June 15, 2011

The Honorable Timothy F. Geithner,
Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Ben S. Bernanke,
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

The Honorable Sheila C. Bair,
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Mr. John G. Walsh,
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Re: Application of Surcharges to Systemically Important Financial Institutions in the United States

Dear Sir or Madam:

The Clearing House Association L.L.C. ("**TCH**"), an association of major commercial banks,[1] is deeply interested in U.S. and international initiatives to reform capital and liquidity regulation and, more broadly, in the overall debate over financial institution regulatory and resolution reform.[2] In this regard, we are writing to express concern with respect to the direction and the potential application of a capital surcharge to systemically important financial institutions ("**SIFIs**")[3] in the U.S., in the context of both the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the ongoing international cooperative efforts under the auspices of the Financial Stability Board (the "**FSB**") and the Basel Committee on Banking Supervision (the "**Basel Committee**").

Public statements from the academic and official sectors have included consideration of the imposition of a significant capital surcharge on some U.S. banking institutions[4] in an amount potentially as large as 100% of the combined Common Equity Tier 1 ("**CET1**") ratio (minimum plus macroprudential conservation buffer) required under the Basel Committee's recently finalized global capital and liquidity standards commonly referred to as "**Basel III**."[5] Because banking institutions are likely to maintain some "cushion" above required regulatory ratios to offset unexpected developments (and to accommodate the volatility introduced by Basel III's requirement that accumulated other comprehensive income ("**AOCI**") not be filtered out of Tier 1 capital calculations), as a practical matter, banks will maintain CET1 ratios at levels that exceed the amount required to satisfy the required effective CET1 ratio plus any applicable surcharge for SIFIs.

To be clear, TCH strongly supports ongoing regulatory reform efforts that aim to make the U.S. and international financial systems safer and more robust—both from a firm-specific microprudential and, to the extent applicable in the context of a particular firm, a broader systemic

macroprudential risk perspective. As a key element of enhanced regulation, TCH supports strong capital and liquidity ratios and the U.S. bank regulatory agencies' objectives of minimizing systemic risk and preventing future financial crises. We believe that the financial crisis demonstrated a direct correlation between the risk of failure and the level of a bank's capital. That correlation, however, was most evident with banks that maintained capital levels *far below* the more strongly capitalized banks.

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

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

I. Executive Summary

As further detailed in this letter, TCH believes:

- A decision to impose a capital surcharge on U.S. SIFIs must be informed by the robust increase in capital levels already mandated by Basel III (and Basel II.5). As a result of the imposition of Basel III's quantitative, qualitative and risk-weighting requirements, the 7% minimum combined CET1 ratio under Basel III is nearly *triple* the amount of Tier 1 common equity currently required by the U.S. banking agencies for an institution to meet the "well-capitalized" requirements under their prompt corrective action regulations (that is, an implicit 4.5% Tier 1 common equity requirement under those regulations[6] compared to a 13% Tier 1 common requirement, which approximately equates to a 7% CET1 ratio under Basel III).

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

- The marginal utility of significant capital surcharges for SIFIs is minimal at best because the Basel III requirements, including the capital conservation buffer, in and of themselves would very likely be effective in preventing both microprudential risks to financial institutions and macroprudential risks to the global economy.

- Capital stringency should be evaluated in the context of the entire framework of capital regulation, including Basel II, the market-risk rule revisions in Basel II.5 and possible differences in the application of parts of the Basel III standards to SIFIs and other large banks versus the banking industry as a whole.

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

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

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

II. Key Issues

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

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

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

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

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

- various requirements that significantly increase the risk weights of derivative exposures not cleared with central counterparties.

In addition, shortly before Basel III was proposed, Basel II.5[7] substantially revised the capital treatment of assets held in the trading book, imposing several new, overlapping risk-measurement requirements and, in the process, significantly increasing the capital charge associated with the trading book.

The new Basel III requirements will translate into a CET1 requirement of approximately $1.0 to $1.1 trillion of common equity for U.S. banking institutions in the aggregate.[8] This represents a *greater than 100%* increase from the approximately $450-$500 billion of common equity at December 31, 2007. Moreover, it is quite unlikely, due to prudential, regulatory and market pressures, that banking institutions will choose to operate at the effective minimum CET1 ratio required under Basel III. In addition, AOCI volatility serves to increase effective capital needs.[9] Under current regulatory reporting practice in the United States, unrealized gains and losses are "filtered out" from the calculation of Tier 1 capital. Under Basel III, they would no longer be. Including unrealized gains and losses when calculating the minimum required ratios and buffers under Basel III can introduce substantial volatility into a banking institution's capital ratios. Many of these securities may be classified as "available for sale," and, as a consequence, increase the volatility of these institutions' capital. As such, a more realistic estimate is that Basel III (before any SIFI surcharge) will actually require an aggregate of almost $1.2 *trillion* of common equity for the U.S. banking industry as a whole. In terms of ratios, the increase is even sharper. For example, the new 7% Basel III CET1 requirement, as indicated above, is equivalent to a Tier 1 common equity ratio of approximately 13% under the current Basel I rules.[10]

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

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

The Dodd-Frank Act introduced a number of reforms specifically intended to implement the lessons learned from the financial crisis and to eliminate various perceived sources of macroprudential systemic risk, including prohibitions and restrictions on certain financial activities,[11]

orderly-liquidation authority,[12] living wills,[13] regular stress tests,[14] concentration limits on expansions,[15] the migration to centrally cleared swaps,[16] the ability to require the prudential supervision of systemically important non-bank financial entities,[17] improvements to the securitization markets (including enhanced disclosures and risk retention requirements),[18] reforms of the credit rating agencies[19] and the establishment of the Financial Stability Oversight Council to coordinate detection and response to systemic risks.[20] To date, most of these reforms have not been broadly adopted by other countries, and it remains uncertain whether they will in the future. The Dodd-Frank Act goes a long way to minimize systemic risks even in the absence of a SIFI capital surcharge. As such, we strongly believe that these other systemic reforms should be taken into account when examining the issue of a U.S. SIFI surcharge.

We agree that meaningful reform must address the "risk of *disorderly failure* of SIFIs".[21] The issue is not any failure of a SIFI *per se*, but a disorderly failure. Accordingly, a pillar of regulatory reform should be the development of a system and related measures that assure that any failure of a SIFI is orderly rather than disorderly. We believe that efforts to enhance resolution regimes such as the orderly-liquidation authority in Title II of the Dodd-Frank Act provide a comprehensive and considered structure to guard against disorderly failures and should be taken into account when examining the nature and extent of a SIFI surcharge.

