at or slightly below the new Basel III effective minimum did not require extraordinary individual government assistance in the recent crisis.

• A significant SIFI-capital surcharge could impose unnecessary economic costs on U.S. banking institutions and their customers, slowing the pace of the still fragile recovery and lowering job growth. We believe it would be unwise to rely on untested academic models and theories to reach definitive conclusions to the contrary.

• A gradually phased-in approach to implementing a significant SIFI surcharge for U.S. banking institutions will not necessarily ameliorate its negative consequences. Recent experience shows that both markets and U.S. regulators expect, as a practical matter, near immediate implementation of new capital requirements.

II. Key Issues

A. Any significant capital surcharge on U.S. SIFIs is premature in view of the substantial capital increases, and other regulatory enhancements, that in practice are being imposed on U.S. SIFIs earlier than on most non-U.S. SIFIs.

Basel III has imposed a sweeping new capital regime on U.S. SIFIs. The new requirements include:

• a new CET1 standard of 7% (the 4.5% minimum requirement plus the 2.5% capital conservation buffer);

• required total deductions or 250% risk-weighting (for items that are not otherwise fully deducted) for three categories of assets that represent a far greater proportion of the assets of U.S. SIFIs than other SIFIs: mortgage-servicing rights, deferred tax assets and investments in other financial institutions;

• a requirement to multiply the asset-value correlation, used in the risk-weight formula for wholesale credit, by 1.25 for all credit-sensitive transactions between certain large financial institutions; and

• various requirements that significantly increase the risk weights of derivative exposures not cleared with central counterparties.
In addition, shortly before Basel III was proposed, Basel II.5 substantially revised the capital treatment of assets held in the trading book, imposing several new, overlapping risk-measurement requirements and, in the process, significantly increasing the capital charge associated with the trading book.

The new Basel III requirements will translate into a CET1 requirement of approximately $1.0 to $1.1 trillion of common equity for U.S. banking institutions in the aggregate. This represents a greater than 100% increase from the approximately $450-$500 billion of common equity at December 31, 2007. Moreover, it is quite unlikely, due to prudential, regulatory and market pressures, that banking institutions will choose to operate at the effective minimum CET1 ratio required under Basel III. In addition, AOCI volatility serves to increase effective capital needs. Under current regulatory reporting practice in the United States, unrealized gains and losses are “filtered out” from the calculation of Tier 1 capital. Under Basel III, they would no longer be. Including unrealized gains and losses when calculating the minimum required ratios and buffers under Basel III can introduce substantial volatility into a banking institution’s capital ratios. Many of these securities may be classified as “available for sale,” and, as a consequence, increase the volatility of these institutions’ capital. As such, a more realistic estimate is that Basel III (before any SIFI surcharge) will actually require an aggregate of almost $1.2 trillion of common equity for the U.S. banking industry as a whole. In terms of ratios, the increase is even sharper. For example, the new 7% Basel III CET1 requirement, as indicated above, is equivalent to a Tier 1 common equity ratio of approximately 13% under the current Basel I rules.

Of particular importance, the Basel III requirements are—for all practical purposes—already fully effective for U.S. SIFIs, unlike at least most non-U.S. SIFIs. Notwithstanding the prolonged Basel III phase-in period, the November 17, 2010, supervisory-capital guidance addendum (the “Temporary Addendum”) issued by the Board of Governors of the Federal Reserve System (the “Federal Reserve”), which is formally applicable to the 19 bank holding companies that were subject to the Supervisory Capital Assessment Program (“SCAP”), effectively implements those requirements immediately. The Temporary Addendum essentially conditioned the approval of capital plans containing increased dividends on meeting Basel III CET1 ratio requirements on a fully phased-in basis. Pursuant to the Temporary Addendum, institutions that meet the minimum Basel III capital ratios as they become applicable during the transition period but remain below the Basel III 7% CET1 ratio target are “expected to maintain prudent earnings retention policies with a view toward meeting the [7% target] as soon as reasonably possible.” In addition, it is our understanding that the Federal Reserve has less formally, but no less decisively, conditioned expansion proposals on full and immediate compliance with Basel III.

B. The significant reforms introduced by the Dodd-Frank Act already provide the regulators with strong macroprudential tools to minimize systemic risk and must also inform the amount and composition of any SIFI surcharge.

The Dodd-Frank Act introduced a number of reforms specifically intended to implement the lessons learned from the financial crisis and to eliminate various perceived sources of macroprudential systemic risk, including prohibitions and restrictions on certain financial activities.
orderly-liquidation authority, living wills, regular stress tests, concentration limits on expansions, the migration to centrally cleared swaps, the ability to require the prudential supervision of systemically important non-bank financial entities, improvements to the securitization markets (including enhanced disclosures and risk retention requirements), reforms of the credit rating agencies and the establishment of the Financial Stability Oversight Council to coordinate detection and response to systemic risks. To date, most of these reforms have not been broadly adopted by other countries, and it remains uncertain whether they will in the future. The Dodd-Frank Act goes a long way to minimize systemic risks even in the absence of a SIFI capital surcharge. As such, we strongly believe that these other systemic reforms should be taken into account when examining the issue of a U.S. SIFI surcharge.

