BANK POLICY INSTITUTE

September 28, 2020

Via Electronic Mail

Financial Stability Board
Basel, Switzerland

Re: **Evaluation of the Effects of Too-Big-to-Fail Reforms**

Ladies and Gentlemen:

The Bank Policy Institute[1] appreciates the opportunity to comment on the Financial Stability Board's (FSB) Evaluation of the Effects of Too-Big-to-Fail (TBTF) Reforms. We commend the significant amount of work and analysis that has been put into the report and agree with the findings of the report that the TBTF reforms have "contributed to the resiliency of the banking sector and its ability to absorb, rather than amplify, shocks." As noted in the report, banks have significantly increased their quantity and quality of capital, reduced their leverage and increased their liquidity since the 2008 financial crisis.

However, as described in more detail below, there are areas of the report that could be improved with regard to data analysis, particularly when presenting and analyzing the data for the United States. While the U.S. is only a single country, its weight in the financial system is sufficiently large that it is important to highlight its progress in a transparent manner. Additionally, we believe that the overall tone of the report should be adjusted to make clear the extraordinary level of progress that has been made in ending TBTF in key G-SIB home jurisdictions over the past decade.

BPI also agrees with a number of the conclusions in the report regarding the need for further work and analysis, particularly with respect to the ongoing monitoring of internal TLAC requirements and whether they are working as intended; further focus on the shift in credit intermediation from the banking sector to non-bank financial institutions; and further work on CCP resilience.

I. Executive Summary

[1] The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ nearly 2 million Americans, make 72% of all loans and nearly half of the nation's small business loans and serve as an engine for financial innovation and economic growth.

- Progress in eliminating TBTF has been meaningful and significant, yet the tone of the report does not sufficiently acknowledge the progress made to date, especially with respect to developed countries and in relation to G-SIB resolvability and resolution planning.

- Key areas of the report that should be improved in the final version include: the analysis on impact of credit; consideration of impacts on market liquidity; better disclosure of country-level data; and a more critical look at the cost-benefit analysis relating to reforms.

- We believe some of the conclusions are unwarranted and not supported by robust analysis of available data. In particular, the conclusions on complexity and fragmentation are insufficiently supported and a more balanced description of the issues is warranted. As discussed more fully in this letter, the report does not sufficiently address the issue of excessive internal TLAC requirements and ex-ante ring-fencing of both capital and liquidity, which should be a topic of increased focus by the FSB, given its potential to impact the overall resiliency of the system.

- We do support a number of the report's recommendations. In particular, we support the FSB's agenda with respect to the ongoing monitoring of internal TLAC requirements and whether they are working as intended; further focus on the shift in credit intermediation from the banking sector to non-bank financial institutions; and further work on CCP resilience.

II. Progress on Too-Big-to-Fail has been meaningful and significant, yet the report downplays the lengthy list of successes that it reports.

Using a wide range of metrics, the FSB working group found that significant progress has been made, especially in the United States, in eliminating too big to fail (TBTF) in the context of bank failures. The group found that any funding advantage of systemically important banks (SIBs) has declined significantly since the TBTF reforms have been implemented—and in some jurisdictions has disappeared. The group further found that SIBs have become relatively smaller and less systemically important.

The group used financial asset prices in many different ways to judge whether investors perceived SIBs to be TBTF and if SIBs benefited from a TBTF funding advantage. They found:

- Bank investors evidently believe that SIBs will be allowed to fail: Market participants charge banks more to invest in senior long-term debt that is eligible to be converted to equity in the event of failure than senior debt that is not, and the spread behaves like spreads on subordinated debt. (p.17)
- G-SIBs pay more for long-term debt that can be converted to equity than do other banks. (p.17)
- An examination of credit default swap (CDS) spreads found that after controlling for other bank characteristics, the TBTF reforms had "significantly reduced the funding cost advantage of SIBs…" (p. 56).
- Another analysis of CDS spreads that controls for market-implied probabilities of default concludes that a TBTF funding advantage has been declining steadily from its peak in the financial crisis. (p. 135)

The working group also examined how SIBs had adjusted in reaction to the reforms. They found that SIBs had responded to the reforms essentially as intended.