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

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

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

In analyzing the performance of banks during the recent financial crisis, McKinsey examined data concerning 124 banks worldwide with more than $68 trillion in assets in the aggregate. The study determined that no institution that entered the 2007-2009 crisis with a CET1 ratio (calculated in accordance with Basel III rules) greater than approximately 6.25% (that is, 75 basis points lower than the Basel III minimum and 150 basis points lower than where firms are likely to operate) failed, was

placed into governmental receivership, was acquired under duress by another financial institution or received a substantial, individually-directed governmental capital investment.[22]

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

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

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

1. A significant SIFI surcharge creates a meaningful risk of economic cost.

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

Although these potential negative economic effects are present in connection with increased bank-capital requirements in general, and are not unique to the imposition of a significant capital surcharge, they are most likely to occur in connection with "marginal" capital requirements (that

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

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

First, in contrast to what some proponents of a significant SIFI surcharge have posited, there is substantial uncertainty as to whether smaller banking institutions would be able to fulfill the credit needs that SIFIs no longer can due to higher capital requirements as described above. Furthermore, many of these smaller institutions in the U.S. continue to struggle with their own asset quality problems and need to raise additional capital.[28] The availability of these activities as a service to customers (whether a credit product or another service) will thus diminish or shift to "shadow" entities outside not just regulatory capital requirements, including the SIFI surcharge, but are outside the broad framework of prudential regulation entirely.

Even if the shadow banking system could conceivably fill any unmet credit needs, in view of the shadow banking system's role in lowering credit standards during the last decade[29] and the absence of regulation and transparency, a migration to that system, even if it occurred, would have negative implications for the macroprudential health of the financial system as a whole.[30] In addition, the shadow banking system can exhibit volatile and intermittent flows compared with the traditional banking system's credit intermediation function, and this lack of reliability as a source of funding would subject borrowers to marketplace vagaries, often at the time of greatest need. Contrary to the objective of a SIFI surcharge, neither of these outcomes is likely to decrease systemic risk, and each may in fact contribute to it.

Second, proponents of significant SIFI surcharges have also argued that, as a result of higher capital requirements, investors will accept lower rates of return and thus offset the decreased ROE that will likely result from having to hold additional capital.[31] We believe that the theory of lower leverage leading investors to require lower ROE from banking institutions is unlikely to hold true in practice. For equity investors to be willing to accept lower returns for holding a banking institution's equity, they would need to conclude that, as a result of holding more capital, the firm's level of risk had lessened by an offsetting amount that warrants lower returns. Such a conclusion appears unlikely to be true. Moreover, in the experience of our members, equity investors, whether in banking institutions or other types of entities that compete for investable funds, are not low ROE investors. If these investors wanted to lower the expected return of their investment portfolios in exchange for a reduced risk of

loss, there are a variety of bond and other fixed-income products that would allow them easily to accomplish this result more effectively.

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

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

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

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

Although the Basel III capital requirements are subject to a prolonged phase-in provision (from January 1, 2013 to January 1, 2019) and the U.S. banking agencies are just now in the process of drafting their proposed regulations implementing Basel III, for all practical purposes Basel III is already fully effective for U.S. SIFIs as a result of the Temporary Addendum as discussed above. The Federal Reserve stated in the Temporary Addendum that it expects banking institutions to "demonstrate with great assurance that they could achieve the ratios required by the Basel III framework, inclusive of any proposed dividend increases or other capital distributions, as those ratios come into effect in the United States." It is obviously very difficult for a bank to be in the position of not increasing its dividends or engaging in expansion transactions for a number of years. In addition, even in the absence of such regulatory incentives, investor and market expectations have tended to internalize higher Basel III-based

capital expectations immediately in evaluating firms irrespective of formal transition periods.[34] We see no reason to conclude that the same would not occur in connection with a significant SIFI surcharge.

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

As even most proponents of a SIFI surcharge readily acknowledge, there are significant uncertainties and open questions regarding the analytical underpinnings and proper calculation of any SIFI surcharge. For example, the three analytical lines of inquiry the Federal Reserve appears to be pursuing in connection with the creation of a SIFI surcharge[35] seem to produce a wide range of results depending on which assumptions are selected. The empirical measurement of systemic importance is in its infancy and academic commentators pursuing this research regularly caution against directly adopting their work as part of a regulatory framework.[36] There has been limited research regarding capital surcharges affecting only the largest institutions. The majority of research focuses on the impact of Basel III or system-wide optimal capital levels. In addition, societal benefits of large financial institutions have not been analyzed thoroughly.[37] Finally, and perhaps most significantly, the full potential combined impact of the current financial-services regulatory reforms in the U.S., including the Dodd-Frank Act, Basel III and the contemplated significant SIFI surcharge, has not yet been fully analyzed, as public sector officials have acknowledged.[38] The cumulative effects of these complex rules, with their web of potentially unknown interrelationships, could very well have economic costs and other unintended consequences and risks that are not readily apparent.

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

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

There is considerable evidence that there are meaningful scale and scope advantages to large banking institutions.[39] A generation of banking mergers suggests that there are substantial cost synergies available to larger institutions. Moreover, there is a strong *a priori* case for expecting such cost synergies, given the high and increasing fixed costs to which financial institutions are subject.

Indeed, this may not even be the most relevant question. Even if banks themselves do not benefit from increased size and scope, it would appear that a number of their customers do benefit. We are not aware of any definitive research that challenges the existence of such benefits.[40]

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

An asserted rationale for imposing a SIFI-capital surcharge is based on the cost of a SIFI failure to other institutions, the underlying premise that firms do not have an incentive to, and have not,

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

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

In addition, the systemic impact of an institution's failure will vary based upon a number of factors, including notably the interconnectedness of the institution with the rest of the financial system.[41] Any SIFI surcharge must be properly calibrated to account for the differences in true systemic risk posed by different institutions.

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

Even accepting, as a theoretical and very simplistic matter, that more capital will reduce the risk of failure and the losses of creditors if failure occurs, that cannot be the ultimate analysis. The appropriate analysis, which is far more complex, incorporates two basic questions which require the most thoughtful consideration: to what extent are the risk of failure and losses reduced by marginal capital requirements; and how does any such value relate to the risk of an adverse impact on banks' ability to issue capital and their competitive position, the impact on borrowers in terms of credit availability and cost, and the effect on the broader economy. Significant surcharges should not be imposed until those questions are satisfactorily answered.