We agree that meaningful reform must address the “risk of disorderly failure of SIFIs”. The issue is not any failure of a SIFI per se, but a disorderly failure. Accordingly, a pillar of regulatory reform should be the development of a system and related measures that assure that any failure of a SIFI is orderly rather than disorderly. We believe that efforts to enhance resolution regimes such as the orderly-liquidation authority in Title II of the Dodd-Frank Act provide a comprehensive and considered structure to guard against disorderly failures and should be taken into account when examining the nature and extent of a SIFI surcharge.

The Dodd-Frank Act’s systemic risk provisions already have a negative competitive impact on U.S. banking institutions. This competitive disparity would be compounded if the U.S. adopted a SIFI surcharge in advance of an international consensus or in excess of such a consensus. Certainly, if the U.S. nevertheless determines to impose some form of a SIFI surcharge, this surcharge should not exceed international standards agreed upon by the FSB and Basel Committee in order to further the goal of decreasing systemic risks to the financial system because the Dodd-Frank Act’s other systemic provisions already otherwise serve to bolster macroprudential soundness.

In addition, TCH strongly believes that the mandate for “more stringent” capital standards under Section 165(b) of the Dodd-Frank Act does not require an additional capital charge for SIFIs beyond the increased requirements recently imposed through the Basel III process. Capital stringency should be evaluated in the context of a comparison of the entire framework of capital regulation applicable to SIFIs, including Basel II, the market-risk rule revisions in Basel II.5 and the application of the Basel III standards to SIFIs versus the remainder of the banking industry as a whole.

C. Empirical evidence demonstrates that banking institutions on a worldwide basis that had capital levels at or slightly below the new Basel III effective minimums did not suffer serious financial distress in the recent crisis.

In analyzing the performance of banks during the recent financial crisis, McKinsey examined data concerning 124 banks worldwide with more than $68 trillion in assets in the aggregate. The study determined that no institution that entered the 2007-2009 crisis with a CET1 ratio (calculated in accordance with Basel III rules) greater than approximately 6.25% (that is, 75 basis points lower than the Basel III minimum and 150 basis points lower than where firms are likely to operate) failed, was
placed into governmental receivership, was acquired under duress by another financial institution or received a substantial, individually-directed governmental capital investment.\textsuperscript{22}

This result is also consistent with a preliminary review of publicly available data to determine how the four largest U.S. banks would perform under stress conditions using SCAP stress scenarios. Such stress conditions resulted in a 120 basis-point reduction in CET1 ratios over an eight-quarter \textit{pro forma} time horizon. This reduction is well within the Basel III 2.5% conservation buffer.\textsuperscript{23}

The Basel III CET1 ratio requirement would appear to have been sufficient to prevent serious financial distress at banking institutions throughout the world even through the severe disruptions of the financial crisis. The marginal utility of additional significant capital surcharges for SIFIs, therefore, is likely to be minimal because the Basel III requirements, including the capital-conservation buffer in and of themselves would very likely be effective in preventing both micro-financial risks to financial institutions and macroprudential risks to the global economy. Indeed, the primary goal of the capital conservation buffer within Basel III is macroprudential, rather than microprudential in nature.\textsuperscript{24} The source of systemic risks proved to be institutions that were undercapitalized by the new Basel III standards or would have been wholly exempt from them. The inadequate capitalization of the weakest banking institutions during the recent crisis should not lead to the conclusion that the strongest banks now need more capital above and beyond Basel III in the form of a significant capital surcharge. Moreover, although it is true that all banks—including the strongest capitalized banks—faced liquidity pressures during the financial crisis, the formal Pillar 1 Liquidity Coverage Ratio and Net Stable Funding Ratio elements of Basel III are specifically designed to address such concerns.\textsuperscript{25}

\textbf{D. A significant capital surcharge imposes unnecessary risks of limiting SIFI lending, potentially slowing the pace of the recovery and lowering job growth.}

\textbf{1. A significant SIFI surcharge creates a meaningful risk of economic cost.}

Material SIFI surcharges are not a cost-free proposition. Imposing materially higher capital requirements on banking institutions is likely to lead to decreased availability of credit as firms are encouraged to shrink their balance sheets (that is, by decreasing the denominator of the CET1 ratio calculation) in order to deal with the effects of such increases.\textsuperscript{26} In addition, as higher capital requirements (that is, in the numerator of the CET1-ratio calculation) cause banking institutions’ return on equity (“ROE”) to decrease, such firms acting rationally will need to attempt to improve such results by increasing the price of credit to generate greater returns. As even some proponents of higher capital requirements acknowledge,\textsuperscript{27} these bank actions could potentially have material negative effects on the economy, slow the pace of the recovery and lower job growth at a particularly difficult juncture for our country.

