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September 30, 2020

Evaluation of the effects of Too-Big-To-Fail reforms
Consultation June 28, 2020

Dear Sir/Madam:

Credit Suisse welcomes the opportunity to comment on the Financial Stability Board's (FSB) consultative document on the evaluation of the effects of the too-big-to-fail (TBTF) reforms.

The draft report undertakes extensive analysis and empirical work to investigate the effects of the TBTF reforms. While Credit Suisse concurs with its overall conclusion that the TBTF reforms have been broadly effective, with a positive cost benefit, we think that there are several areas which could be improved for the final report.

For ease of reading, we summarize our key messages in the text box below. This is followed by answers to selected questions asked in the consultative document.

Key Messages

1. **The draft report provides a useful and broad analysis** of the structure and objectives of TBTF reforms. The FSB report assembles a wide variety of analytical approaches that help measure the progress of the reforms and the degree of implementation.
2. **Jurisdictional Transparency**: The report notes significant differences in the implementation of the TBTF reforms across jurisdictions. In general, the major financial centers such as the US, UK and Switzerland achieve very high scores in the implementation of the TBTF reforms (i.e. the RRI[1]). However, other FSB countries show significant gaps in the TBTF reform implementation. The draft report's summary delivers a blended overall conclusions on a global basis. The FSB's conclusion that further efforts are necessary and justified by the incremental cost/benefit trade-off is also asserted broadly, without a clear perspective on whether the jurisdiction or institution is at an advanced stage or in a developmental stage:

[1] We note that the RRI is based on legal tests only; it suggest that could be significantly improved by the addition of simple financial metrics, especially TLAC. For example, a jurisdiction with high levels of subordinated TLAC outstanding gives the authorities the resources to address a much wider range of potential problems.

- The final report should clearly distinguish between specific advanced jurisdictions and less advanced jurisdictions in its assessments. It should also distinguish clearly between G-SIBs and D-SIBs as well as Financial Market Infrastructures (FMIs)
- It should distinguish what should be done by the Authorities, versus what should be done by the respective G-SIBs / D-SIBs / FMIs and if the incremental effort is
  - Critical to enable resolvability, or
  - Beneficial for additional or enhanced resolvability options, but not critical
- This level of granularity is important to assess the cost-benefit of additional reforms, providing clear guidance on where to invest further or where cost-benefits no longer justify further investment (or where costs might be borne by the wrong party)

3. The draft report is structured to **focus on externally observable data** that can be treated statistically. Because of this, other factors – especially non-public data – are downplayed or dismissed. This approach limits the conclusions that can be drawn, especially regarding internal bank fragmentation where external data generally does not exist. Credit Suisse would appreciate if the final report acknowledges that:
   - Local (often non-public) rules can require high and sometimes super-equivalent local resources. They can restrict the fungibility of these resources (e.g. capital, TLAC and liquidity) within a banking group.[2]
   - Resolution planning requirements which are often not codified nor public can include business restrictions, organizational changes and cross-border limitations. They can also restrict the fungibility of capital and liquidity within a banking group.
   - The complexity analysis presented in the draft report could only provide weak insight since it relied on "subsidiary counts", which are generally not a useful indicator of any recovery or resolution challenges. RRP credibility trends could provide a much more useful measure, and would also highlight the strongly positive trend of this effort.
4. **Fragmentation**: The report delivers forceful - but unwarranted - conclusions on this topic. It comments on two separate elements: cross border credit and internal bank ring-fencing.
   - The conclusion on cross-border credit excludes the significant decline of cross-border credit by European banks which is a major part the global system. We believe that this is partly caused by fragmentation pressures.
   - The report also ignores other bank services besides credit provision. For example, banks undertake important underwriting and market making services in the capital markets; however, the share of foreign banks in the world's largest capital market (the US) has declined precipitously. [3]
   - The larger issue of resource fragmentation <u>within</u> groups, especially ring-fencing and preplacement requirements remains a serious issue. It remains worthy of further FSB engagement, building on the discussion initiated by the 2019 FSB report. This

[2] For example, the recent COVID-related constraints imposed on capital repayments/dividends have typically been applied to subsidiaries as well as groups. This creates a new constraint for rebalancing internal capital.

