January 16, 2024

Ann Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15); Docket No. R–1814 and RIN 7100–AG65; 88 Fed. Reg. 60385 (Sept. 1, 2023)

Dear Ms. Misback:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Notice of Proposed Rulemaking ("Proposal") issued by the Board of Governors of the Federal Reserve System ("Fed" or "the Agency").[2]

The Proposal would make changes to the current framework for calculating risk-based capital surcharges for global systemically important bank holding companies ("GSIBs"), which was originally finalized in 2015.[3] These changes include: data averaging for certain systemic risk indicators, calculation adjustments to increase the sensitivity of results and reduce cliff effects, and reductions in the lag between calculations of the surcharge amounts and their implementation.

While largely technical in nature, the proposed changes are consequential and important. Regulators and academics have observed GSIB behavior and market impacts since the implementation of the 2015 rule and conducted extensive analysis and research on the topic. The results of this work have, appropriately, informed this Proposal. For example, Fed research has shown that some domestic GSIBs appear to have indeed engaged in window dressing to reduce measures of systemic risk at year-end relative to other times during the year, which leads to an

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies – including many in finance – to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2] Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15); Docket No. R–1814; RIN 7100–AG65; 88 FED. REG. 60385 (Sept. 1, 2023), https://www.federalregister.gov/documents/2023/09/01/2023-16896/regulatory-capital-rule-risk-based-capital-surcharges-for-global-systemically-important-bank-holding.

[3] Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; RIN 7100; AE–26; 80 FED. REG. 49082 (Aug. 14, 2015), https://www.govinfo.gov/content/pkg/FR-2015-08-14/pdf/2015-18702.pdf.

inappropriate reduction in the surcharge calculation.[4] This Proposal is critically necessary to address and correct these loopholes and as a result, improve measures of GSIBs systemic risk and strengthen capital levels at the largest banks.

While we strongly support the Proposal and urge the Fed to implement it as soon as possible, we believe that it does not go far enough to account for the risk that GSIBs present. Therefore, we also recommend that GSIB capital surcharges be increased to protect the financial system, economy, and American public from risk at these largest, most complex, and systemically important banks.

BACKGROUND

The 2008 Crash and the bank failures in the spring of 2023 highlighted the significance of large, interconnected financial firms, particularly with regard to their potential to cause stress in the financial system and harm the real economy.[5] As part of the Dodd-Frank Act,[6] the Fed was given the authority to establish more stringent prudential standards:

> to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure . . . of large, interconnected financial institutions.[7]

Thus, capital surcharges are applied to require GSIBs "to maintain additional capital to strengthen the firm's resiliency, thereby reducing the probability of its failure and the risks that the firm's failure or distress could pose to the U.S. financial system."[8]

Two methods are employed to identify GSIBs and determine their capital surcharge:

- **Method 1** is used to identify a GSIB, based on the Basel Committee Framework. The Method 1 calculation is made up of five categories of metrics that measure the systemic importance of a financial firm: size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity. Each of these categories contains additional calculations that are combined to produce a total score that determines whether or not the firm is a GSIB.

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4 Jared Berry, Akber Khan, & Marcelo Rezende, *How Do U.S. Global Systemically Important Banks Lower Their Capital Surcharges?*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM: FEDS NOTES (Jan. 31, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/how-do-us-global-systemically-important-banks-lower-their-capital-surcharges-20200131.html.

5 Bank for International Settlements, *The G-SIB Framework – Executive Summary,* FINANCIAL STABILITY INSTITUTE EXEC. SUMM. 2 (Oct. 25, 2018), https://www.bis.org/fsi/fsisummaries/g-sib_framework.pdf.

6 Public Law No. 111-203, 165 Stat. 1376 (July 21, 2010) ("Dodd-Frank Act").

7 12 U.S.C. § 5365.

8 Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15), *supra* note 2.