Although these potential negative economic effects are present in connection with increased bank-capital requirements in general, and are not unique to the imposition of a significant capital surcharge, they are most likely to occur in connection with “marginal” capital requirements (that
is, those above both economic-capital requirements and the requirements imposed by competition), such as large surcharges. The key question from a policy perspective should be whether the potential benefits associated with a significant SIFI-capital surcharge outweigh the potential disadvantages. Given the uncertain utility of such a surcharge in light of the robust nature of the Basel III capital framework and other regulatory requirements as described above, we believe that the macroprudential benefits, to the extent applicable in the context of a particular firm, of a significant SIFI-capital surcharge are not likely to outweigh the very real risks such a surcharge would pose to the U.S. economy. At minimum, the introduction of such a surcharge is premature at this time.

2. **The hypothetical mitigating factors of the costs of a significant capital surcharge are uncertain at best and pose their own macroprudential systemic risks in practice.**

First, in contrast to what some proponents of a significant SIFI surcharge have posited, there is substantial uncertainty as to whether smaller banking institutions would be able to fulfill the credit needs that SIFIs no longer can due to higher capital requirements as described above. Furthermore, many of these smaller institutions in the U.S. continue to struggle with their own asset quality problems and need to raise additional capital. The availability of these activities as a service to customers (whether a credit product or another service) will thus diminish or shift to “shadow” entities outside not just regulatory capital requirements, including the SIFI surcharge, but are outside the broad framework of prudential regulation entirely.

Even if the shadow banking system could conceivably fill any unmet credit needs, in view of the shadow banking system’s role in lowering credit standards during the last decade and the absence of regulation and transparency, a migration to that system, even if it occurred, would have negative implications for the macroprudential health of the financial system as a whole. In addition, the shadow banking system can exhibit volatile and intermittent flows compared with the traditional banking system’s credit intermediation function, and this lack of reliability as a source of funding would subject borrowers to marketplace vagaries, often at the time of greatest need. Contrary to the objective of a SIFI surcharge, neither of these outcomes is likely to decrease systemic risk, and each may in fact contribute to it.

Second, proponents of significant SIFI surcharges have also argued that, as a result of higher capital requirements, investors will accept lower rates of return and thus offset the decreased ROE that will likely result from having to hold additional capital. We believe that the theory of lower leverage leading investors to require lower ROE from banking institutions is unlikely to hold true in practice. For equity investors to be willing to accept lower returns for holding a banking institution’s equity, they would need to conclude that, as a result of holding more capital, the firm’s level of risk had lessened by an offsetting amount that warrants lower returns. Such a conclusion appears unlikely to be true. Moreover, in the experience of our members, equity investors, whether in banking institutions or other types of entities that compete for investable funds, are not low ROE investors. If these investors wanted to lower the expected return of their investment portfolios in exchange for a reduced risk of
loss, there are a variety of bond and other fixed-income products that would allow them easily to accomplish this result more effectively.

We believe that any decreases in ROE (on a percentage basis) are likely to far exceed any offsetting benefits in the form of lower cost of equity (“COE”). In analyzing this issue, McKinsey estimates that, under the increased capital requirements of Basel III (even before any SIFI surcharge), ROE is expected to fall by approximately 250-300 basis points, with each additional percentage-point increase from the proposed SIFI surcharge reducing ROE by an additional 50 basis points.\textsuperscript{32} Even when assuming that lower leverage does in fact lead to decreased COE, the resulting hypothetical decrease resulting from Basel III would likely only be approximately 80 basis points, with each additional percentage-point increase in capital from a significant SIFI surcharge decreasing COE by only an additional approximately 20 basis points. As such, the expected hypothetical decrease in COE would be significantly less than the very real expected ROE drop resulting from a significant SIFI surcharge.

Regardless of whether the premise regarding some relationship between lower leverage and COE proves correct, the imposition of a significant SIFI capital surcharge can be expected to further decrease ROE substantially. Such an additional decrease in ROE will pose heightened challenges for attracting capital to U.S. banking institutions as they seek to meet the crucial financial intermediation needs of our economy.\textsuperscript{33}

E. A gradually phased in approach to implementing a significant SIFI surcharge will not, as a practical matter, ameliorate its potential negative consequences due to regulatory pressure and market expectations.

The proponents of a significant SIFI-capital surcharge have maintained that the effect would be ameliorated by a phased in transition period. This transition period is apparently meant to deal with acknowledged concerns regarding COE issues and the perceived difficulty that banking institutions subject to the surcharge may experience in trying to raise the additional needed CET1 in the short term. Recent experience with regulatory implementation and market expectations with the increased Basel III capital requirements, however, demonstrates that such a transition period is likely to be illusory.

Although the Basel III capital requirements are subject to a prolonged phase-in provision (from January 1, 2013 to January 1, 2019) and the U.S. banking agencies are just now in the process of drafting their proposed regulations implementing Basel III, for all practical purposes Basel III is already fully effective for U.S. SIFIs as a result of the Temporary Addendum as discussed above. The Federal Reserve stated in the Temporary Addendum that it expects banking institutions to “demonstrate with great assurance that they could achieve the ratios required by the Basel III framework, inclusive of any proposed dividend increases or other capital distributions, as those ratios come into effect in the United States.” It is obviously very difficult for a bank to be in the position of not increasing its dividends or engaging in expansion transactions for a number of years. In addition, even in the absence of such regulatory incentives, investor and market expectations have tended to internalize higher Basel III-based
capital expectations immediately in evaluating firms irrespective of formal transition periods. We see no reason to conclude that the same would not occur in connection with a significant SIFI surcharge.