* * *

If you have any questions, or need further information, please contact Paul Saltzman, President and General Counsel of TCH, at (212) 613-0318 (e-mail: paul.saltzman@theclearinghouse.org), Joseph Alexander, Senior Vice President and Deputy General Counsel of TCH, at (212) 612-9234 (e-mail: joe.alexander@theclearinghouse.org) or Eli Peterson, Vice President and Regulatory Counsel of TCH, at (202) 649-4602 (email: eli.peterson@theclearinghouse.org).

Respectfully submitted,

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The Clearing House Association and Payments Company

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

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

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

The Honorable Spencer Bachus
Chairman
House Committee on Financial Services

The Honorable Barney Frank
Ranking Member
House Committee on Financial Services

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

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

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

The Honorable Daniel K. Tarullo
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The Honorable Gene Sperling
Director
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The Honorable Neal Wolin
Deputy Secretary
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The Honorable Jeffrey A. Goldstein
Under Secretary of the Treasury for Domestic Finance
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The Honorable Martin J. Gruenberg
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Mr. Nout Wellink
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Basel Committee on Banking Supervision

Mr. Adair Turner
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Mr. Thomas Huertas
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ENDNOTES

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

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

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

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

[5] *See* Basel Committee on Banking Supervision, Bank for International Settlements, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010) ("**Basel III—A Global Framework**").

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

[7] "**Basel II.5**," as used in this letter, refers to revisions set forth in the Basel Committee's June 2009 publication, *Revisions to the Basel II Market Risk Framework and Guidelines for Computing Capital for Incremental Risk in the Trading Book*, in its July 2009 publication, *Enhancements to Basel II Framework*, and in its February 2011 publication, *Revisions to the Basel II Market Risk Framework—Updated as of 31 December 2010*. The U.S. banking agencies published a joint notice of rulemaking earlier this year (76 Fed. Reg. 1890 (Jan. 11, 2011)) addressing the U.S. implementation of Basel II.5. The comment period expired on April 11, 2011, and implementation is expected by year-end.

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

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

[10] See pages A-1 through A-5 of **Annex A** attached hereto for further information.

[11] *See* Sections 619 and 716 of the Dodd Frank Act.

[12] *See* Title II of the Dodd-Frank Act.

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

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

[15] *See* Title VI of the Dodd-Frank Act.

[16] *See* Title VII of the Dodd-Frank Act.

[17] *See* Section 113 of the Dodd-Frank Act.

[18] *See* Subtitle D of Title IX of the Dodd-Frank Act.

[19] *See* Subtitle C of Title IX of the Dodd-Frank Act.

[20] *See* Subtitle A of Title I of the Dodd-Frank Act.

[21] Daniel K. Tarullo, Remarks at the Peter G. Peterson Institute for International Economics, Washington, D.C. (June 3, 2011) (transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm) (emphasis added).

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

[23] See page A-12 of **Annex A** for additional information concerning this preliminary assessment.

[24] *See* Basel Committee on Banking Supervision, Bank for International Settlements, *Guidance for National Authorities Operating the Countercyclical Capital Buffer* (Dec. 2010).

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

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

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

[28] *See* Federal Deposit Insurance Corporation, *Quarterly Banking Profile: First Quarter 2011* (May 2011), at 3, http://www2.fdic.gov/qbp/2011mar/qbp.pdf.

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

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

[31] *See, e.g.*, David Miles, Jing Yang and Gilberto Marcheggiano, *Optimal Bank Capital*, Discussion Paper No. 31: Revised and Expanded Version, at 9, 10 (Apr. 2011), http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031revised.pdf; Myths in the Discussion of Capital Regulation, *supra* endnote 27, at i.

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

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

[34] *Cf.* The BIS Macroeconomic Impact Assessment, *supra* endnote 27, at 38 (noting that some private sector analysts have predicted that "once supervisors announce the parameters for capital requirements, markets are likely to press banks to achieve these ratios rapidly regardless of the official implementation date").

[35] *See* Daniel K. Tarullo, Remarks at the Peter G. Peterson Institute for International Economics, Washington, D.C. (June 3, 2011) (transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm) (discussing three different approaches to calibration, including the "expected impact" approach, "long-run economic impact" approach and the approach that tries to determine how much additional capital would be needed "to offset any reduction in funding costs associated with the perceived too-big-to-fail status of SIFIs"). In addition, TCH would caution against basing a SIFI surcharge on risk-weighted assets given jurisdictional differences in the calculation of risk-weighted assets and the risk that U.S. banking institutions would be disadvantaged by these differences.

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

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

[38] *See* Chairman Bernanke, Remarks at a Question and Answer Session Following Chairman Bernanke's Speech on the U.S. Economic Outlook (June 7, 2011) (transcript available at http://video.cnbc.com/gallery/?video=3000026289) (noting that no one had yet done an analysis of the impact of the recent financial reform on credit and stating, "It's just too complicated. We don't really have the quantitative tools to do that.").

[39] As discussed in additional detail in endnote 2, TCH has retained McKinsey to study the economic and social benefits attributable to larger financial institutions.

[40] Another benefit of SIFIs is their capacity to acquire larger troubled institutions and thereby prevent the otherwise self-fulfilling prophecy of proponents of large surcharges.