- One analysis found that, relative to non-G-SIBs, G-SIBs grew more slowly, became less complex, became less profitable, increased their leverage ratios, and became relatively less likely to default. (p. 145)
- Another study found that SIBs increased their risk-based capital ratios and leverage ratios relative to other banks, grew more slowly, and reduced the share of derivatives in total assets. The study found that G-SIBs had greater reduction in their probability of default and share of non-performing loans (p. 156) compared with other banks, and reduced profitability (p. 157).
- The complexity of U.S. G-SIBs, as measured by the number of majority-owned subsidiaries, after peaking in 2009, has fallen by more than half (p. 110).[2]

Lastly, the working group examined characteristics of the overall financial system. They found that the systemic risks from the banking system had declined.

- Prior to the TBTF reforms, the macro economy was vulnerable to idiosyncratic shocks at banks, but after the reforms the economy "seems to be shielded from idiosyncratic banking shocks." (p. 241).
- Analysis of two market-based measures of the systemic risk – ΔCoVaR and SRISK – demonstrated that "…TBTF reforms have been associated with a reduction in G-SIBs systemic risks." (p. 266)

Based on the Resolution Reform Index (RRI), which measures progress on resolution reform based on scores between 0 (not implemented) to 1 (fully implemented) across 17 different categories, the United States is the global leader in eliminating TBTF. The United States led the group of 24 countries reviewed in every year that the RRI was calculated, from 2010 to 2019, usually by a wide margin, and ended with a score of about 0.95 (p.10).[3][4] While the US score speaks for itself, it is worth highlighting some of the specific resolvability advances that have been made over this time which did not receive much mention in the report itself. These include: the buildup of external TLAC, structural subordination of TLAC debt through implementation of clean holding company requirements, legal entity rationalization, development of contractual mechanisms for recapitalization and downstreaming of funds at the point of resolution, capability testing, operational continuity mechanisms, and the adoption of resolution stay language in financial contracts.

Given all of the positive indicators, as outlined above, it is surprising that, overall, the tone of the report fails to highlight how much progress has been made in tackling TBTF. For example, the report states that indicators of systemic risk and moral hazard have "moved in the right direction," which seems to suggest

[2] Unless otherwise specified, page number references are to the technical appendix.

[3] Each category was assigned a weight of 0 (not implemented), 0.33 (under development), 0.67 (partial implementation), nor 1 (fully implemented). The categories were apportioned into three sub-indexes (resolution powers, policy and guidance, and loss allocations). The value for each sub-index was calculated as a simple average of the applicable category scores. The resolution reform index (RRI) was then calculated as the simple average of the three sub-indexes.

[4] The paper reports the number of subsidiaries using two different measures one based on the FED/NIC dataset the other based on the BvD dataset. The figure cited above is for the FED/NIC data. The BvD data experienced a sharp series break in 2017 that makes comparison over time impossible

only a small incremental improvement and focuses on gaps that need to be addressed while not recognizing the decreasing marginal benefit of some of the further reform work. The report also downplays the progress that has been made by casting doubt on whether positive outcomes can be attributed to TBTF reforms even though, the report clearly indicates that many positive outcomes have been attributed to the reforms. This glass-half-empty tone may in part be because the report is looking across both developed and developing countries, as well as G-SIBs and D-SIBs, but presenting the findings as a consolidated view. From the outset, the international efforts to end TBTF were driven by countries that were home jurisdictions to G-SIBs and the reforms were primarily focused on G-SIBs. Therefore, it only makes sense that progress would be seen in those jurisdictions sooner than in developing countries and in relation to D-SIBs, which began their efforts later. The conclusion that progress on TBTF is "uneven" should not dilute the fact that significant systemic risk has been taken out of the system. The largest risks were housed in the developed countries, and their tremendous progress along with the enhanced resolvability of G-SIBs, has taken the majority of systemic risk from TBTF banks out of the system.