F. **There are significant uncertainties and open questions regarding the analytical underpinnings and proper calibration of any SIFI surcharge.**

As even most proponents of a SIFI surcharge readily acknowledge, there are significant uncertainties and open questions regarding the analytical underpinnings and proper calculation of any SIFI surcharge. For example, the three analytical lines of inquiry the Federal Reserve appears to be pursuing in connection with the creation of a SIFI surcharge seem to produce a wide range of results depending on which assumptions are selected. 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. 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. In addition, societal benefits of large financial institutions have not been analyzed thoroughly. Finally, and perhaps most significantly, the full potential combined impact of the current financial-services regulatory reforms in the U.S., including the Dodd-Frank Act, Basel III and the contemplated significant SIFI surcharge, has not yet been fully analyzed, as public sector officials have acknowledged. The cumulative effects of these complex rules, with their web of potentially unknown interrelationships, could very well have economic costs and other unintended consequences and risks that are not readily apparent.

In addition, many of the analytical underpinnings of and academic theories concerning the contemplated significant SIFI surcharge are open to reasonable interpretation and debate. Such assertions and arguments include:

- **There is little evidence that the size, complexity, and scope of SIFIs are necessary to realize economies of scale and scope.**

There is considerable evidence that there are meaningful scale and scope advantages to large banking institutions. A generation of banking mergers suggests that there are substantial cost synergies available to larger institutions. Moreover, there is a strong *a priori* case for expecting such cost synergies, given the high and increasing fixed costs to which financial institutions are subject.

Indeed, this may not even be the most relevant question. Even if banks themselves do not benefit from increased size and scope, it would appear that a number of their customers do benefit. We are not aware of any definitive research that challenges the existence of such benefits.

- **There would be significant negative externalities in the event of a disorderly failure of any SIFI, distinct from the costs incurred by the SIFI and its stakeholders.**

An asserted rationale for imposing a SIFI-capital surcharge is based on the cost of a SIFI failure to other institutions, the underlying premise that firms do not have an incentive to, and have not,
already addressed such externalities, and the belief that these costs should therefore be addressed through extraordinarily stringent macroprudential regulation. The assumed costs of a SIFI failure include direct losses on counterparty exposures and assumed losses on assets that are subject to fire-sale prices as firms sell assets into a declining market. Proponents of a significant SIFI surcharge reason that, by increasing capital, the surcharge will make SIFIs less prone to failure and thereby reduce the likelihood that these costs will occur. As discussed above, there is little evidence to suggest that a significant SIFI surcharge, as compared with the current Basel III enhanced capital requirements, including the explicitly macroprudential capital conservation buffer, will have more than marginal utility in decreasing such macroprudential risk by preventing SIFI failures. Capital alone is not the solution.

Moreover, the assertion above concerning the negative externalities of a SIFI failure does not answer several important questions, such as whether a more measured and effective solution would be to ensure proper counterparty-risk-management practices instead of using the blunt instrument of a significant SIFI-capital surcharge. Another question relates to the true magnitude of a “fallen domino” risk due to counterparty exposure. Even a 15% loss on such exposures would not reduce the counterparties capital by 5%, unless the counterparties exposure exceeded 33 1/3% of its capital. Although crucial to understanding whether a SIFI surcharge is warranted and, if so, how it should be calibrated, these and other pertinent questions have apparently not yet been fully examined and debated.

In addition, the systemic impact of an institution’s failure will vary based upon a number of factors, including notably the interconnectedness of the institution with the rest of the financial system. Any SIFI surcharge must be properly calibrated to account for the differences in true systemic risk posed by different institutions.

We believe a measured, transparent and deliberate course should be pursued in connection with determining the U.S. approach to a SIFI surcharge. TCH welcomes an open and spirited discussion and debate concerning the various issues surrounding a SIFI surcharge—a debate in which all affected parties have an opportunity to make their views heard—before decisions are made. A presumptive rush to judgment that “more is always better” when it comes to capital should be avoided, given the uncertainties and complex questions regarding the analytical underpinnings and calibration, as well as the questionable marginal benefits, of further increases in capital levels when compared to the potential risks and economic costs.

Even accepting, as a theoretical and very simplistic matter, that more capital will reduce the risk of failure and the losses of creditors if failure occurs, that cannot be the ultimate analysis. The appropriate analysis, which is far more complex, incorporates two basic questions which require the most thoughtful consideration: to what extent are the risk of failure and losses reduced by marginal capital requirements; and how does any such value relate to the risk of an adverse impact on banks’ ability to issue capital and their competitive position, the impact on borrowers in terms of credit availability and cost, and the effect on the broader economy. Significant surcharges should not be imposed until those questions are satisfactorily answered.
If you have any questions, or need further information, please contact Paul Saltzman, President and General Counsel of TCH, at (212) 613-0318 (e-mail: paul.saltzman@theclearinghouse.org), Joseph Alexander, Senior Vice President and Deputy General Counsel of TCH, at (212) 612-9234 (e-mail: joe.alexander@theclearinghouse.org) or Eli Peterson, Vice President and Regulatory Counsel of TCH, at (202) 649-4602 (email: eli.peterson@theclearinghouse.org).