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

ANNEX A

Contents

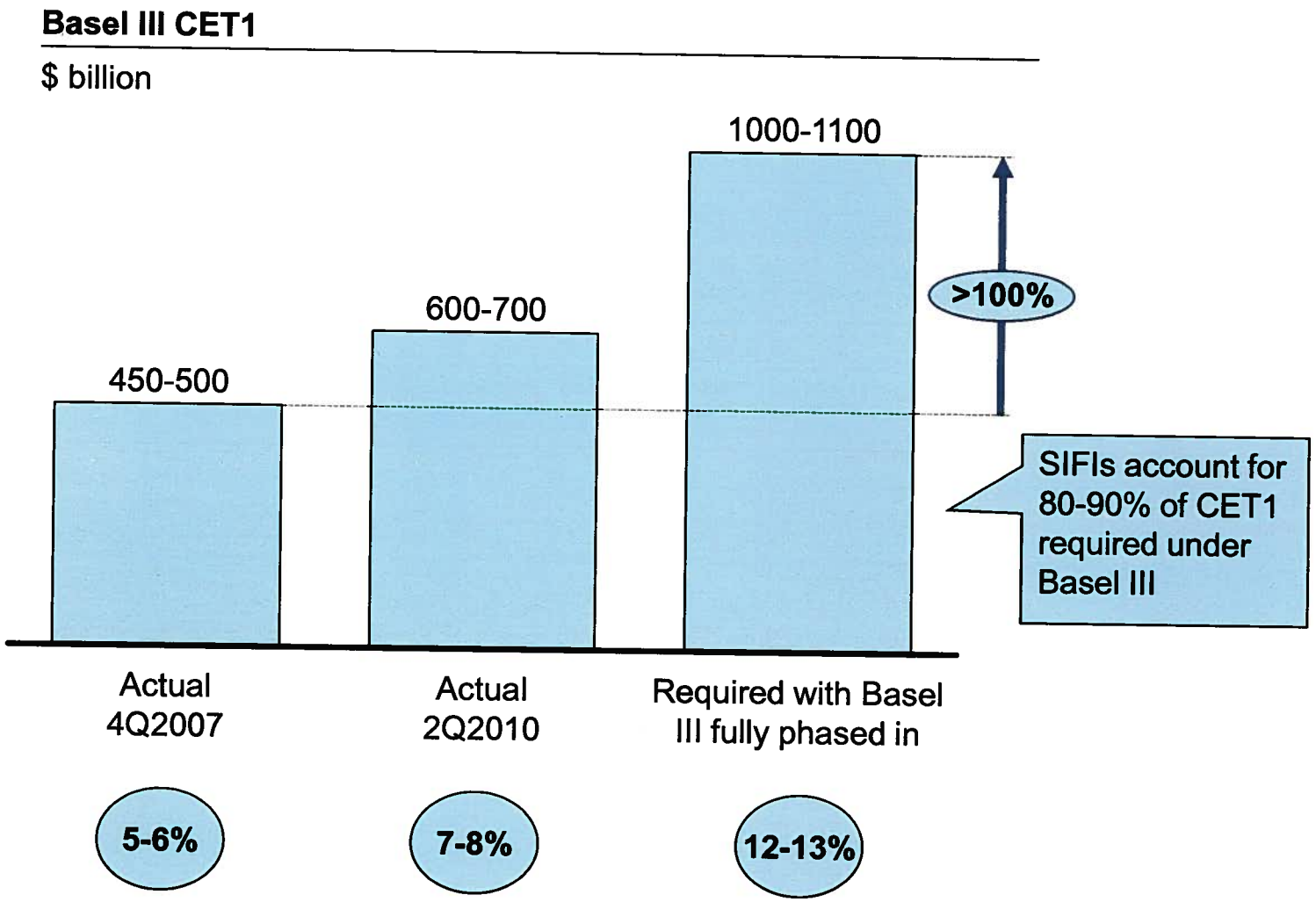
This report is based on results from the 11 US based participating banks, which account for 59% of total US banking assets

Banks for whom we have capital & liquidity data

Total assets USD billions (% of US market)	9,363 (59%)

SOURCE: BHCPR assets data from 2009 Q4

Relative to pre-crisis levels, Basel III requires US banks in aggregate to hold over 100% more common equity relative to pre-crisis levels of capital

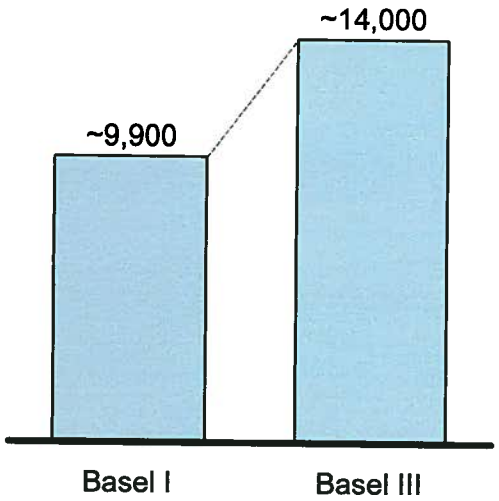


SOURCE: TCH QIS6 member data, SNL

How we estimate that Basel III is equivalent to 12-13% capital under Basel I

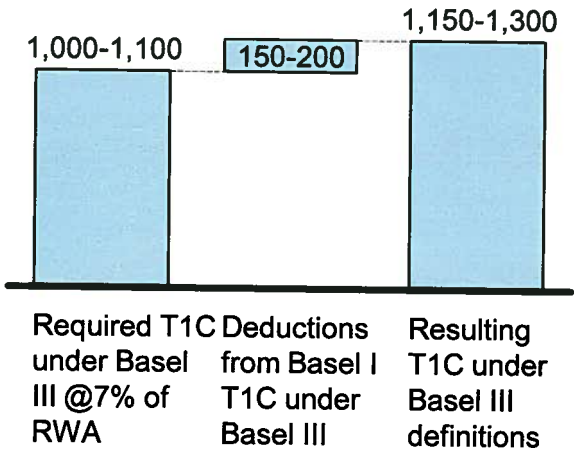
Tier 1 common equity and RWA under Basel I and Basel III

Industry RWA
$ billions, as of 6/30/2010



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

Industry Tier 1 common capital
$ billions, as of 6/30/2010



The $1,000-1,100 of required T1C under Basel III equates to $1,150-$1,300 once Basel III deductions from T1C are removed