[3] The balance sheets of the four largest foreign-owned broker dealers ("LISCC dealers"), has declined by over 80% since the GFC, while US-owned broker dealers increased somewhat in size. See Quarles, "Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision" (Jan. 17, 2020). While many factors are likely relevant, the severity and consistency of this trend suggests a common factor, such as the large burdens placed on capital-markets oriented FBOs in the US implementation of post-Crisis reforms.

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is not limited to internal TLAC alone, but should also include liquidity and capital requirements. We agree that host preplacement is a useful commitment device, but it can lead to counter-productive policy outcomes when taken to excessive levels. For these reasons, we propose that the assertions on fragmentation in the draft report be substantially reconsidered. (See Annex 1 for a further discussion.)

5. **COVID related observations**: As discussed more fully in Question 5, the COVID shock to financial markets in March and April of 2020 provided an unfortunate - but valuable - "natural experiment" that revealed how the new post-GFC regime responds to a large external shock.

   - The banking sector was resilient and retained market confidence throughout. This provides a broad validation of the GFC reforms, the reforms already provide a robust capability to withstand a severe shock at this stage, even prior to full finalization.
   - Other market participants did not perform as well; several sectors such as Money Market Funds and other vehicles appeared fragile and became forced sellers. When combined with the (now) severely limited ability of the banking sector to respond in a flexible way, markets shifted quickly into a distressed mode, with extremely high volatility and wide bid-offer spreads, even in US treasuries.
   - Central banks responded forcefully and repaired most of this damage. However, the breadth and extent of the required response suggests some shortcomings in the post-GFC reforms. We suggest that some refinements would be useful, including:
     - Refining the regulatory framework for NBFI entities, with a focus on certain types of fund vehicles, and on FMIs (especially CCPs). The post-GFC reforms have made banks safer, but also shifted considerable activity outside the regulatory perimeter. It is fair to ask whether this trade-off has made the overall system stronger – or more fragile overall.
     - Mitigating the pro-cyclical nature of certain bank regulations (such as RWA calculations and liquidity regulations). We believe that this can addressed in many areas without compromising risk sensitivity.
     - Reviewing the rules on leverage and liquidity, which unduly constrained balance sheets and exacerbated market difficulties during March/April.
     - Addressing buffer usage and stigma more forcefully so that the new regime works better in downturns, not just in the resource accumulation phase. We believe that a simpler buffer stack, with CCyB comprising a larger portion of the stack, could provide a constructive path forward.

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Responses to Specific Questions:

Question 1: Does the report draw the appropriate inferences about the extent to which TBTF reforms have achieved their objectives?

Broadly yes. Credit Suisse agrees with the broad direction of the report. However, we believe a number of jurisdictions, including Switzerland, the US and the UK, have progressed much further than would be inferred from the report.

Firstly, Credit Suisse would welcome a final report that distinguished its conclusions clearly by jurisdiction or sensible groupings. For example, it should distinguish between the large financial centers in specific developed markets (or regions), vs the developing markets.

Secondly, the report shows significant differences between G-SIBs and D-SIBs, which need to be set out more clearly in the conclusions.

Thirdly, the analysis on Financial Market Infrastructures (FMI) is welcome, but it does not adequately analyze the relative roles of bank activities and FMI activities, and the need for further progress around FMI resolution. For example, Credit Suisse is of the opinion that banks should not provide all the financial resilience on behalf of the FMIs via (highly pro-cyclical) initial margin and variation margin rules. Rather the FMI's own financial resilience (e.g. "skin in the game") should provide assurance, would reduce the current (moral hazard) mismatch between FMI management and downside (loss allocation) responsibilities. There also needs to a stronger definition of obligations of the FMI to support continuity in resolution. Given the importance of CCPs (and the requirements for banks to use them), we believe that this interface continues to warrant senior FSB attention.

Lastly, the responsibilities of the resolution authorities play an integral role in the success of the TBTF reforms. However, the report does not sufficiently analyze the progress by resolution authorities or identify the remaining gaps to be closed. For example, inefficiencies in cooperation between home and host authorities, poor understanding of resolution mechanisms, and execution details under the relevant multiple point of entry (MPE) or single point of entry (SPE) resolution regimes can fuel ring-fencing and exacerbate fragmentation. These costs fall back to banks and could make resolution more difficult. They can also shift the activity outside the regulatory perimeter. If the final report would attempt to estimate these frictional costs or identify key gaps, we believe it would improve the cost benefit trade-offs.