Respectfully submitted,

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The Clearing House Association and Payments Company

Paul Saltzman
President of The Clearing House Association
EVP and General Counsel of The Clearing House Payments Company

cc: The Honorable Tim Johnson
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Senate Committee on Banking, Housing & Urban Affairs

The Honorable Richard Shelby
Ranking Member
Senate Committee on Banking, Housing & Urban Affairs

The Honorable Spencer Bachus
Chairman
House Committee on Financial Services
The Honorable Barney Frank
Ranking Member
*House Committee on Financial Services*

The Honorable Janet L. Yellen
Vice Chairman
*Board of Governors of the Federal Reserve System*

The Honorable Elizabeth A. Duke
Governor
*Board of Governors of the Federal Reserve System*

The Honorable Sarah Bloom Raskin
Governor
*Board of Governors of the Federal Reserve System*

The Honorable Daniel K. Tarullo
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The Honorable Neal Wolin
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ENDNOTES

1 Established in 1853, The Clearing House is the United States’ oldest banking association and payments company. It is owned by the world’s largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. TCH is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs, and white papers the interests of its member banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. See TCH’s web page at www.theclearinghouse.org.

2 TCH has striven to inform its views with independent and empirically based quantitative analysis. To this end, we retained McKinsey & Company, Inc. (“McKinsey”) to assist TCH in its analysis of the impact of Basel III and the SIFI surcharge on U.S. banking institutions. McKinsey had access to the quantitative-impact studies and other confidential data provided by 11 large financial institutions, accounting for 59% of U.S. banking assets at June 30, 2010. Those sample data and other sources were used to extrapolate certain estimates for the U.S. banking industry at large and in other aspects of the quantitative analyses set forth herein, as applicable. In addition, TCH and McKinsey are in the process of conducting other empirically-based analyses on: (i) how bank-capital levels would be affected by more adverse economic environments, considering current bank portfolios and the Basel III capital requirements; (ii) how bank-capital levels would have been affected during the last crisis had Basel III been in place before the beginning of the crisis; and (iii) what economic and social benefits are attributable to larger financial institutions and what particular economies of scale and economies of scope larger banks provide. The analyses in clauses (i) through (iii) above will leverage proprietary bank information—both historical and forward-looking—collected from TCH member banks to provide analysis that is unavailable outside the banks themselves.

3 For purposes of this letter, we use the term SIFI generically to refer to both “systemically important financial institutions” and the so-called “global systemically important financial institutions,” or “G-SIFIs.” Section 165(b) of the Dodd-Frank Act generally applies to banking institutions having more than $50 billion in total consolidated assets. It bears noting that the degree of systemic importance and the potential costs of failure can vary greatly among banking institutions with more than $50 billion in total consolidated assets. The FSB and the Basel Committee have not yet released their final criteria with respect to what constitutes a SIFI or a G-SIFI.

4 As noted above in endnote 3, Section 165(b) of the Dodd-Frank Act generally applies to banking institutions having more than $50 billion in total consolidated assets; however, it appears that the largest surcharge may be contemplated only for some yet-to-be-determined subset of the largest U.S. financial institutions.

The U.S. banking agencies’ existing regulations require that common equity be the “predominant” component of Tier 1 capital. Their prompt corrective action regulations require that an institution have at least a 6% Tier 1 capital ratio in order to be “well-capitalized,” which under the predominance test translates into approximately a 4.5% Tier 1 common ratio.


U.S. financial institutions with more than $250 billion in total consolidated assets, in the aggregate, account for approximately 85% of the aggregate CET1 required under Basel III.

Under U.S. GAAP, certain unrealized gains and losses on securities in the investment portfolio that are classified as “available for sale” are recorded directly to equity, as opposed to being treated as income or expense items for income statement purposes. AOCI volatility may be exacerbated by the need for these banking institutions to acquire additional investment securities in order to comply with Basel III’s liquidity ratio requirements.


See Sections 619 and 716 of the Dodd Frank Act.

See Section 165(d) of the Dodd-Frank Act. The Dodd-Frank mandate for resolutions plans, as proposed, would be a far-reaching strategic exercise for SIFIs.

See Section 165(i) of the Dodd-Frank Act; Capital Plans, Docket No. R-1425 (proposed June 10, 2011), [http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110610a1.pdf](http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110610a1.pdf) (proposing amendments to 12 CFR part 225 to require large bank holding companies to submit capital plans on an annual basis and to require such bank holding companies to provide prior notice under certain circumstances before making a capital distribution).

See Title VI of the Dodd-Frank Act.

See Title VII of the Dodd-Frank Act.

See Section 113 of the Dodd-Frank Act.

See Subtitle D of Title IX of the Dodd-Frank Act.

See Subtitle C of Title IX of the Dodd-Frank Act.