III. Despite the extensive data provided in the report, improvements should be made with regard to a number of points.

A. Impact on Credit

With respect to costs, the working group evaluated the impact of TBTF reforms on the supply of credit. The group found that the global G-SIB contribution to the global credit-to-GDP ratio declined after the reforms were implemented, and that the decline was greater in countries with a higher RRI score. However, the technical appendix argues that the net impact on credit supply has been minimal because "…other financial intermediaries, in particular…NBFIs [non-bank financial institutions] and non-systemic banks, have picked up the slack." (p. 233). The conclusion that other credit intermediaries had "picked up the slack" is repeated in the overall report and even in the press release, but it is difficult to determine its basis. The conclusion appears to be based on the fact that the overall credit-to-GDP level has risen over the post-crisis period, but that rise is unsurprising given the sharp contraction in credit that occurred in the crisis. Indeed, for the United States, the BIS measure of credit-to-GDP remains below trend despite rising steadily since its post-crisis trough. The relevant question is whether the supply of credit is lower than it would have been absent the added regulations, a question the report does not ask. Moreover, it seems extraordinary in current circumstances, with rapid outflows from prime money funds in March 2020 having contributed to an unprecedented disruption in U.S. Treasury markets, to conclude that a shift in credit intermediation into the non-bank financial system should be considered net positive in the battle against systemic risk. To the contrary, we believe this phenomenon has increased risk. As noted above, we support the FSB's recognition that further work should be conducted on the shift in credit intermediation to the non-bank financial system and whether it poses systemic risk.

B. Market Liquidity

A significant shortcoming of the report is that it did not consider a reduction in financial market liquidity as a possible cost of TBTF reforms. As discussed in a recent BPI blog post (here), there has been a debate for over a decade whether the extent of the G-SIB surcharge and leverage ratio requirements, two key components of the TBTF reforms, reduce the ability of broker-dealer

subsidiaries of G-SIBs to engage in the market-making activities that are critical to credit intermediation in financial markets. This debate has now become highly relevant in that, in March, the Federal Reserve was forced to purchase $1 trillion in Treasury securities in 3 weeks, in order to prevent the collapse of what is normally the most liquid financial market. (See Nelson and Parkinson (2020), Duffie (2020), and Correa et al (2020).) Treasury market liquidity had evaporated as sales of Treasury securities from hedge funds and foreign institutions overwhelmed a one directional market that lacked buyers and the balance sheet capacity of broker-dealers was insufficient to fully absorb this excess supply. Nevertheless, the term "market liquidity" does not even appear in either the report or the technical appendix, much less any analysis of the issue. Therefore, we recommend that the final report recognizes that market liquidity is a critical element that should be taken into account when assessing the impacts of the TBTF reforms. While we recognize such analysis may not be completed by the FSB in time for the publication of the final report, the FSB should clearly include the issue on its agenda for future and, we believe, immediate work.

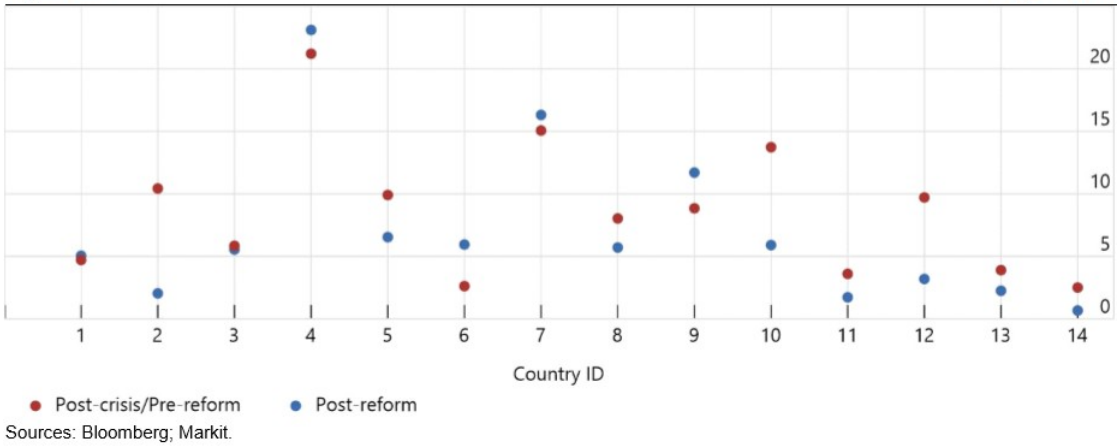
C. Country-level Reporting

While the report finds that TBTF funding advantages have been eliminated in some countries, especially those that have made the most progress making banks resolvable, the report anonymizes key results that it reports for individual countries. The report should provide transparency around country-level results, so that it can be used to judge the success of TBTF reforms in a way that is helpful for national policy makers, including, importantly, the extent to which SIBs remain exposed to moral hazard.