Capital ratio calculations

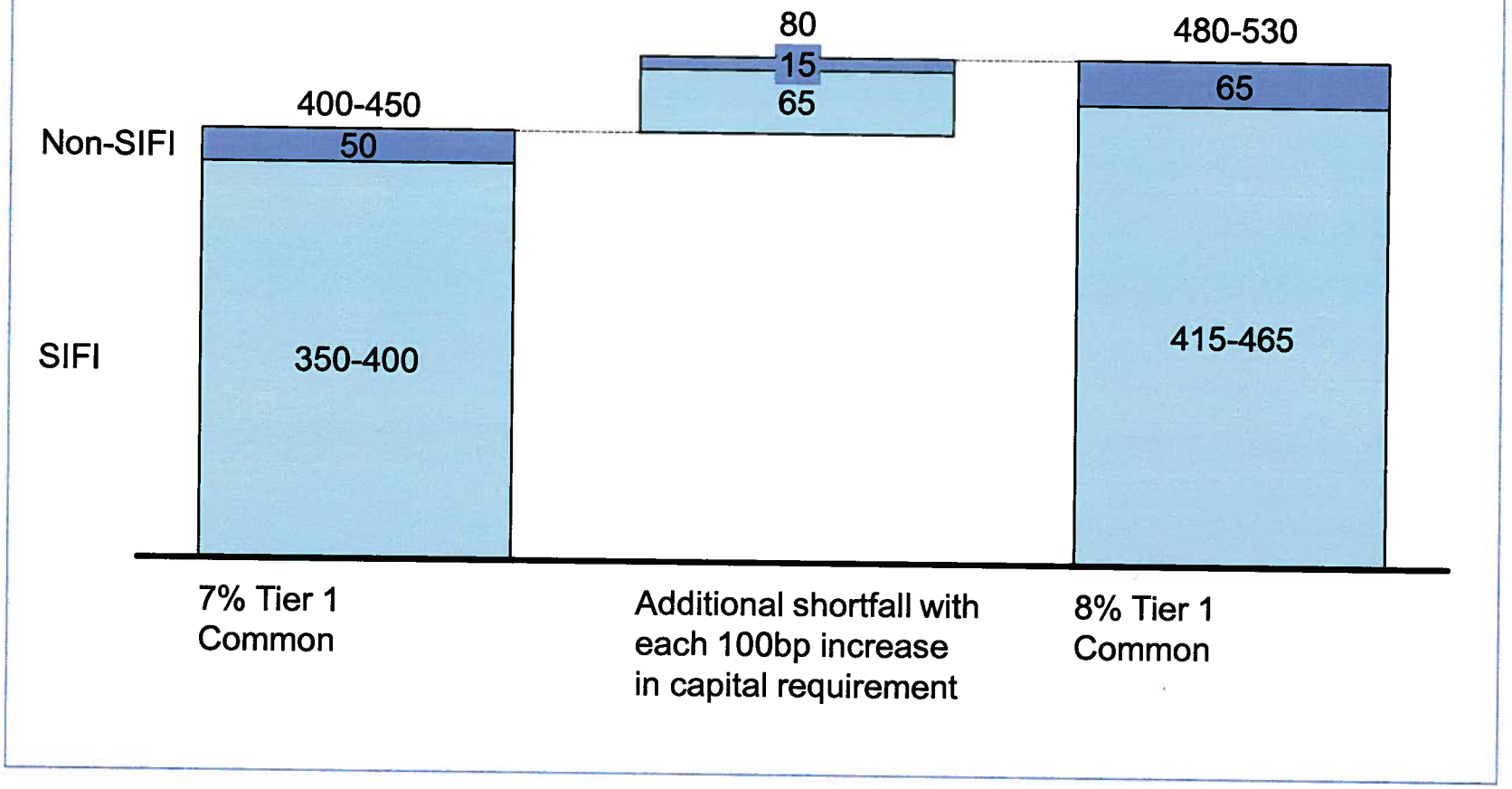
Basel III CET1 (adjusted) as % of Basel I RWA
= Basel III T1C with deductions / Basel I RWA
= 1,150/9,900
= 12%

= 1,300/9,900
= 13%

SOURCE: TCH QIS6 member data; SNL

For US banks, each additional percentage point of capital requirement increases required T1C by ~$80 billion

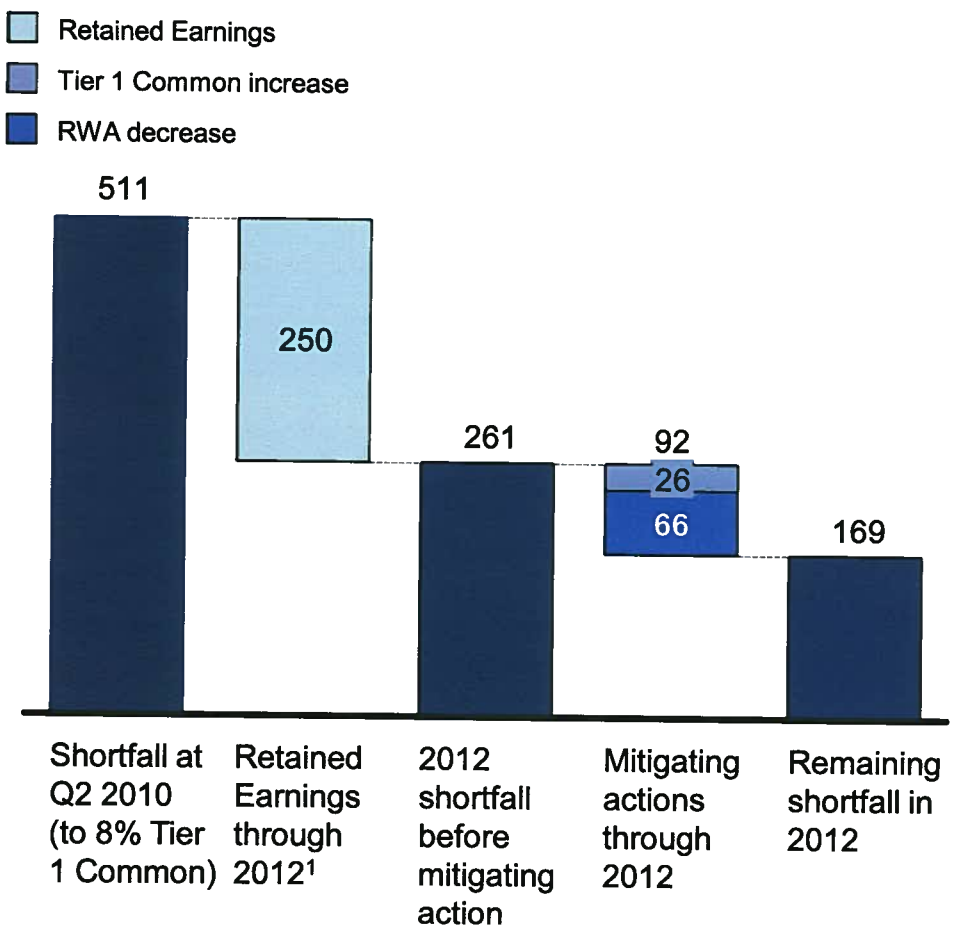
Capital shortfall estimates for US banking industry, $ billions