- **Method 2** is used for U.S. firms to determine their degree of systemic risk. The components of the Method 2 calculation are very similar to Method 1. The only change is the replacement of the substitutability measure with a measure of reliance on short-term wholesale funding, which was a key indicator of stress in the 2008 Crash and remains an important source of vulnerability for banks.

Currently, firms classified as Category 1, II, and III by the Fed[9] must calculate Method 1 and Method 2 scores annually with data as of December 31. For each firm, the higher of the two calculations is used to determine its capital surcharge, from a low of 1.0 percent to a high of 3.5 percent of the firm's risk-weighted assets.[10]

When the current rule was finalized in 2015, former Fed Chair Janet Yellen explained:

> A key purpose of the capital surcharge is to require the firms themselves to bear the costs that their failure would impose on others. . . . [T]hey must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system. Either outcome would enhance financial stability.[11]

An empirical study,[12] believed to the be the first of its kind, indicates that the GSIB surcharges have indeed delivered some intended results. The evidence presented in the study suggests that there have been two positive outcomes from the GSIB surcharges: (1) a decline in lending to some of the riskiest corporate borrowers in response to higher GSIB surcharges, and (2) limited impact to these corporate borrowers because when GSIB credit is reduced, their borrowing from non-GSIBs increased. While the study is somewhat limited with its inclusion of data only from 2014 through 2017, a period of relatively low interest rates and strong economic conditions, it does support the Proposal's goal of refining the GSIB surcharge methodology to yield the most accurate measurement possible.

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[9] Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15), *supra* note 2.

[10] Bank for International Settlements, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement (Nov. 27, 2023), https://www.bis.org/bcbs/gsib/index.htm.

[11] Press Release, Board of Governors of the Federal Reserve System, *Federal Reserve Board approves final rule requiring the largest, most systemically important U.S. bank holding companies to further strengthen their capital positions* (July 20, 2015), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20150720a.htm.

[12] Giovanni Favara, Ivan Ivanov & Marcelo Rezende, *GSIB Surcharges and Bank Lending: Evidence from U.S. Corporate Loan Data,* 142 J. OF FIN. ECON. 1426 (2021), https://ssrn.com/abstract=3676674.

SUMMARY OF THE PROPOSAL

The Proposal introduces several technical changes that would improve the robustness and risk-sensitivity of the GSIB capital surcharge calculations and process, including:

(1) **Shift from point-in-time input values to average input values** for numerical calculations within the framework, to be more representative of the overall risk that a GSIB presents, rather than being reliant on data points from a specific day that could be subject to anomalies or manipulation;

(2) **Adjustments to make the GSIB's surcharge calculation more granular**, to yield results that are more precise and thus more sensitive to differences in risk; and

(3) **Shorten the lag time between a change in the GSIB surcharge calculation and its implementation**, to be more responsive to changes in risk levels.

Along with these changes, the source of the data – the Systemic Risk Report ("FR Y-15") – will be revised to supply the required inputs to the new calculations.

SUMMARY OF COMMENTS

Better Markets has supported the GSIB capital surcharges since the original Proposal and implementation.[13] We maintain this support and applaud the Fed's efforts to further strengthen the surcharge calculations to better protect the financial system and economy from the damaging effects of a GSIB failure. We also agree with the proposed implementation timeline—2 calendar quarters after the Proposal's approval. This is reasonably prompt and achievable since the changes are relatively simple and involve only a small number of institutions.

More specifically, there are several aspects of the Proposal that we support, including:

- The change from point-in-time to average data inputs will strengthen and improve the GSIB capital surcharge calculations and in turn better support financial stability. This change will make the results more representative of the typical risk profile of each GSIB over the entire year and reduce the likelihood that firms can or will manipulate financial results. Furthermore, shifting to average data inputs should not present an operational burden for the GSIBs.