As the report notes, some jurisdictions have opted not to use the new resolution toolkit, even where reforms are quite advanced. If this political preference persists, it could create credibility challenges for the reforms in those countries. That, in turn, could also undermine the international level playing field when compared to banks operating in jurisdictions that are more committed to ending bailouts and where banks pay a full credit cost for their funding in the market.

Question 2: Does the report identify suitable findings for consideration by the relevant policy-making bodies?

The direction of the report is constructive, but the findings of the report should be more specific.

A great deal of information was processed, analyzed and summarized. The broad conclusion of the current report could be summarized as "a lot has been achieved, but there is a lot to be done as well". This is certainly accurate, but also far too vague in many cases. As noted under question 1,

splitting the findings into specific jurisdictions would greatly enhance effectiveness of the report. By introducing further specificity (e.g. by identifying clusters of particularly good or poor implementation), efforts could be more easily directed into the areas that most need improvements and that yield the best cost-benefit ratio.

The reforms were designed to address issues that were problematic in the 2008 financial crisis, and many elements (G-SIB surcharge, TLAC requirements) were specific to G-SIBs. The draft report unsurprisingly indicates that the speed and the implementation of the full reform package differs significantly between G-SIBs and D-SIBs.

D-SIBs also exist in different forms, which vary more widely than G-SIBs; several are organized as cooperatives or are state owned (with or without a guarantee). Resolution mechanisms designed for traditional public equity owned banks many not work as well for these for these other legal forms. In other words, some D-SIBs structures might require significant further work and/or tailored resolution strategies, but these concerns should not detract from the resolvability assessment of G-SIBs.

Total loss absorbency (TLAC) is also often vastly different between G-SIBs and D-SIBs. In the USA, for example, the US G-SIBs and the US IHC subsidiaries of foreign G-SIBs are required to carry additional bail-inable resources, but US "superregionals" have no such requirements. Some of these superregionals are many times larger than the IHCs but have no specific resources that could be deployed to support a resolution via bail-in recapitalization.[4]

Credit Suisse would therefore appreciate a clearer distinction between G-SIBs and D-SIBs in the final report, as well as the jurisdictional transparency mentioned at the top of this question.

Question 3: Are the analytical approaches used to evaluate the effects of the TBTF reforms appropriate? Are there other approaches to consider?

Data Sources: The report uses a variety of tools to assess global TBTF progress, including some methods that are inherently difficult to calibrate (such as model implied CDS prices). We suggest that the FSB should consider more direct approaches in some markets. For example, we were surprised that US bond market data was not used in the report, despite the importance and transparency of that market. The US market also provides a unique "natural experiment" since its resolution mechanism for small and mid-sized banks (FDIC) is long-standing and reliable. A simple – but direct - "TBTF premium" can thus be estimated by comparing a portfolio of large bank credit spreads vs a mid-sized peer group. This premium – which widened significantly in favor of big banks (often exceeding 100bps) vs smaller banks during the 2007-2010 period, has reversed and now large banks trade slightly wider than small banks (generally attributed to pressure from TLAC issuance requirements). This approach could be important – in part because the US sector is so large, and in part because it could provide a useful benchmark that could be tested against other markets.

SRISK: We also question the prominence given to the SRISK calculation, which can be affected by a number of market and regulatory factors. It appears to be fairly pro-cyclical, which is not helpful for such a tool, and some of the main results are suspicious. We would seriously question a model that indicated low systemic risk in the years just before 2008, but high systemic risk in 2020 - after massive capital and other reforms. Investor confidence in banks remained high in the recent episode, in contrast to their skeptical and jittery behavior in the 2007-8 period.

[4] In prior years, regional resolution often was accomplished via P&A solutions. In the current regulatory context (which places a high penalty on increased size), it is much less likely that such a solution would be forthcoming.

We would also highlight a specific flaw in SRISK. The SRISK model aims to measure the amount of capital needed to restore the system to health. This model ignores the gone-concern portion of TLAC, which is designed to address exactly that problem and which is clearly an integral part of the TBTF reforms. The report indicates that future approaches could address that gap; we would regard that as essential if this type of analysis is to be fit for purpose.