For example, as shown in the figure, for several countries the funding advantage was essentially eliminated, and the study indicated that the countries with a higher RRI – recall that the United States consistently had the highest index – were the most successful eliminating any TBTF funding advantage. It seems likely, therefore, that the funding advantage is gone for the United States given its RRI score but this is impossible to decipher because the figure lists the countries by anonymized numbers, not by names.

Average TBTF premium of selected countries

In per cent **Figure 3.7.2**



Sources: Bloomberg; Markit.

Disappointingly, while the report provided estimates of TBTF funding advantage using bond data for Canada, the Euro area, and Germany, it did not do so for the United States. The main report indicated that the regions were chosen based on access to data (p.34), which seems an implausible reason for excluding the United States because there are already many studies that use the data including a major GAO study in 2014.[5] As the working group recognized in the main report (p. 33) "…few studies include the period after 2015, when reforms were still being implemented…". An updated estimate of the TBTF premium, if any, of U.S. banks based on bank bond data should be included in any final report. For example, recent analysis by Covas and Dionis (2020) looking at unsecured bond spreads of US G-SIBs and non G-SIBs (data equally available to the FSB working group) during March 2020 shows that US-G-SIBs are not benefiting from a funding advantage in comparison to other domestic banks.[6]

D. Cost-Benefit analysis

The report concludes with an assessment of the net benefits of the TBTF reforms and determines that they are large and positive; specifically, the benefits for FSB member jurisdictions equals $216 billion and the costs equal $65 billion (p. 272). To measure the costs and benefits of the reforms, the working group uses a technique from a 2010 Basel Committee report (available here) and updated in Fender and Lewrick (2016) (available here). The methodology measures the benefit of higher bank capitalization in terms of a reduced probability of future financial crises and the cost in terms of a reduced supply of bank credit and therefore GDP. The working group combined the G-SIB surcharge, TLAC requirements, and the SLR requirement into a single 2.1 percentage point increase in G-SIBs' CET1 ratio (the ratio of common equity to risk-weighted assets). They then multiplied the increase by the global percentage of bank assets held by G-SIBs (28 percent) to boil the TBTF reforms down to a single 59 basis point increase in banks' average CET1 capital ratio.

However, the conclusion reached about the benefit of increasing banks' CET1 ratio depends critically on the CET1 ratio from which the methodology relies on as a starting point. The benefit of additional capital declines as the level of capital goes up. The working group assumes the average CET1 ratio increases from 7 percent to 7.59 percent because 7 percent is the current CET1 capital requirement for a non-G-SIB. The increase from 7 percent to 7.59 percent reduces the annual probability of a financial crisis by 30 basis points, from 1.6 percent to 1.3 percent.

Since the last financial crisis, U.S. banks have nearly doubled their capital ratios. That increase reflects banks' greater sensitivity to, and assessments of, risk as well as the post-crisis regulatory reforms including stress tests and higher stated capital requirements. According to the New York Federal Reserve Bank's quarterly report (available here) the CET1 ratio of U.S. bank holding companies has risen from 7.10 percent in the middle of 2009 to 12.24 percent at the end of 2019.[7] The FSB working group, by considering the implications of raising capital levels from 7.0 to 7.59 percent, has essentially calculated the costs and benefits of the *first* 59 basis points of the massive post-crisis buildup in capital.

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[5] July 2014, General Accounting Office, "Large Bank Holding Companies Expectation of Government Support," https://www.gao.gov/assets/670/665162.pdf

[6] Covas and Dionis. "Putting 'Too Big to Fail' to Rest: Evidence from Market Behavior in the COVID-19 Pandemic." September 2020. https://bpi.com/putting-too-big-to-fail-to-rest-evidence-from-market-behavior-in-the-covid-19-pandemic/

[7] On average, bank capital levels are similar in other countries. The Basel Committee's April 2020 Compliance Report (available here) indicates that the world's large banks have a combined average CET1 ratio of 12.8 percent.