- Increasing the granularity of results in the Method 2 scoring framework will yield several useful benefits. The current Method 2 calculation framework results in surcharge amounts that increase in increments of 0.5 percent (1.0%, 1.5%, 2.0%...). The proposed change would adjust this framework to increase surcharge amounts in increments of 0.1 percent

[13] *See* Better Markets Comment Letter, *Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies (GSIBs)* (Apr. 3, 2015), https://bettermarkets.org/wp-content/uploads/2021/07/FRS-CL-Risk-Based-Capital-Guidelines-Implementation-of-Capital-Requirements-for-Global-Systemically-Important-Bank-Holding-Companies-4-3-2015.pdf.

(1.0%, 1.1%, 1.2%...). This adjustment reduces "cliff effects" that currently exist for firms transitioning between categories and treats similar firms more alike.

- The effective date for implementation of new capital surcharge amounts should be moved to the start of the second quarter (April 1) of the year that immediately follows the calculation of the increased GSIB surcharge. This change will promote financial stability and benefit the American public because GSIBs will be required to promptly adjust capital surcharges following a change in risk in the prior calendar year. Furthermore, GSIBs would be able to conduct capital planning for potential changes more easily because of the shift to annual average values for input data. Unexpected data shifts at the end of the calendar year that could have substantially affected surcharge calculations in the prior framework would be less of a hindrance to banks' capital planning.

We recommend additional consideration of the following comment:

- The GSIB capital surcharge amounts should be increased to provide the American people with additional protection against GSIB failure. Since the Basel Endgame proposal that is currently being considered does not increase the minimum required capital ratio levels, despite several Agency, academic, and banking industry analyses that indicate net benefits from such an increase, it is reasonable and prudent to increase the surcharge levels for the largest and most systemically important banks.

COMMENTS

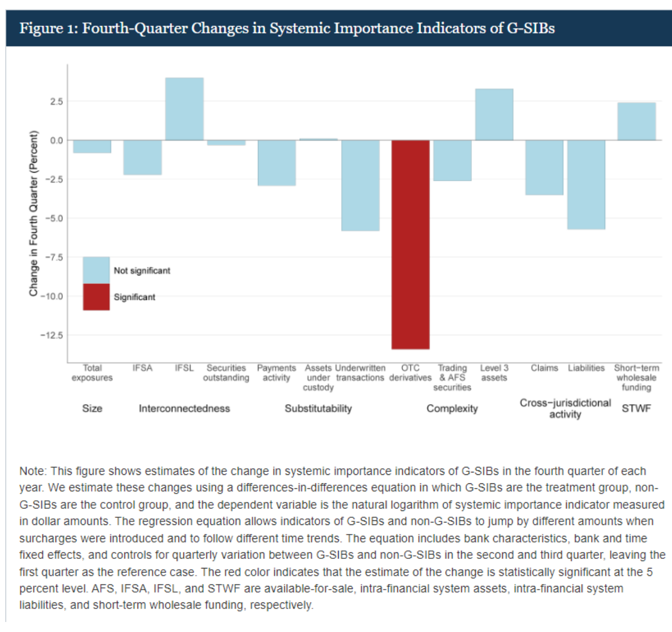
I. THE CHANGE FROM POINT-IN-TIME TO AVERAGE DATA INPUTS WILL STRENGTHEN AND IMPROVE THE GSIB CAPITAL SURCHARGE CALCULATIONS AND IN TURN BETTER SUPPORT FINANCIAL STABILITY.

Currently, several inputs to the Method 1 and 2 calculations are based on values as of a single day (December 31), including: intra-financial system assets, intra-financial system liabilities, securities outstanding, assets under custody, notional value of over-the-counter derivatives, trading and available-for-sales securities, Level 3 assets, cross-jurisdictional claims, and cross-jurisdictional liabilities.

The proposed change to use average values for all data inputs makes sense for several reasons. First, this change will make calculation results more representative of systemic risk levels at each GSIB over the course of the entire year, which is the intention of the Method 1 and 2 calculation frameworks. Basic statistical principles, such as seasonality, also support a shift to annual average data. Data from any single day throughout a calendar year may not accurately represent a metric's value over the course of the entire year. A simple shift to using average values greatly improves the meaningfulness of calculation results.