Cost- Benefit Analysis and the RWA "yardstick": A final analytical issue that we want to raise is the approach to the overall cost-benefit of the reforms. We do not question the need for reforms after the severe issues exposed in the 2008 crisis, and indeed we tried hard to be active and constructive participants in this reform. The consultation report looks to address whether the TBTF reforms have had a positive cost benefit – but it addresses only the first 59bps of capital uplift. This is only a small fraction of the overall increase in CET1 ratios. The key policy question is not whether it made sense to *start* increasing capital, but whether we have achieved a reasonable balance of social benefits and costs today. Other responses, such as the BPI response letter, address this issue more fully and we would support their comments.

We would like to add a further issue, however, which is often overlooked in these exercises. This issue is the impact of the Basel 2.5 and Basel 3 reforms, which dramatically toughened the yardstick for measuring capital, affecting both the numerator and denominator of the CET1 ratio. Analyzing cost benefit ratios without taking RWA inflation into account is like trying to measure real GDP by simply looking at nominal GDP and not adjusting for price inflation. Given the scale of the Basel reforms, a proper cost benefit calculation must take this factor into account. (see Annex II).

Question 5: The analysis was carried out before the COVID-19 pandemic, which may have produced new evidence relevant to the evaluation. Within the terms of reference, what updated analytical work would be most useful?

The COVID-19 pandemic is the first real-world "stress test" for banks subsequent to the post global financial crisis (GFC) reforms. While we are still in the early phases of this crisis, the post-GFC reforms appear to have worked effectively in the banking sector so far, and supported confidence in regulated banks.[5] This is a major achievement, and was achieved even before all the final Basel reforms were implemented.

Other areas have experienced more stress, however, and may justify more urgent further work. One important area is the effect of the post-Crisis reforms on financial markets. A number of important markets, even including US Treasuries, experienced substantial stress and breakdowns in the March/ April 2020 period.[6] It was quickly apparent that aggressive intervention by the authorities (in particular the Central Banks) was required to repair these breakdowns. Among other actions, regulatory authorities implemented a number of "forbearance" actions to reduce the effects of pro-cyclical capital rules and allow banks some balance sheet capacity to the support the markets. Overall, the Yale Tracker has identified over 1300 macro prudential actions taken since March to respond to the COVID-19 crisis. While the post-GFC regime helped ensure a far more robust banking sector, the

[5] We would also point to a recent analysis of Covas & Dionis, which reviewed bank credit spread behavior in the recent crisis to test its reaction to severe external stress; the response was consistent with a robust TBTF solution in at least the U.S. market; we expect that similar results would obtain in most of the other advanced GSIB home jurisdictions https://bpi.com/putting-too-big-to-fail-to-rest-evidence-from-market-behavior-in-the-covid-19-pandemic/

[6] See, for example, Darrell Duffie, "Still the world's safe haven? Redesigning the U.S. Treasury market after the COVID-19 crisis, Brookings, June 22 2020.

performance of the financial markets has required extensive maintenance and numerous "urgent repairs".

The massive scale and breadth of the central bank actions required showed that "rough spots" persist in the new post-GFC architecture. In the wake of the GFC, many reforms were naturally centered on augmenting bank capital and liquidity resources. Significant restrictions (including large increases in effective risk weights) were imposed, especially on market-related functions. But now that a far more robust level of resourcing has been achieved, how should bank resourcing work through the cycle? How should bank regulation interact with non-bank financial intermediaries (NBFI), with markets, and with the real economy? We believe that an FSB review of how these elements worked through the downturn is critical to ensure that the new framework works efficiently in "all seasons".

In particular, it would be useful to investigate the dynamics of the market breakdown during March-April 2020, focusing on: what refinements might best assure resilience from the non-bank participants, and what adjustments might restore an appropriate degree of balance sheet flexibility for banks. Ideally, future refinements should reduce or eliminate the need for the authorities to step in so often and so aggressively. We should use this recent "COVID stress test" to improve the trade-off between tight regulation and the benefits of a more flexible, less pro-cyclical system that does not require so many on-the-fly adjustments.

We also think it would be useful for Basel to assess the design of the buffer stack in the light of COVID crisis reactions. There have been significant concerns about the complexity and usability of some buffers, especially stigma concerns with respect to the layers that affect MDA (see BoE, 2020 financial stability report). From the reactions to the first, intense phase of the COVID shock, it appears that the size of the overall regulatory stack was ample to maintain confidence in banks, but that numerous emergency regulatory changes were required to support sufficient lending and meet market needs.