Furthermore, this analysis ignores tighter standards for measuring RWA that have been introduced over the last decade. If shown on a like-for-like basis, the increase would be significantly greater.

The results are much different if one calculates the costs and benefits of the *last* 59 basis points of the buildup. Using the Fender-Lewrick analysis, the annual probability of a financial crisis when the aggregate CET1 ratio is 12.24 percent (its current level in the United States) is 0.26 percent. When a delta of CET1 ratio is 59 basis points lower (11.65 percent), the probability is 0.31 percent. Thus, the last 59 basis points of the post-crisis buildup in capital reduced the probability of a financial crisis by only 5 basis points, one-sixth as much as the first 59 basis points. But if the reduction in the probability of a crisis is one-sixth as large, then the benefit is one-sixth as large as well. In that case, the social costs *exceed* the social benefits. In other words, by this measure, the banks CET1 ratios are actually a bit above levels where net social benefit is maximized. The final report should reflect these additional points and evaluate them in coming to its conclusion on the cost-benefit analysis.

E. Holistic Consideration of Reforms

In 2016, the FSB stated to the G20 that "[t]he FSB… is working to enhance the analysis of the effects of reforms, including whether the reforms are working together as intended." The terms of reference of the TBTF working group[8] state that its analysis would be based on the July 2017 FSB "Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms,"[9] which reiterated the FSB's intention to evaluate whether the TBTF reforms are working together as intended. The working group did not, however, consider the impact of the reforms holistically. For example, it did not consider the implication of success in reducing resolution costs on the calibration of the G-SIB surcharges, even though the surcharges are calibrated to equate the expected resolution costs of a G-SIB with a reference non G-SIB. It did not adjust for the significant changes to more exacting RWA measurements. As shown in Nelson (2020), using a consistent measurement based on G-SIB market disclosures, the more exacting RWA measurements reduced bank CET1 ratios by nearly 30%.[10] It did not consider how the LCR reduces the costs and likelihood of bank failures: Covas and Lindgren (2018) estimate that G-SIB surcharges, which were calibrated using data when the LCR requirement did not exist, should be 50 to 100 basis points lower in the United States.[11] It also did not consider how TLAC requirements changed the appropriate calibration of the G-SIB surcharge: An impact study of the TLAC rule that the FSB itself conducted in November of 2015 provides empirically based estimates of the reduction in probability of default and resolution cost resulting from the new requirements.

The impact study cites research by Afonso et al (2014) that estimates that long-term debt requirements reduce banks' default probabilities by 30 percent. The FSB impact study also presents research suggesting that TLAC reduces the cost of resolutions—and ultimately the cost of G-SIB failure-induced financial crises— by roughly 10 percent. As noted in Campbell, Covas, and Nelson (2018), in combination, these two effects reduce the expected systemic impact of a G-SIB failure by about one third.[12] The FSB TLAC impact study also reports that the additional required long-term debt is roughly

[8] https://www.fsb.org/wp-content/uploads/P230519.pdf
[9] https://www.fsb.org/wp-content/uploads/P030717-4.pdf
[10] Bill Nelson, "The U.S. G-SIB Surcharge is Overstated in Light of Basel III Changes," August 13, 2020. https://bpi.com/the-u-s-G-SIB-surcharge-is-overstated-in-light-of-basel-iii-changes/
[11] Francisco Covas and Rob Lindgren, "Estimating How Basel III Liquidity Requirements Should Affect a G-SIB Surcharge," June 2018, https://bpi.com/wp-content/uploads/2018/07/research-note.pdf.
[12] https://bpi.com/seeing-the-forest-for-the-trees-G-SIB-capital-and-enhanced-G-SIB-regulation/

equivalent to a 1 percentage point increase in capital. We recommend that the final report provides additional analysis of the holistic impact of the reforms and how that contributes to overall financial stability.

IV. Along with the specific data elements that should be improved upon in the final report, there are additional points of discussion in the report that are premature in their conclusions.