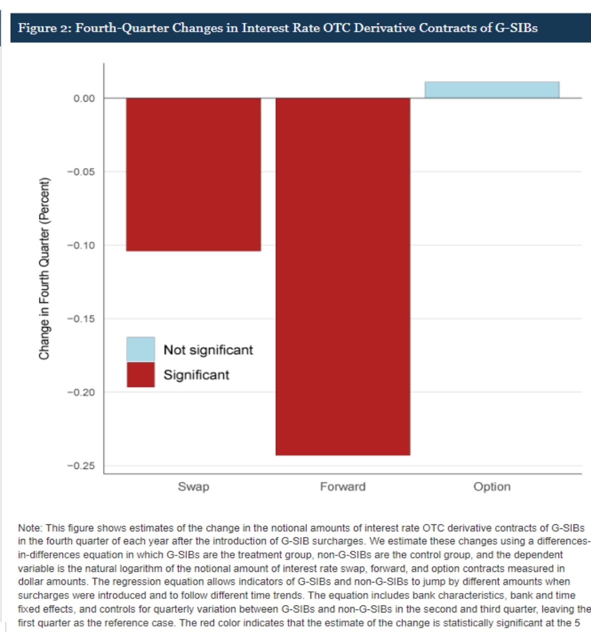
Second, the change to average data inputs will reduce the likelihood that firms can manipulate financial reporting to their benefit, and to the detriment of financial stability and the American people. In fact, research shows that this type of manipulation has indeed occurred since the original capital surcharge rule was put in place. As mentioned earlier, Fed researchers analyzed GSIBs' behavior in the fourth quarter of the year compared with non-GSIBs for various systemic importance indicators.[14] The research results show that GSIBs reduce several systemic indicators in the fourth quarter of the year more than non-GSIBs (see the several negative bars in Figure 1). The research results show that GSIBs' reduction of over-the-counter derivatives holdings in the fourth quarter was statistically significant, as indicated by the dark red shading (see Figure 2). In other words, GSIBs reduce swap and forward contracts in the fourth quarter of the year more than non-GSIBs, presumably to reduce the GSIB capital surcharge which is calculated using data from the end of the calendar year.

Figure 1: Fourth-Quarter Changes in Systemic Importance Indicators of G-SIBs



Note: This figure shows estimates of the change in systemic importance indicators of G-SIBs in the fourth quarter of each year. We estimate these changes using a differences-in-differences equation in which G-SIBs are the treatment group, non-G-SIBs are the control group, and the dependent variable is the natural logarithm of systemic importance indicator measured in dollar amounts. The regression equation allows indicators of G-SIBs and non-G-SIBs to jump by different amounts when surcharges were introduced and to follow different time trends. The equation includes bank characteristics, bank and time fixed effects, and controls for quarterly variation between G-SIBs and non-G-SIBs in the second and third quarter, leaving the first quarter as the reference case. The red color indicates that the estimate of the change is statistically significant at the 5 percent level. AFS, IFSA, IFSL, and STWF are available-for-sale, intra-financial system assets, intra-financial system liabilities, and short-term wholesale funding, respectively.

Figure 2: Fourth-Quarter Changes in Interest Rate OTC Derivative Contracts of G-SIBs



Note: This figure shows estimates of the change in the notional amounts of interest rate OTC derivative contracts of G-SIBs in the fourth quarter of each year after the introduction of G-SIB surcharges. We estimate these changes using a differences-in-differences equation in which G-SIBs are the treatment group, non-G-SIBs are the control group, and the dependent variable is the natural logarithm of the notional amount of interest rate swap, forward, and option contracts measured in dollar amounts. The regression equation allows indicators of G-SIBs and non-G-SIBs to jump by different amounts when surcharges were introduced and to follow different time trends. The equation includes bank characteristics, bank and time fixed effects, and controls for quarterly variation between G-SIBs and non-G-SIBs in the second and third quarter, leaving the first quarter as the reference case. The red color indicates that the estimate of the change is statistically significant at the 5 percent level.