Question 6: Does the report accurately describe the ways in which TBTF reforms may affect banks' behavior and markets' responses? Are there other channels that the evaluation has not considered?

The report takes a relatively narrow view of fragmentation and dismisses evidence that it is a current problem. We strongly disagree. Fragmentation, in the form of internal resource ring fencing, does exist; today it is likely the single largest driver of market behavior within large international banks. Examples include:

- Heavy solo requirements: Subsidiarization requirements have forced many banking groups to create a number of smaller subsidiaries (UK ring-fence entities, US IHCs, Swiss domestic banks, etc.), with heavy local resourcing and governance requirements. These subsidiaries are subject to a number of solo level resource requirements and stress tests. Because these entities will naturally have a less diversified business mix (whether due to natural business objectives, geographic or regulatory requirements), stress calculations will often result in higher resourcing requirements when compared to a fully diversified banking group.

  These stress tests are used to size additional capital and liquidity buffers for many individual regulated entity (both the Parent entities and its subsidiaries). These often result in requirements that are at a premium to standalone domestic entities. For example, the effective internal TLAC

requirements for LISCC banks lie well above the 75%-90% range of the FSB standard, and also far above local G-SIBs.[7]

Such high internal requirements create major challenges in the distribution of internal resources, as we discuss further below.

- Access to central bank liquidity: Ring-fenced banks often accumulate good collateral for central bank funding, but when this is ring-fenced it is often not available for the group overall. This either increases the financial risk in the system (brittleness) or forces more leverage into large banks (with additional costs to net interest margins) because additional collateral needs to be purchased to support other parts of banking group.
- Sum-of the parts: When regulation is applied to each regulated entity within a banking group, it generally results in double counting, because inter-company exposures has to be capitalized as well as third party exposures. This effectively doubles up the capital needed to support the consolidated external risk.

  A related challenge is a new operational risk: some jurisdictions are discussing whether a parent bank would need to incorporate dividend income from its subsidiaries into its stand-alone operational risk requirements, if the subsidiary paying the dividend already recognizes in its earnings indicator the operational risk from its client activities.
- Measurement: There is no comprehensive external data that can be used to measure fragmentation externally. Only a few internal requirements are typically available in the public domain (e.g. US IHC reporting). However, there are a few areas where this issue can be inferred. For example, when analyzing the reported capital and liquidity ratios for international banking groups, it becomes evident that many banks carry substantially higher LCR and RWA ratios compared to consolidated group requirements. This is a global phenomenon, but is perhaps most visible in continental Europe where solo level regulation also exists in the home markets subjecting the parent bank to large double counts.

In order to have a better picture of the post-GFC reforms, less analyzed and academically researched areas like fragmentation needs to be considered. The FSB took some initial steps when it set standards for resource distribution with internal TLAC. But these rules are often violated in practice and the FSB has not yet addressed the distribution issues around capital and liquidity seriously. Today, we fall well short of the thoughtful framework espoused by FSB Chairman Quarles in his "Brand Your Cattle" speech (2018).

Question 7: Does the report accurately describe the remaining obstacles to the resolvability of systemically important banks (SIBs)? Are there other major obstacles that should be highlighted?

Unfortunately, no. The report should be much clearer on the remaining obstacles and issues to be addressed. This needs to distinguish banks, authorities and NBFIs (especially FMIs). In addition,

[7] While the nominal ratios are within the FSB bands, the multiple constraints of the US system produce effective overall requirements that are far above the nominal level, when applied to a capital markets-oriented IHC (such as the 4 LISCC IHCs). For example, the LISCC IHCs carry internal TLAC of roughly 130% of the FSB requirement, well above Basel's recommended 75%-90% range. We use the US example primarily because it is the only country with sufficient transparency in the public domain to perform these calculations; other countries also have rules that lead to similarly gold-plated effective requirements

given the large discrepancies identified in the report, the report also needs to distinguish between G-SIBs vs D-SIBs and distinguish among specific jurisdictions.

Credit Suisse believes that – for many of the key G-SIB jurisdictions – the key impediments to resolution have been solved and resolution has become a fully credible tool for the authorities. The level of TLAC, the legal certainty around bail-in, restructuring powers of the authorities, contractual stays and the level of preparedness of G-SIBs through their own resolution planning, makes SPE or MPE resolution strategies usable today.[8]

We strongly support the design of SPOE, and refer readers to the quote of J. Powell cited in Question 9. However, we also need to guard against supervisory and regulatory developments that can work against the grain of a single point of entry in favor of "inadvertent MPOE". Both options are legitimate if the logic is consistently applied and followed, but for SPOE to work effectively in practice as well as on paper we need to monitor the application and calibration of solo level requirements.