SOURCE: TCH QIS6 member data, SNL

Banks indicate that they are likely to reduce their Tier 1 Common shortfall in part through asset sales and RWA reductions

Tier 1 Common shortfall in 2012 after RWA reduction, asset sales and retained earnings
USD billion



- **Banks indicate that they may reduce their Tier 1 common shortfall to Basel III requirements, in part by reducing RWA** ($821 billion in RWA; $66 billion in capital at 8% Tier 1 Common ratio) and **increasing Tier 1 Common** through asset sales ($26 billion)
- **Banks may reduce RWA and assets using measures such as:**
  - Winding down existing portfolios, as many banks have publically announced
  - Decreases in low rated securitization in the trading book (and rating "unrated" securities)
  - Decrease in certain businesses, including correlation trading, sub-prime retail (e.g., credit cards)
- **Increases in Tier 1 Common may include:**
  - Sales of unconsolidated financial subsidiaries
  - DTA realization of net operating losses
  - Sales of MSRs above the 10%/15% cap

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

Contents

Methodology for analyzing the relationship between pre-crisis bank capital ratios and the likelihood of a bank going into distress

Approach

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

Banks in sample

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

Definition of distress

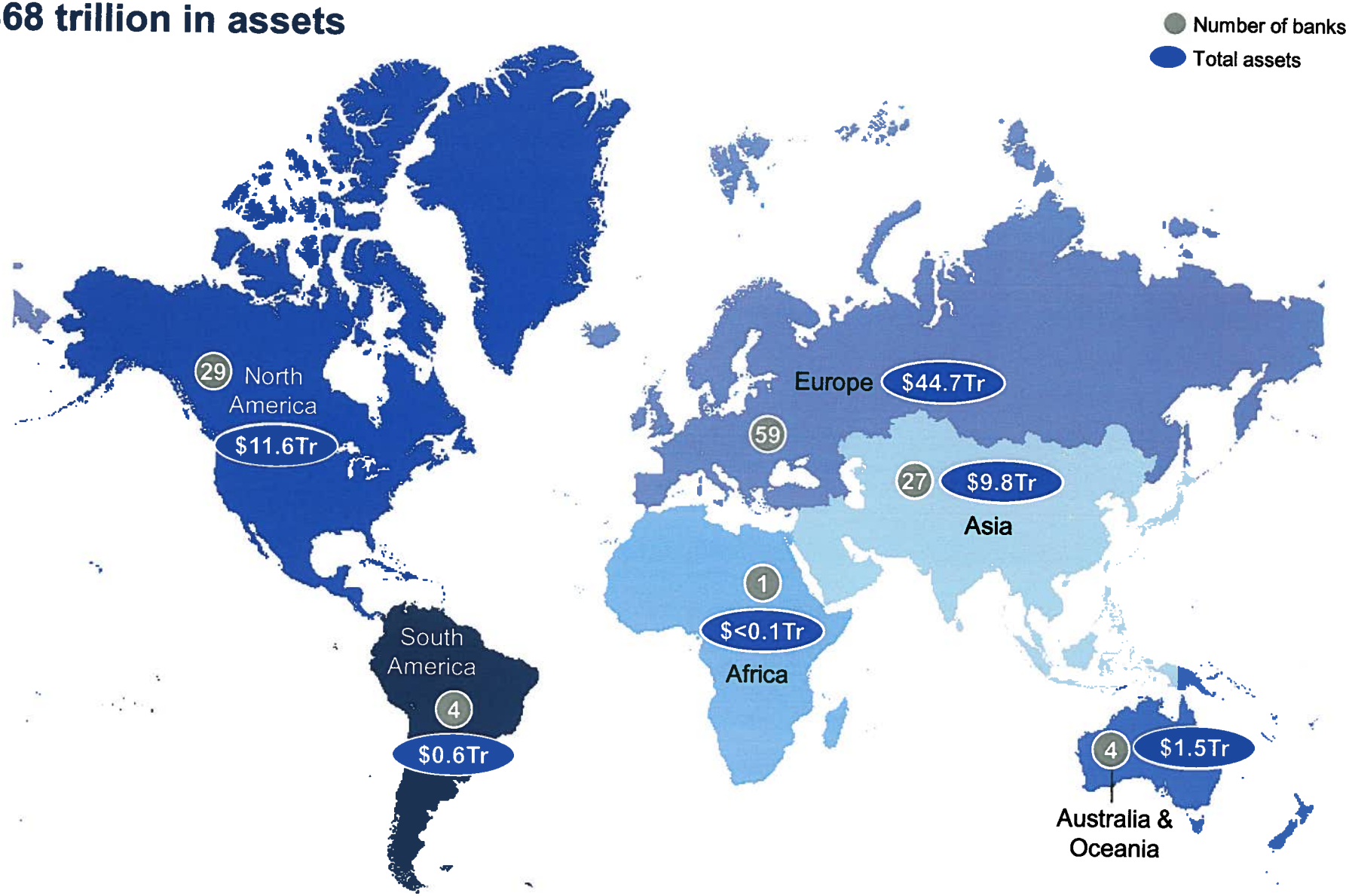
- An institution is defined as distressed if any of the following conditions was met 2007-09:
  1. Bankruptcy
  2. Government takeover or placement into government conservatorship
  3. Merger under duress with another bank
  4. Receipt of a substantial direct government capital investment or bailout[1]
- Using the above definition, a total of 28 banks were deemed distressed (23% of banks in the sample, covering 30% of the assets)

Adjustments for Basel III

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

1 Defined as total government capital investment greater than 30% of the bank's starting Tier 1 capital as of December 31, 2007