A. Complexity

The report's discussion of bank complexity is misleading for two reasons, albeit the report does acknowledge some of the limitations of its methodology. First, the report uses the total number of subsidiaries as its measure of complexity, which is a poor measure. Second, the report does not look at firm complexity in the context of the overall changes that have occurred to make resolution more feasible (e.g. clean holding company requirements, the implementation of recognition powers for resolution authorities, the development of cross-border resolution stay protocols). When looked at in the round, "practical" complexity has declined materially as firms have implemented resolvability measures and policymakers have improved the underlying resolution regimes.

Moreover, the report conveys the perception that there has been relatively little change in subsidiary count by focusing on a data series with sharp discontinuity in 2017 that is attributed to the data vendor significantly increasing the scope of its data collection, as in figure 4.4.4. However, as the report acknowledges, for the United States there is a consistent dataset on the number of subsidiaries from the Federal Reserve's own bank structure database. As shown by the blue bars in figure 4.4.5, those data show that the average number of subsidiaries of U.S. G-SIBs has declined by half between 2010 and 2019.

With regard to subsidiary count, the report states in bold "[a]s measured by numbers of subsidiaries, G-SIBs remain fairly complex".[13] While the number of subsidiaries has been used in the economic literature as a measure of complexity, it is a poor measure. Banks may establish subsidiaries for multiple reasons, including regulatory requirements and tax reasons. Some subsidiaries present no complexity problems whatsoever from an operational, examination or resolution perspective: in particular, some subsidiaries are actually designed to enhance resolvability (e.g. clean holding companies and group service companies for operational continuity). Explicitly for this reason, the Federal Reserve and the FDIC, along with other international regulators, have for purposes of banks' resolution plans distinguished between "material legal entities" (MLEs) and other legal entities, and focused attention on the former.[14] The vast majority of subsidiaries are in fact immaterial: currently, the maximum number of MLEs for any of the eight U.S. G-SIBs that file resolution plans is 30 – in stark contrast to the 1,335 subsidiaries cited in a recent paper that uses subsidiary count as a measure of complexity (Goldberg and Meeh (2019)). There are a total of 170 MLEs across all eight US. G-SIBS; that number may be somewhat inflated in terms of the actual importance of all of the entities, but regardless, 170 MLEs across eight G-

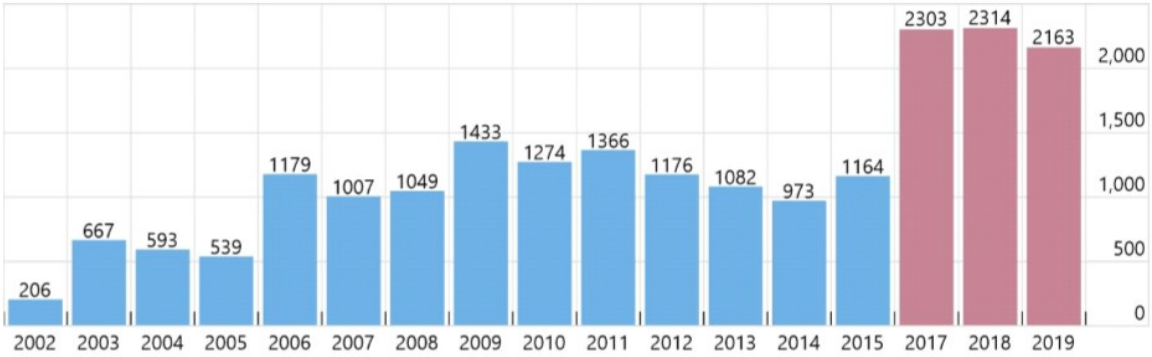
[13] See pg 47 of the main report.

[14] Material Legal Entities (MLEs) are assessed and identified based on the overall contribution the businesses or operations conducted to the group. Metrics used include revenues, profits, assets and also the entities' support of core lines of business or critical operations. By focusing on the resolvability of these MLEs, the G-SIBs are able to develop a plan that supports an orderly resolution of the group without systemic impact to the global markets.

SIBs is a manageable number of legal entities particularly in the context of single point of entry resolution strategies.