Third, the change to average data for calculations would reduce the social cost that can result from GSIBs' data manipulation. For some financial transactions and products, GSIBs account for a significant share of the market because of their large size, so changes in financial holdings or a change in GSIBs' willingness to participate in financial markets can have a detrimental effect on all financial market participants. Researchers have referred to GSIBs as "lenders-of-second-to-last-resort" and cite not only GSIBs' important role in the commercial banking system but also their role in the facilitation of transactions underlying monetary policy.[15] When GSIBs change their holdings or their willingness to conduct certain financial transactions, it has the potential to harm average financial market participants with higher costs or less

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[14] Jared Berry, Akber Khan, & Marcelo Rezende, *supra* note 4.

[15] Ricardo Correa, Wenxin Du, & Gordon Y. Liao, *U.S. Banks and Global Liquidity*, NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER 27491 (July 2020), https://www.nber.org/system/files/working_papers/w27491/w27491.pdf.

availability of financial instruments. Policymakers should unquestionably make the change to average data to protect the public interest in a well-functioning financial system.

The Proposal mentions concerns that the change to average reporting may place a large operational burden on GSIBs. We disagree with this concern. Annual average data calculations are simple and straightforward. Furthermore, GSIBs likely have and are tracking the data that would be needed to compute average calculations. Even if the changes do result in a small added cost, we believe this is a small and reasonable price to pay for a more robust and accurate measure of GSIB risk. ***Finally, if the GSIBs still resist making the change to reporting average annual metrics, the Fed should then consider shifting the reporting to the highest (and riskiest) one-day metric during the calendar year*** to ensure that the highest level of systemic risk is being incorporated into the surcharge calculations. In light of the apparent past yearend manipulation and the reasonable belief in likely future similar manipulation, this may in fact be the best and most appropriate action to take.

II. INCREASING THE GRANULARITY OF RESULTS IN THE METHOD 2 SCORING FRAMEWORK WILL YIELD SEVERAL USEFUL BENEFITS.

In the original rule, the Method 2 surcharge calculations increase in increments of 0.5 percent (1.0%, 1.5%, 2.0%...). The Proposal presents a change to instead calculate surcharge amounts in increments of 0.1 percent (1.0%, 1.1%, 1.2%...), which we support as another means, along with averaging, to reduce the incentives for GSIBs to attempt to manipulate the reported factors that are used to calculate the surcharge.

This proposed adjustment will reduce detrimental "cliff effects" that currently exist for firms transitioning between categories. In the current rule, the 0.5 percent jump between surcharge levels is large enough that it could cause firms to undertake manipulative techniques, as discussed earlier, so as to not incur a change in the surcharge amount.

A more continuous distribution of surcharge amounts will also treat similar firms more alike. In the current framework, one firm may have just crossed a threshold and moved into a higher surcharge category while another firm may be just below the threshold between the two categories. These can be considered "similar" firms based on their financial metrics, but one would have a 0.5 percent higher surcharge than the other under the current rule. While this situation could still happen with the proposed distribution for the surcharge amounts, the difference in surcharge amount between the two firms would be much smaller, only 0.1 percent, and therefore less likely to cause changes in behaviors of the firms that would be detrimental for financial markets or the public.

III. THE EFFECTIVE DATE FOR IMPLEMENTATION OF NEW CAPITAL SURCHARGE AMOUNTS SHOULD BE MOVED TO THE START OF THE SECOND QUARTER (APRIL 1) OF THE YEAR THAT IMMEDIATELY FOLLOWS THE CALCULATION OF THE INCREASED GSIB SURCHARGE.