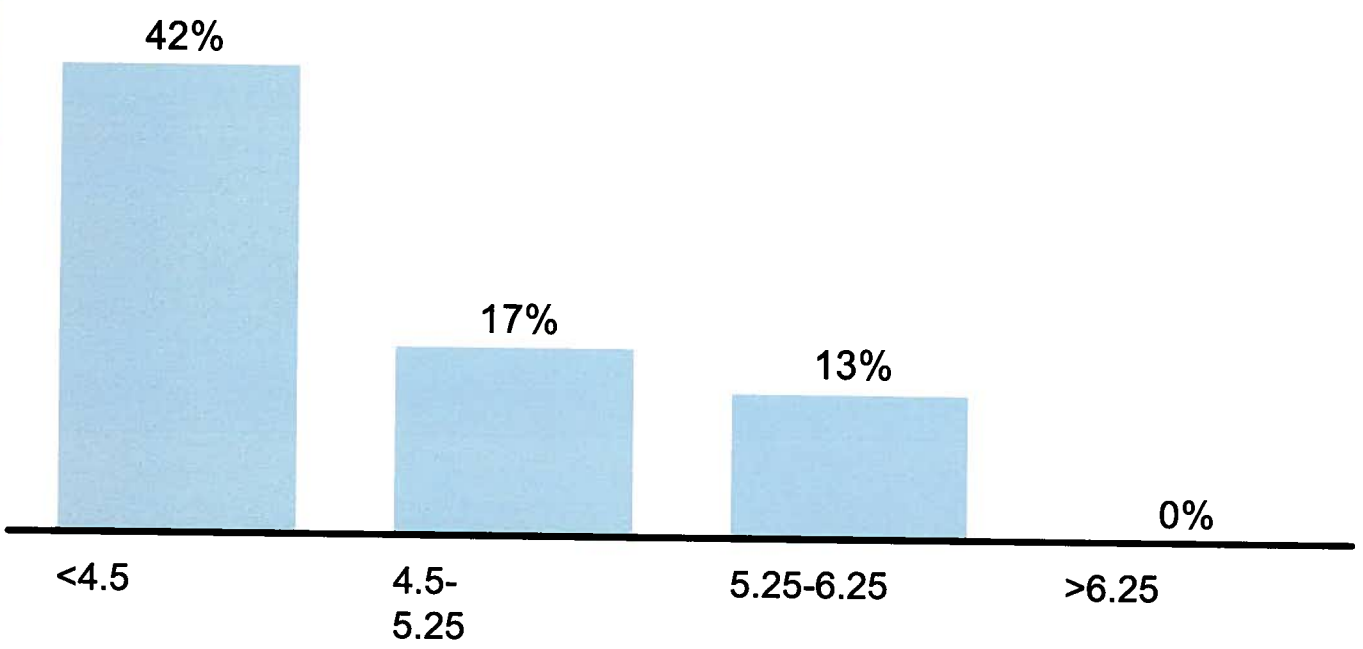
The sample includes 124 banks worldwide, with more than $68 trillion in assets



Measured under Basel III definitions, no bank with a Basel III common equity to RWA over 6.25% experienced distress

PRELIMINARY

Likelihood of Distress vs. Starting Capital Ratio, Percent



Bins chosen to have approximately equal number of banks per bin
SOURCE: Company 10Ks, regulatory filings, team analysis

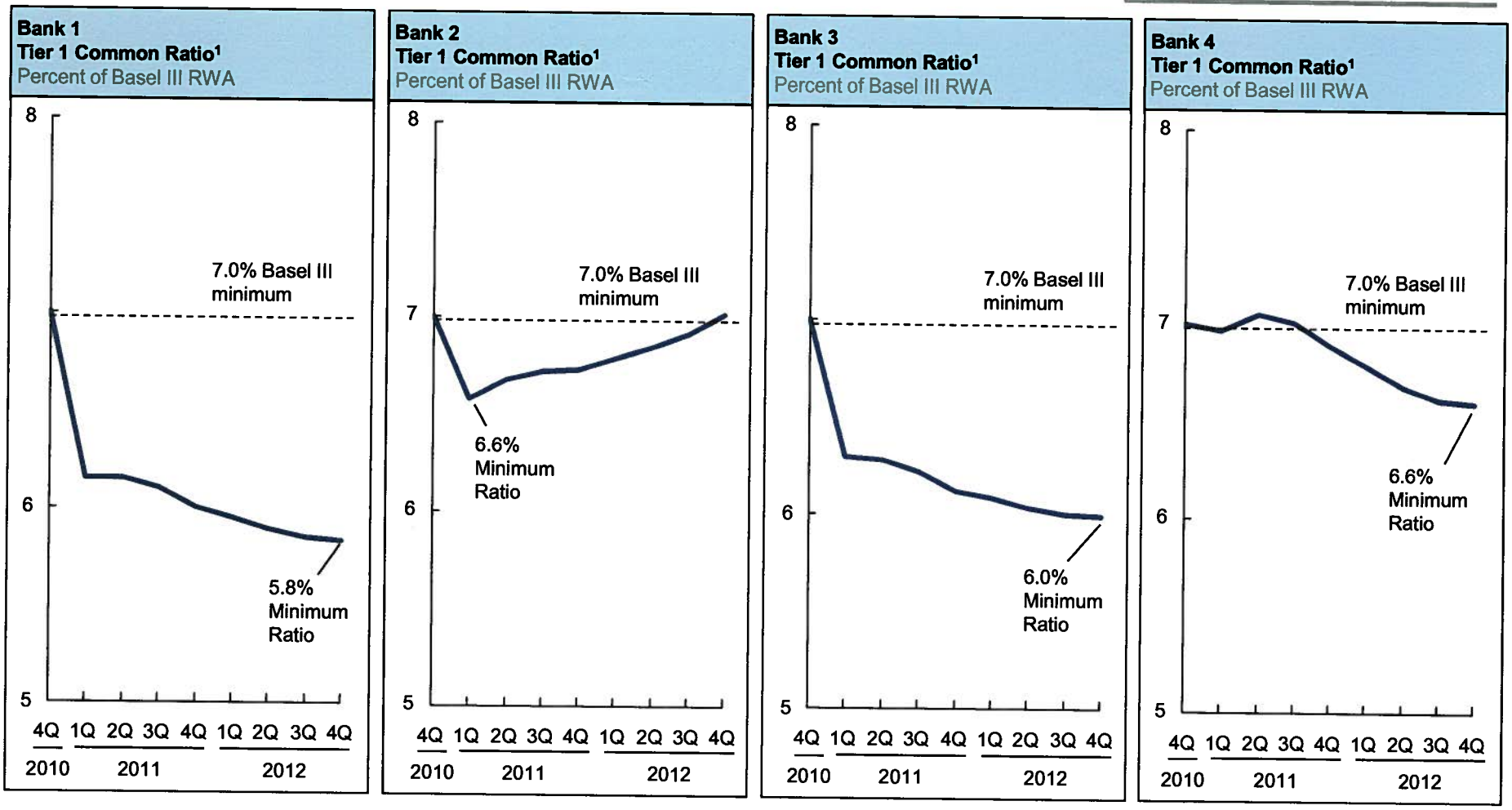
Questions to be answered through additional work