Importantly, the reductions in complexity of G-SIBs must be considered in the context of 1) the benefits provided to end-users from the ability of banks to operate globally across borders providing a number of critical banking services to businesses worldwide in an efficient means; and 2) the development of single point of entry resolution strategies to eliminate the need for authorities to have to take action in relation to a number of geographically dispersed subsidiaries. While reduced complexity can be beneficial, it is not an indicator that can be viewed in isolation since there are corresponding benefits as well as costs and there are other mitigating changes (e.g. SPOE resolution strategies, resolution stay protocols, operational continuity arrangements, etc.) that have been developed since the financial crisis that preserve the benefits of cross-border banking while also making cross-border resolution feasible.

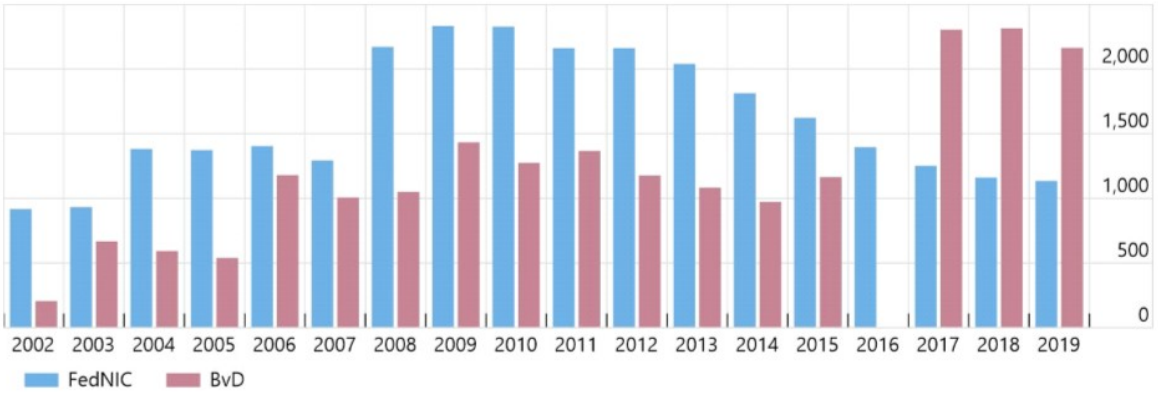
Number of majority-owned subsidiaries of US G-SIBs (2002-2019) **Figure 4.4.4**



Notes: G-SIBs in the sample are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corporation, Wells Fargo. Data refer to a specific month for each year. Data for 2016 are missing as they were not collected during that year and only current data can be retrieved from BvD for each point in time. Majority-owned subsidiaries are defined as those for which the G-SIB is the ultimate owner with a minimum control path of 50.01 % in each node of the control chain. Orange bars for 2017, 2018 and 2019 indicate years for which Bureau van Dijk data were based on an expanded data coverage for US banks.

Sources: Carmassi and Herring on Bankscope, Orbis and BankFocus data.

Number of majority-owned subsidiaries of US G-SIBs according to BvD and FED/NIC dataset (2002-2019) **Figure 4.4.5**



Note: G-SIBs in the sample are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corporation, Wells Fargo. For BvD, data refer to a specific month for each year (see Figures 1-4); BvD data for 2016 are missing as they were not collected during that year and only current data can be retrieved from BvD for each point in time. FED/NIC data displayed in the Figure all refer to yearend. For BvD data, majority-owned subsidiaries are defined as those for which the G-SIB is the ultimate owner with a minimum control path of 50.01 % in each node of the control chain. For FED/NIC data, the definition of control under Regulation Y, which is essentially a 25% control, applies. However, additional entities that meet FR Y-10/10F "reportability criteria" are included, as well as entities for which the relationship is "of interest to the Federal Reserve".

Sources: Carmassi and Herring on Bankscope, Orbis and BankFocus data.

B. Fragmentation

One significant and potential costly consequence of TBTF regulations in terms of reduction in social welfare has been fragmentation. In particular, host internal TLAC and liquidity requirements impair the ability of banks to deploy their capital and liquidity resources where needed in times of stress, increasing the total amount of capital and liquidity needed to achieve the same level of bank resilience relative to the amounts needed if banks' resources were not restricted. Because higher effective capital and liquidity requirements result in less and more costly lending to businesses and households, and because the use of ex ante ringfencing beyond de minimis levels appears to owe largely to distrust and lack of cooperation among regulatory authorities in different jurisdictions,[15] fragmentation results in an avoidable loss in social welfare. Indeed, on June 4, 2019, the FSB published a report on fragmentation and identified "… approaches and mechanisms that may enhance the effectiveness and efficiency of international cooperation and help to mitigate any negative effects of market fragmentation on financial stability."