See Subtitle A of Title I of the Dodd-Frank Act.

See pages A-7 through A-11 of Annex A for further information regarding, and a description of the methodologies employed in, this study. For purposes of McKinsey’s study, a “substantial direct governmental capital investment” is defined as a total government capital investment greater than 30% of the banking institution’s Tier 1 capital as of December 31, 2007. Such 30% threshold generally filters out institutions that accepted TARP funds as mandated during the U.S. government’s response to the financial crisis.

See page A-12 of Annex A for additional information concerning this preliminary assessment.


TCH has also undertaken significant analysis on the calibration of the liquidity coverage ratio (the “LCR”) and the net stable funding ratio (the “NSFR”), and our work has shown that the calibration of the ratios is more conservative than the experience of our member institutions (including failed legacy institutions) during the crisis. TCH shared its perspectives with the Financial Stability Oversight Council in an unsolicited comment letter dated November 5, 2010. We are continuing work on the LCR and NSFR, focusing on the impact of the ratios as currently calibrated on the cost and availability of credit to end users, and look forward to sharing our findings with supervisors and policymakers.

The banks in the sample reported that they will meet the capital requirements under Basel III by, among other things, reducing risk-weighted assets by approximately $821 billion through a variety of actions, including by winding down existing portfolios, decreasing low rated securitizations in the trading book and decreasing certain businesses (for instance, correlation trading). See page A-6 of Annex A for further information.

See generally Macroeconomic Assessment Group, Bank for International Settlements, Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements, at 2 (Dec. 2010) (discussing the potential decline in GDP and the transactional costs of heightened capital requirements) (“The BIS Macroeconomic Impact Assessment”); Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig and Paul Pfeifer, Failacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive, at 1, 2 (Mar. 2011), https://gsbapps.stanford.edu/researchpapers/library/RP2065R1&86.pdf (stating, “It is more expensive for banks to fund assets with capital than with deposits or wholesale debt. This suggests that, while banks facing stronger capital requirements will seek to increase capital levels by retaining earnings and issuing equity as well as reducing non-loan assets, they may initially increase the interest rates they charge borrowers and reduce the quantity of new lending. Any increase in the cost and decline in the supply of bank loans could have a transitory impact on growth, especially in sectors that rely heavily on bank credit.”) (“Myths in the Discussion of Capital Regulation”).


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”).

See pages A-13 through A-15 of Annex A for further details concerning this analysis.

Specifically, for example, payment system reforms are likely to decrease banking industry ROE more generally. Based on an analysis of publicly available financial data by Novantas, a private consulting firm, on behalf of TCH, such reforms embodied in the CARD Act, overdraft charge changes in Regulations E and DD of the Board of Governors of the Federal Reserve System (the “Board”), and applicable Federal Deposit Insurance Corporation guidelines, as well as Regulation II of the Board (debit interchange regulations), if fully implemented in 2009, would have reduced 2009 bank industry revenue by more than $35 billion. This translates to an after-tax reduction of bank industry ROE by approximately 1.5%. This estimate does not reflect any other regulatory impacts of the Dodd-Frank Act or other changes affecting payments or other parts of the banking industry.

Cf. The BIS Macroeconomic Impact Assessment, supra endnote 27, at 38 (noting that some private sector analysts have predicted that “once supervisors announce the parameters for capital requirements, markets are likely to press banks to achieve these ratios rapidly regardless of the official implementation date”). In addition, TCH would caution against basing a SIFI surcharge on risk-weighted assets given jurisdictional differences in the calculation of risk-weighted assets and the risk that U.S. banking institutions would be disadvantaged by these differences.


To remedy this knowledge gap, TCH has retained McKinsey, as discussed in additional detail in endnote 2, to study what economic and social benefits are attributable to larger financial institutions, among other things.

See 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.”).

As discussed in additional detail in endnote 2, TCH has retained McKinsey to study the economic and social benefits attributable to larger financial institutions.
Another benefit of SIFIs is their capacity to acquire larger troubled institutions and thereby prevent the otherwise self-fulfilling prophecy of proponents of large surcharges.

See, e.g., Financial Stability Board, Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: Interim Report to G20 Leaders, at 6 (June 2010), http://www.financialstabilityboard.org/publications/r_100627b.pdf (noting that an “important reason for public intervention to avoid the failure of a financial institution is its interconnectedness with market participants”).
Contents

- Impact of Basel III capital requirements
- Assessing capital needs from crisis experience
- Impact on returns and cost of equity
This report is based on results from the 11 US based participating banks, which account for 59% of total US banking assets.

<table>
<thead>
<tr>
<th>Banks for whom we have capital &amp; liquidity data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
</tr>
<tr>
<td>Goldman Sachs</td>
</tr>
<tr>
<td>Capital One Bank</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
</tr>
<tr>
<td>US Bank</td>
</tr>
<tr>
<td>BB&amp;T</td>
</tr>
<tr>
<td>Citi</td>
</tr>
<tr>
<td>PNC Bank</td>
</tr>
<tr>
<td>Comerica Bank</td>
</tr>
<tr>
<td>Wells Fargo</td>
</tr>
<tr>
<td>BNY Mellon</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total assets</th>
<th>9,363</th>
<th>59%</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD billions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(% of US market)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Relative to pre-crisis levels, Basel III requires US banks in aggregate to hold over 100% more common equity relative to pre-crisis levels of capital.