PRELIMINARY

Questions	Additional work to do
1 *Even if some banks didn't fail, how much capital was depleted and how close were they to distress?*	Analyze capital ratios over time for surviving firms, measure how much they fell, and how does this compare to the Basel III minimums today including the capital conservation and countercyclical buffers
2 *For failed banks, how much more capital did they need?*	Analyze capital ratios and estimated losses over time for distressed/failed firms during the 2007-09 period, and how does this compare to the Basel III minimums today including the capital conservation and countercyclical buffers
3 *Even if capital ratios didn't fall much during the crisis, what about future stresses?*	Analyze performance of current portfolio and how much capital ratios would fall given hypothetical stress events, and how this compares to Basel III minimums including the capital conservation and countercyclical buffers

Initial stress test analysis: based on publicly available US S-CAP results, the top 4 US banks see estimated reductions of at most 1.2% of CET1

ALL NUMBERS PRELIMINARY



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

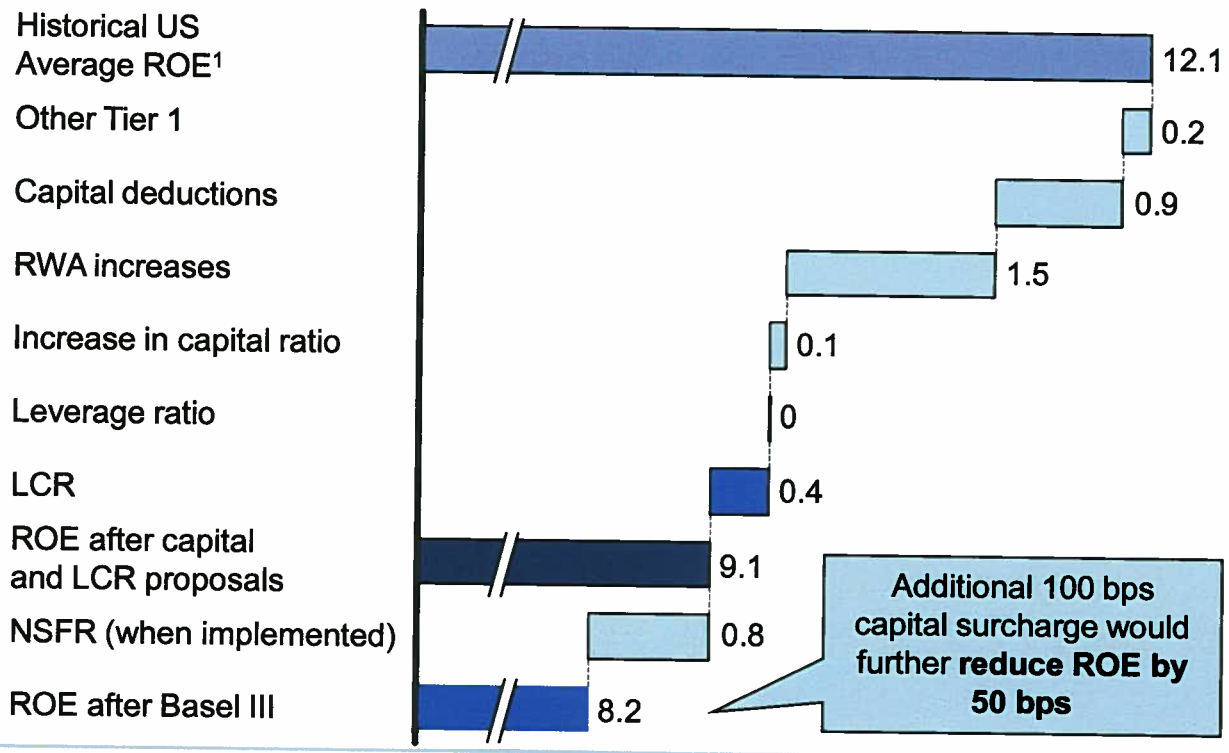
SOURCE: Federal Reserve Supervisory Capital Adequacy Assessment Program, May 2009

Contents

- Impact of Basel III capital requirements
- Assessing capital needs from crisis experience
- **Impact on returns and cost of equity**

The capital and liquidity proposals could reduce RoE by 300-390 bps, depending on implementation of the NSFR

ROE impact of Basel III capital and liquidity proposals
Percentage points



Other potential changes not included in modeling

- Living wills
- "Volcker rule"
- Central clearing of OTC derivatives
- Bank taxes/levies
- Accounting
- Consumer protection
- …

- Key **question as to where the incidence** of regulatory changes **will fall**; i.e.,
  - **On customers**, through higher loan pricing
  - **On banks**, through cost reduction (e.g., compensation, consolidation among small banks)
  - **On shareholders**
- Analysis does not consider likely business model changes
- Even in an environment where banks are better capitalized and more liquid, the reduction in return on equity will likely be greater than the reduction in cost of equity

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

SOURCE: BIS; Bloomberg

The declining ROE may be minimally mitigated by a lower COE (~80 bps) due to lower beta for the industry

Effect of Basel III on the cost of equity (COE)

Theoretical foundation

- **Modigliani-Miller**'s principle of conservation of risk suggests that an **increase in capital should reduce systematic risk** (i.e., beta)

Empirical estimation

- Kashyap et al (2010) **empirically estimate the effect of additional capital on beta** by regressing beta on the ratio of equity to assets with a 1976-2008 panel dataset
- They find that a **one percentage point increase of the equity ratio reduces beta by 0.045**

Specific Basel III implications

- We estimate that banks will **increase their Tier 1 Common ratio by 3.5 percentage points** (of total assets) in response to Basel III
- Using the empirical estimates from above, this **implies a 16bps decline in beta or a 80bps decline in the COE** (at a market risk premium of 5%)[1]

- Empirical estimates suggest that the **COE may fall by 80 bps** if banks increase their capital to meet 8% Tier 1 Common ratio
  - Additionally, each 100 bps of capital surcharge is likely to result in further COE decline of 20 bps
  - Note, there are several factors that will impact COE which are not accounted-for by this estimate
- Using historical 10.2% COE for banks as the baseline, **this implies a 9.4% COE post- Basel III**
- The expected decrease in ROE (300-390 bps) is over 3-4x the reduction in the Cost of Equity
- Thus, **banks will need to take significant steps to increase their income** and ROE

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

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