[15] See Bill Nelson, "Cooperation Between Home and Host Central Banks Rather than Fragmentation of International Banks," BPI Staff Working Paper 2019-1, November 19, 2020, https://bpi.com/wp-content/uploads/2019/11/Cooperation-Between-Home-And-Host-Central-Banks-Rather-Than-Fragmentation-Of-International-Banks.pdf

Despite what appears to be an opportunity for the FSB to enhance the workings of the financial system through greater cooperation across financial authorities—its core mission—the working group report gives fragmentation short shrift.[16] The working group evidently conducted no additional research on the impact of fragmentation – no research on the impact of fragmentation is reported in the technical appendix. Instead, the report simply asserts that if fragmentation had raised bank funding costs it would have resulted in reduced credit and that, as "shown" earlier in the report, aggregate credit has not declined but instead has shifted outside of the banking sector – "while market shares have changed, there has been no impact on aggregate credit" (p. 65). But one cannot reach the simplistic conclusion that fragmentation has not had an effect because the aggregate level of credit has not changed. Moreover, as we discuss above, it is wrong to conclude that fragmentation is not a serious issue because credit intermediation has simply moved into the shadow banking system. In this regard, we welcome further evaluation of the financial stability implications of the shift in credit intermediation and the impact of fragmentation on that disintermediation.

The report then notes that while pre-positioning of capital in host jurisdictions through elevated internal TLAC requirements may be a costly result of a lack of cooperation, pre-positioning of capital and liquidity in host jurisdictions can help encourage cooperation. In particular, the report notes that

> "High pre-positioning or ring-fencing requirements may be the outcome of a collective action problem, whereby host authorities are not confident that sufficient financial resources will be available for the subsidiaries in crisis and hence require resources to be available up front." p. 65

It goes on to note that

> "Pre-positioning of internal TLAC can serve as a commitment device that aligns incentives and hard-wires cooperation in stress." p. 66

While it is inarguably true that ex ante ringfencing prevents the need for ex post ringfencing, this seems more like tautology than a constructive public policy. While we agree with the benefits of a well-designed moderate level of prepositioning for commitment purposes, calibration is crucial.[17] Critically, if ex ante prepositioning is over calibrated or overly rigid due to statutory construction or regulatory requirements, it can actually disincentivize cooperation and lead to individual jurisdictions only taking account of their own interests. It can also reduce group resilience, since internal resource allocation becomes less flexible in times of need. We urge the working group to consider ways to promote cross-border cooperation among regulatory authorities so that local capital and liquidity requirements are appropriately calibrated taking into account consolidated requirements and resolvability requirements imposed at the group level. Any local requirements should be designed to enhance, rather than deter, cooperation.

V. Conclusion

[16] According to its mandate, the FSB is intended to, among other things, "…promote coordination and information exchange among authorities responsible for financial stability." https://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf

[17] See Robert Lindgren and Bill Nelson, "Ringfencing versus Cooperation: A Game-theoretic Perspective," BPI research note, January 22, 2020. https://bpi.com/wp-content/uploads/2020/01/Ringfencing-versus-Cooperation-A-Game-theoretic-Perspective.pdf

As outlined above, BPI agrees with the findings of the report that state TBTF reforms have "contributed to the resiliency of the banking sector and its ability to absorb, rather than amplify, shocks." This is largely due to increased financial resilience in direct response to post-crisis reforms as well as the significant amount of work that has been undertaken by both banks and authorities to improve resolvability and the operational feasibility of resolution. However, as described above, the report could be improved with regard to data analysis, particularly when analyzing the data for the United States. Additionally, we believe that the overall tone of the final report should reflect the extraordinary level of progress that has been made in ending TBTF in key G-SIB home jurisdictions over the past decade.

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The Bank Policy Institute appreciates the opportunity to comment on the proposal. If you have any questions, please contact the undersigned by phone at +1 202-737-36-36 or by email at Lauren.Anderson*@bpi.com.*

Respectfully submitted,

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