As former Fed Chair Yellen stated,[16] the purpose of capital surcharges is to shift the burden of the costs of failure ***to*** the GSIBs themselves, and ***away from*** taxpayers, the government, or other banks. ***Currently, there is a delay of more than one calendar year between the calculated surcharge and its implementation.*** For instance, capital surcharges calculated using fourth quarter 2021 data were implemented on January 1, 2023. As the bank failures in the spring of 2023 demonstrated, shifts in bank conditions can happen quickly and therefore the measures that recognize these shifts and inform actions to protect the public and the financial system should react and move with commensurate speed. We support the proposed reduction in lag time between recognition and implementation because it will better promote financial stability than the current lag.

Furthermore, as explained earlier, the shift to using annual average data inputs will significantly reduce uncertainty related to the inputs to the GSIB surcharge calculations. This uncertainty had been used to justify long delays between data reporting and implementation of surcharge changes. For several components of the GSIB surcharge calculation, however, the inputs that were previously derived from a single year-end data point will shift to be derived from an annual average calculation. The GSIBs should already be calculating annual averages and potential capital surcharges to facilitate their own internal capital planning through the year. Therefore, in the interest of the American people and financial stability, revised capital charges should be implemented as soon as possible after revision of data.

IV. THE GSIB CAPITAL SURCHARGE AMOUNTS SHOULD BE INCREASED TO PROVIDE THE AMERICAN PEOPLE WITH ADDITIONAL PROTECTION AGAINST GSIB FAILURE.

As Better Markets detailed in its comment letter on the Basel endgame proposal,[17] while the calculations of capital and risk weighted assets are proposed to change, the minimum required capital ratios are not. Better Markets has also detailed several regulatory agency statements, academic research studies, and banking industry analysis which show that higher capital is necessary to adequately protect against the risk at the largest banks. For example, economists Anat Admati and Martin Hellwig[18] found that capital levels of at least 20% - 30% of total assets would

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[16] Federal Reserve Board of Governors, *supra* note 11.

[17] *See* Better Markets Comment Letter, *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity* (Jan. 16, 2024), https://bettermarkets.org/wp-content/uploads/2024/01/Better-Markets-Comment-Letter-Regulatory-Capital-Rule-Large-Banking-Organizations.pdf.

[18] ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT - NEW AND EXPANDED EDITION (Jan. 9, 2024).

make banks substantially stronger without sacrificing economic growth. The Federal Reserve Bank of Minneapolis[19] estimated that increasing bank capital levels to 23.5% of risk-weighted assets and 15% of total assets would substantially reduce the likelihood of future taxpayer-funded bailouts while strengthening the economy by making the banking and financial system more resilient. Even many bank risk management professionals,[20] who manage bank risk for a living, believe that current capital minimums are insufficient and should be significantly increased. In summary:

> [H]igher capital requirements have not hurt banks, [and] they have not hurt borrowers . . . . [I]t is difficult to find any social costs associated with increasing capital requirements and improving the resilience of the financial system.[21]

Although an increase in the capital surcharge amount will only boost the total capital levels at GSIBs, it is reasonable and prudent to make this change to at least protect against risk at the largest and most influential banks.

[19] Federal Reserve Bank of Minneapolis, *The Minneapolis Plan To End Too Big To Fail* (Nov. 16, 2016), https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-2016.pdf?la=en.

[20] Steve Cecchetti & Kim Schoenholtz, *What Risk Professionals Want*, MONEY AND BANKING (Mar. 11, 2019), https://www.moneyandbanking.com/commentary/2019/3/10/what-risk-professionals-want.

[21] Steven Cecchetti & Kermit Schoenholtz, *Setting Bank Capital Requirements*, MONEY AND BANKING (Oct. 12, 2020), https://www.moneyandbanking.com/commentary/2020/10/11/setting-bank-capital-requirements; *see also* Better Markets, *Fact Sheet: Ten False Claims About Bank Capital* (July 25, 2023), https://bettermarkets.org/wp-content/uploads/2023/07/Better_Markets_Capital_Fact_Sheet-7.25.23.pdf.

CONCLUSION

We hope these comments are helpful in the finalization of the Proposal.

Sincerely,

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