<table>
<thead>
<tr>
<th>Basel III CET1</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ billion</td>
</tr>
</tbody>
</table>

- **Actual 4Q2007**: 450-500
- **Actual 2Q2010**: 600-700
- **Required with Basel III fully phased in**: 1000-1100

SIFIs account for 80-90% of CET1 required under Basel III.

| % of Basel I RWA | 5-6% | 7-8% | 12-13% |

**Source**: TCH QIS6 member data, SNL
How we estimate that Basel III is equivalent to 12-13% capital under Basel I

Tier 1 common equity and RWA under Basel I and Basel III

<table>
<thead>
<tr>
<th>Industry RWA</th>
<th>Industry Tier 1 common capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ billions, as of 6/30/2010</td>
<td></td>
</tr>
<tr>
<td>~9,900</td>
<td>~14,000</td>
</tr>
</tbody>
</table>

Basel III RWA (including changes under Basel II and Basel II.5) is an increase of approximately 40% over Basel I RWA, as of 2Q 2010.

Required T1C Deductions from Basel I T1C under Basel III definitions

1,000-1,100 150-200 1,150-1,300

Resulting T1C under Basel III definitions

Capital ratio calculations:

Basel III CET1 (adjusted) as % of Basel I RWA

= Basel III T1C with deductions / Basel I RWA

= 1,150/9,900

= 12%

= 1,300/9,900

= 13%

SOURCE: TCH QIS6 member data; SNL
For US banks, each additional percentage point of capital requirement increases required T1C by ~$80 billion

**Capital shortfall estimates for US banking industry, $ billions**

<table>
<thead>
<tr>
<th>Category</th>
<th>7% Tier 1 Common</th>
<th>Additional shortfall with each 100bp increase in capital requirement</th>
<th>8% Tier 1 Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-SIFI</td>
<td>400-450</td>
<td>80</td>
<td>480-530</td>
</tr>
<tr>
<td></td>
<td>50</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>65</td>
<td></td>
</tr>
<tr>
<td>SIFI</td>
<td>350-400</td>
<td></td>
<td>415-465</td>
</tr>
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<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

**SOURCE:** TCH Q1S6 member data, SNL
Banks indicate that they are likely to reduce their Tier 1 Common shortfall in part through asset sales and RWA reductions

- Banks indicate that they may reduce their Tier 1 common shortfall to Basel III requirements, in part by reducing RWA ($821 billion in RWA; $66 billion in capital at 8% Tier 1 Common ratio) and increasing Tier 1 Common through asset sales ($26 billion)

- Banks may reduce RWA and assets using measures such as:
  - Winding down existing portfolios, as many banks have publically announced
  - Decreases in low rated securitization in the trading book (and rating “unrated” securities)
  - Decrease in certain businesses, including correlation trading, sub-prime retail (e.g., credit cards)

- Increases in Tier 1 Common may include:
  - Sales of unconsolidated financial subsidiaries
  - DTA realization of net operating losses
  - Sales of MSRs above the 10%/15% cap

1 Bloomberg estimated net income for banks with capital shortfalls from Q2 2010-2012
Contents

- Impact of Basel III capital requirements
- Assessing capital needs from crisis experience
- Impact on returns and cost of equity
Methodology for analyzing the relationship between pre-crisis bank capital ratios and the likelihood of a bank going into distress

**Approach**
- Analyzed the relationship between capital ratios of large global banks, at the onset of the financial crisis (defined as December 2007), and subsequent Bank distress during the crisis
  - Initial capital ratios as defined in both Basel III and Basel I terms used to study relationship to Bank distress

**Banks in sample**
- 124 large global banks with minimum asset size of $30 billion
  - Represent $68.2 trillion in total assets
  - About 85% of developed-market banking and 65% of total banking assets worldwide
  - Broker-dealers excluded as risk-weighted assets data unavailable in December 2007.

**Definition of distress**
- An institution is defined as distressed if any of the following conditions was met 2007-09:
  1. Bankruptcy
  2. Government takeover or placement into government conservatorship
  3. Merger under duress with another bank
  4. Receipt of a substantial direct government capital investment or bailout

- Using the above definition, a total of 28 banks were deemed distressed (23% of banks in the sample, covering 30% of the assets)

**Adjustments for Basel III**
- Adjustments developed to convert December 2007 capital and RWA for each bank into estimates of what Basel III capital ratios would have been, had Basel III rules existed at the time
  - Adjustment factors estimated for different type of banks (e.g., by country, by mix of business such as wholesale vs. retail, trading assets)

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1 Defined as total government capital investment greater than 30% of the bank’s starting Tier 1 capital as of December 31, 2007
The sample includes 124 banks worldwide, with more than $68 trillion in assets.
Measured under Basel III definitions, no bank with a Basel III common equity to RWA over 6.25% experienced distress