The final report should not shy away from calling out where there are doubts e.g. that resolution powers would be used by authorities, or that the is the political will to support resolution with market stabilizing actions like access to central bank funding with non-standard collateral, or that cooperation agreements had not been finalized. The final report should also be clear about the additional efforts that NBFIs need to make.

Question 9: Does the report accurately describe changes in the structure and behavior of SIBs? Are the findings about the extent to which these changes can be attributed to TBTF reforms appropriate?

Partially. For example, the report doesn't acknowledge some of the changes in G-SIB activities, such as the very large reduction in the market activities of G-SIBs, or the significant increase in HQLA[9]. The changes imposed by Basel 2.5 and Basel 3 (as well as other regulatory and technology changes) have forced considerable adjustments to the scale of trading positions and especially proprietary positions. While these changes reduced risks at some banks, the impact on broader financial stability (as seen in the dislocations in the spring of 2020) is more mixed.

Another element of G-SIB structure that the draft report discusses extensively is "complexity". The draft report analyses this primarily through the lens of legal entity count. Credit Suisse does not agree with such simplified view. It weights a simple asset management vehicle identically to a large operational entity that requires capital, liquidity and independent governance, and which could materially complicate a resolution or other strategic event.

The rationale for legal entities can be split into several groups:

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[8] Former RESG chair Paul Tucker is one of the very few who have spoken plainly on this issue. In a 2013 speech, he noted that "the US authorities have the technology- via Title II of Dodd-Frank…. Most US banks are… organized in a way that lends them to top-down resolution on a group wide basis… in extremis, it [resolution] could be done now. Europe has not reached the same point but, contrary to some commentary it is not far behind." In the recent FSB TBTF workshop, Sir Tucker confirmed this assessment.

[9] The large increase in HQLA is perhaps a better explanation for the graphs in Figure 14 (p45) of the draft report. The title asserts that "G-SIBs have much lower ratios of capital to assets than other banks" – although the graphs show this is not true on a risk adjusted basis (RWA). A large increase in HQLA at G-SIBs will tend to dilute Leverage Ratios, but will not affect RWA ratios much because of the very low risk weight of HQLA. We think this is an important driver and that the title of this graph is therefore somewhat misleading.

- Operating entities in our core business (generally few in number): These often exist due to regulatory requirements, such as the requirement to maintain a ring-fenced banking entity, separation of banks and broker dealers, or a local operational support subsidiary. Many of these requirements are caused by regulation, including post-crisis regulation.
- Holding companies (generally few in number): These exist for either regulatory purposes (US IHCs, future EU IPU, or Group Holding) or for tax or other funding consideration.
- Single purpose or special purpose vehicles (the vast bulk of entities): These are custom purposed entities which are facilitating specific transactions, these are unregulated and as SPVs are not widely connected to the group and financial markets. Because of their isolated structure, pose no impediment to resolution and do not create complexity in practice. Indeed, they often provide legal protection to the rest of the group.

Since legal entity count may often be driven by the last element (remote, non-strategic SPVs), an analysis based on count may not be relevant for the issue of too big to fail. If count is retained in the final analysis, the graphs and headline summaries should be re-worked to note the large (roughly 30%) decline in GSIB subsidiaries over the last decade, when consistent time series are used. [10]

A much better measure of effective complexity for this purpose is the enhanced credibility of recovery and resolution plans (RRP). The purpose of RRP is to ensure that banks can be recovered or resolved, without being jeopardized by organizational impediments such as those observed in, for example, the (very complex) Lehman or Fortis failures. The increased credibility of these plans indicates that "practical complexity" has materially declined as a practical matter.

Indeed one of the reasons these plans have become credible is the imposition of clean holding company requirements (at a global and/or intermediate level). These entities increase the subsidiary count, but simplify resolution and other critical activities in practice, because it insulates operating entities from resolution activities. For SPE banks, it ensures structural subordination of TLAC and simplifies and clarifies resolution planning.