**Likelihood of Distress vs. Starting Capital Ratio, Percent**

<table>
<thead>
<tr>
<th>Banks entering distress vs. starting CET1/RWA (percent)</th>
</tr>
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<tbody>
<tr>
<td>&lt;4.5</td>
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<tr>
<td>4.5-5.25</td>
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<tr>
<td>5.25-6.25</td>
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<tr>
<td>&gt;6.25</td>
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</tbody>
</table>

Estimated pre-crisis ratio of Basel III CET1 to Basel III RWA

Bins chosen to have approximately equal number of banks per bin
SOURCE: Company 10Ks, regulatory filings, team analysis
Questions to be answered through additional work

Questions

1. Even if some banks didn’t fail, how much capital was depleted and how close were they to distress?

2. For failed banks, how much more capital did they need?

3. Even if capital ratios didn’t fall much during the crisis, what about future stresses?

Additional work to do

1. Analyze capital ratios over time for surviving firms, measure how much they fell, and how does this compare to the Basel III minimums today including the capital conservation and countercyclical buffers.

2. Analyze capital ratios and estimated losses over time for distressed/failed firms during the 2007-09 period, and how does this compare to the Basel III minimums today including the capital conservation and countercyclical buffers.

3. Analyze performance of current portfolio and how much capital ratios would fall given hypothetical stress events, and how this compares to Basel III minimums including the capital conservation and countercyclical buffers.
Initial stress test analysis: based on publicly available US S-CAP results, the top 4 US banks see estimated reductions of at most 1.2% of CET1

1 Assumes that each of the 4 banks start at the 7% Basel III minimum (including conservation buffer) fully phased-in as of 4Q 2010

Contents

- Impact of Basel III capital requirements
- Assessing capital needs from crisis experience
  - Impact on returns and cost of equity
The capital and liquidity proposals could reduce RoE by 300-390 bps, depending on implementation of the NSFR

**ROE impact of Basel III capital and liquidity proposals**

<table>
<thead>
<tr>
<th>Percentage points</th>
<th>12.1</th>
<th>0.2</th>
<th>0.9</th>
<th>1.5</th>
<th>0.1</th>
<th>0.4</th>
<th>9.1</th>
<th>0.8</th>
<th>8.2</th>
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<tbody>
<tr>
<td>Historical US Average ROE¹</td>
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<tr>
<td>Other Tier 1</td>
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<td>Capital deductions</td>
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<td>RWA increases</td>
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<tr>
<td>Increase in capital ratio</td>
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<td>Leverage ratio</td>
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<tr>
<td>LCR</td>
<td>0.4</td>
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<tr>
<td>ROE after capital and LCR proposals</td>
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<tr>
<td>NSFR (when implemented)</td>
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<tr>
<td>ROE after Basel III</td>
<td>8.2</td>
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</table>

- **Key question as to where the incidence of regulatory changes will fall**, i.e.,
  - **On customers**, through higher loan pricing
  - **On banks**, through cost reduction (e.g., compensation, consolidation among small banks)
  - **On shareholders**

- Analysis does not consider likely business model changes

- Even in an environment where banks are better capitalized and more liquid, the reduction in return on equity will likely be greater than the reduction in cost of equity

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1 Using consensus 2012 analyst forecasts does not materially change the results

**SOURCE**: BIS; Bloomberg
The declining ROE may be minimally mitigated by a lower COE (~80 bps) due to lower beta for the industry

<table>
<thead>
<tr>
<th>Effect of Basel III on the cost of equity (COE)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Theoretical foundation</strong></td>
</tr>
<tr>
<td>• Modigliani-Miller’s principle of conservation of risk suggests that an increase in capital should reduce systematic risk (i.e., beta)</td>
</tr>
<tr>
<td><strong>Empirical estimation</strong></td>
</tr>
<tr>
<td>• Kashyap et al (2010) empirically estimate the effect of additional capital on beta by regressing beta on the ratio of equity to assets with a 1976-2008 panel dataset</td>
</tr>
<tr>
<td>• They find that a one percentage point increase of the equity ratio reduces beta by 0.045</td>
</tr>
<tr>
<td><strong>Specific Basel III implications</strong></td>
</tr>
<tr>
<td>• We estimate that banks will increase their Tier 1 Common ratio by 3.5 percentage points (of total assets) in response to Basel III</td>
</tr>
<tr>
<td>• Using the empirical estimates from above, this implies a 16bps decline in beta or a 80bps decline in the COE (at a market risk premium of 5%)¹</td>
</tr>
</tbody>
</table>

¹ The Kashyap et al (2010) study considers the effect of the equity to assets ratio on beta. We are interested in the effect of changing the Basel III-defined Tier 1 Common ratio on beta. However, it is not possible to estimate this relationship historically - the data that would be required to calculate this Basel III Tier 1 Common ratio is not available. We thus use the Kashyap et al. estimate as the best available proxy.

**SOURCE:** internal estimates; Kashyap, Stein and Hanson (2010) “An Analysis of the Impact of “Substantially Heightened” Capital Requirements on Large Financial Institutions*