FRB Governor Jay Powell explained it this way: *From the outset, my earlier experience had led me to be skeptical about the possibility of resolving one of the largest financial companies without destabilizing the financial system. Today's global financial institutions are of staggering size and complexity. I believed that an attempt to resolve one of these firms--a firm with multiple business lines carried out through countless legal entities, across many jurisdictions and different legal systems--could easily spin out of control. […] What changed my mind was the FDIC's innovative "single-point-of-entry" approach, which was just coming into focus in 2011.* ***This approach is a classic simplifier, making theoretically possible something that seemed impossibly complex.*** [11]

The increase in the entity count from adding a clean holding company provides a clear reduction in "practical complexity", because resolution tools can be applied without having to intervene in the operating subsidiaries at all.

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[10] We believe that the current graphs are visually misleading, because of the break in US data. The BvD data for the US (with an acknowledged, major break) should be replaced by the consistent regulatory (FRB data, see 4.4.5), which would produce a consistent approach across the time period – and produce a very different global trend line. It would show a substantial global reduction (~ 30%) in subsidiaries since 2011, and the summary description should change to acknowledge the material drop in subsidiary count.

[11] Governor J. Powell, Ending "Too Big to Fail", 4 March 2013, https://www.federalreserve.gov/newsevents/speech/powell20130304a.htm). Bolding added.

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In summary, it is important to clarify in the final report that legal entity count statistics should not be seen as evidence that the objectives of the TBTF reforms have not been achieved. RRP credibility is a much better measure for this issue.

Before we conclude, we would like to reiterate how important it is that the regulatory authorities, in consultation with the private sector, use this consultation to evaluate the effect of the financial reforms in a full and balanced manner. In particular, we suggest a focus on identifying and rectifying any unintended consequences such as the ones listed above. We believe this is critical to ensure the sustainability of the work accomplished to date to make the financial system more resilient and to make banks resolvable.

We would be happy to discuss our perspective more fully with FSB staff if this would be helpful, and appreciate the opportunity to comment on this consultation.

Yours sincerely

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Annex 1: Fragmentation:

The Executive Summary delivers emphatic – but unwarranted - conclusions on this topic:

> "Some respondents …argued that such internal TLAC requirements could drive market fragmentation. The evaluation does not support this claim. Rather internal TLAC supports orderly resolution and incentivizes coordination between home and host authorities" (draft report, p 8)

This conclusion appears to be based on two separate views of fragmentation. The main evidence cited in the report centers on whether global reforms have affected aggregate cross-border credit supply (pp 64-65). This conclusion highlights the increases in some jurisdictions and excludes the significant decline of cross-border credit by European banks, which are an important component of the global system. This analysis also ignores other bank services besides credit. For example, the size of capital markets activities undertaken by foreign banks in the world's largest capital market (the USA) has declined precipitously.[1] These activities are important – as we saw when market makers hit regulatory constraints that contributed to the dysfunction in the March -April meltdown.

The other type of fragmentation discussed is the issue of host preplacement requirements, sometimes called internal ring-fencing. In the body of the draft report (p66) there is a brief acknowledgement of the potential cost of ring-fencing and preplacement of internal TLAC - but largely as a matter of theory. The discussion then moves to dismiss "industry estimates" (developed by one of the co-signatories of this letter) as "quite unrealistic" because they assume "fully mobile capital".

- Fully mobile capital *is* possible within fully branched structures in some jurisdictions; branching provides a longstanding alternative solution to mitigate host concerns on walkaway risk.
- The ring fencing paper cited (Ervin 2017) does not ignore the question of preplacement in subsidiaries; in fact, it includes an *elaborate* discussion of preplacement vs mobility alternatives in bank structures, and what partial preplacement structures can produce more resilient outcomes that also protect hosts. We would be happy to discuss that analysis with the report's authors. The draft report ends this section without a developed conclusion, merely saying that it is "being discussed by home and host authorities and at the FSB" (p66).
- We support a balanced approach to this issue. We agree with the framework of Chairman Quarles that it is critical to balance "host certainty" with "home flexibility". But to date, the FSB has not yet progressed this initiative beyond the scoping stage.
- For these reasons, we propose that the report's conclusions on fragmentation be reconsidered, and confined to elements that can be backed up by data. The issue of ring-fencing and preplacement distribution remains a serious issue[12] and worthy of substantial direct FSB engagement, such as the discussion initiated by the 2019 FSB report.

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[1] As noted above, the balance sheets of the four largest foreign-owned broker dealers declined by over 80% in the last decade, while US owned broker dealers have generally increased in size. See Quarles, "Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision" (Jan. 17, 2020)

[12] Indeed the issue may well be greater today because of some of the additional measures undertaken in the COVID crisis. Restrictions on capital distribution/dividends that appear designed for groups also often affect subsidiaries as well. The ability to reallocate key resources among subsidiaries is fundamentally different from the issue of global resource sufficiency – but it is often captured by the same rules. This could lead to significant and unfortunate problems, if not addressed proactively.

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Annex 2: Capital Uplift from the post-GFC reforms – RWA yardstick inflation

The report substantially underestimates the massive amount of additional solvency resources (CET1, AT1 and TLAC) required by the post-Crisis Reforms. For example, the cost and benefit analysis of the TBTF reforms assumes that the reforms moved required CET1 levels up from 7.0 to 7.59 percent. (The 0.59 incorporates GSIB surcharges and leverage, and multiplies that by the fraction of bank assets at GSIBs). The required capital levels in the main GSIB jurisdictions are much higher than this assumption. Global large bank CET1 ratios are well over 12 percent, not 7.6 percent. This has significant implications for both bank safety, and for the social cost benefit analysis (the marginal benefits of increasing capital decline as capital goes up.)

Moreover this analysis (and many other analyses) ignore the dramatic tightening of RWA post crisis. A BIS working paper[13] estimated this effect as 28% (1/0.78) in 2016, even before Basel 3 was fully implemented. Because of the multiple rounds of reform and different implementation dates (and resulting portfolio shifts), it is difficult to estimate this figure precisely, but it is clearly significant. Ignoring this effect would be like ignoring price inflation when estimating real GDP.

This RWA inflation factor may well be larger for GSIBs, given the particularly large impact on market risk positions. We were able to identify two GSIBs during the transition period who showed a full comparison across different Basel measures at a single point in time. Both of these suggested larger impacts: +46% for one bank and over 100% for the other.[14] Furthermore, these estimates for the early post-GFC period do not account for the further revisions to Basel III adopted in more recent years. The EBA estimated that the average impact for large European banks was roughly 15%.[15] If we assume that this 15% estimate is roughly correct and add it to the earlier uplift estimate of 28%, the combined impact of tougher RWA capital standards rises to 47% total uplift.

The change in RWA standards was a core post-GFC reform priority and dramatically tightened effective capital requirements. These effects are often ignored, but are critical for many analyses. They clearly affect the optimal level of capital and the underlying cost-benefit analysis (for example they would change the 59bp increase used in the cost benefit analysis to 272 bps, if just the 28% increase estimated by the BIS WP in 2016 was used against the 7.59% figure of the draft paper). If applied to the overall amount of current capital levels the effect would be much larger still. In sum, the overall amount of bank strengthening is even more substantial when this factor is included. This should clearly affect the cost-benefit analysis; we recommend that the report factor this element into their analysis in a more holistic fashion, since it affects many underlying analyses and trends.

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[13] See BIS Working Paper 591, "Adding it all up: the macroeconomic impact of Basel III and outstanding reform issues", by Ingo Fender and Ulf Lewrick, p5 at https://www.bis.org/publ/work591.pdf

[14] Citibank's 2012 annual report disclosure implies a 46% uplift between Basel 1 Tier1 common ratios (12.7%) and the Basel III CET1/ RWA ratio (8.7%) at year end 2012 (see p43 of https://www.citigroup.com/citi/investor/quarterly/2013/ar12c_en.pdf?ieNocache=988. UBS's 2012 annual report suggests an even larger effect between Basel 2 and Basel III. (see pp 174-5 of https://www.ubs.com/content/dam/static/epaper/pdf/Annual%20Report%202012%20-%20en.pdf). The text indicates a Tier 1 ratio uplift of between B2 and B2.5 of 23.3% (as at 12/2011) and a further B3 vs B2.5 uplift of 94% (at 2012), for a cumulative increase of 139%. While these 2 institutions may not provide a comprehensive guide to the impact of the reforms at GSIBs, they suggest that the BIS estimate of 28% inflation may well understate the impact for GSIBs (perhaps due to higher markets activity; the tightening of market risk RWA was particularly acute).

[15] See McKinsey analysis, https://www.mckinsey.com/business-functions/risk/our-insights/basel-iii-the-final-regulatory-standard#