The Clearing House
At the Center of Banking Since 1853

VANQUISHING TBTF:

RHETORIC VERSUS REALITY

AND

THE VALUE OF SYSTEMICALLY IMPORTANT BANKS IN THE GLOBAL FINANCIAL SYSTEM

Paul Saltzman, President & General Counsel
Bob Chakravorti, MD & Chief Economist
John Court, MD & Senior Associate General Counsel
The Clearing House Association

March 26, 2013
Boston University
Center for Finance, Law & Policy

Contents

Debate Over Financial Reform

AREAS OF CONSENSUS

1. No bank should be "Too Big to Fail."
2. No bank should be "Too Big to Jail."
3. We need better *ex ante* macro-prudential tools to identify areas of systemic risk.
4. Taxpayers should not be exposed to loss stemming from bank activities.
5. The macro-prudential statutory and regulatory framework to limit systemic risk should be robust, effective, and transparent.
6. Central banks should continue their historical role of providing temporary liquidity funding to markets in times of systemic crisis.
7. Financial activity should be subject to appropriate levels of regulation whether it is conducted in banking organizations or in the shadow banking sector.

AREAS OF CONTINUED DEBATE

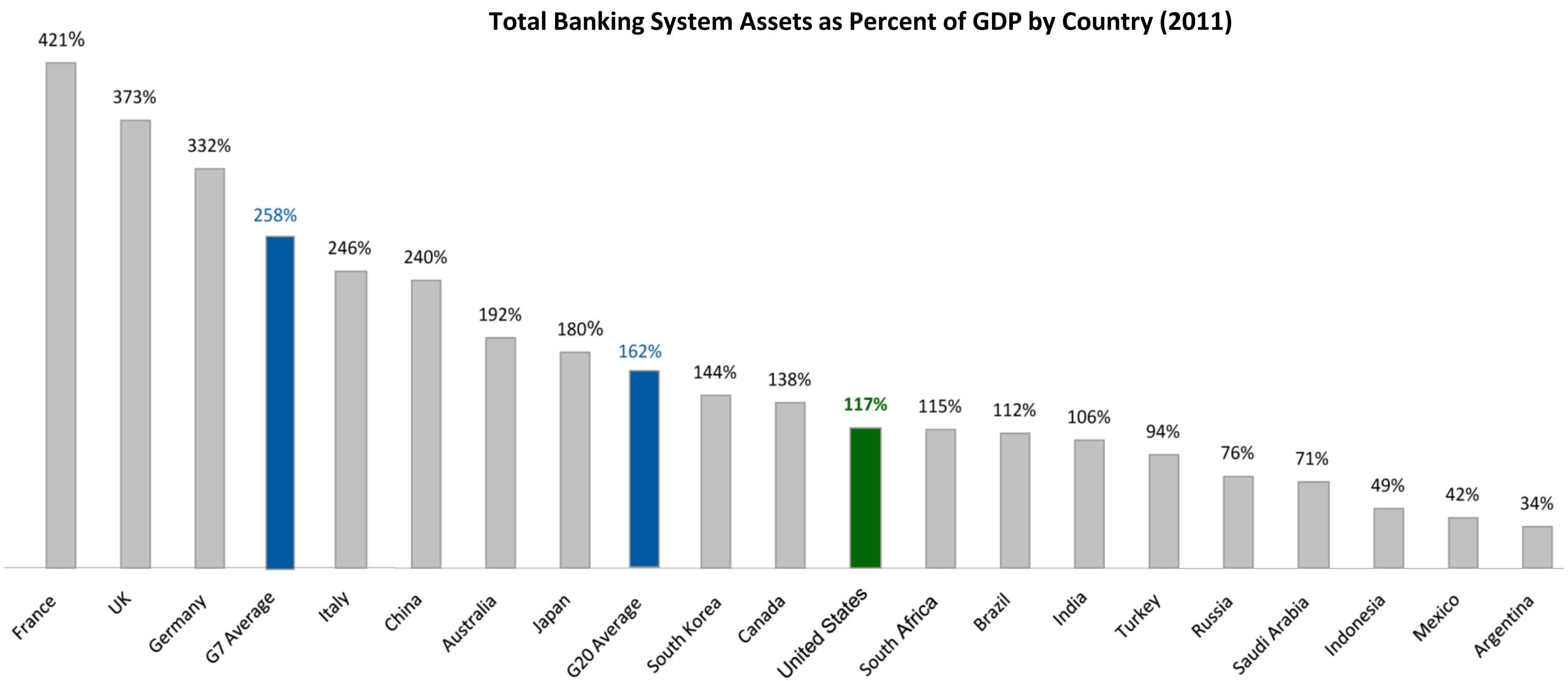
1. Whether the current statutory and regulatory framework is effective, and whether it's fair to judge the effectiveness while Dodd-Frank implementation is ongoing.
2. The appropriate balance between the costs associated with some reform measures (*e.g.*, reduced lending, decreased liquidity and greater volatility) and the potential cost of the systemic event they seek to prevent.
3. The value proposition of systemically important banks.
4. The value of diversification in the banking sector and bank holding company organization and structure.

10 Myths Surrounding Systemically Important Banks

1. Systemically important banks in the United States are "too big."
2. Systemically important banks provide little value to our economy and their break-up would have minimal impact on America's global competitiveness.
3. A network of smaller banks could provide the same services as large universal banks.
4. Systemically important banks were the primary cause of the financial crisis.
5. Narrow banking and community banks are less risky than systemically important banks.
6. Systemically important banks have an unfair funding advantage stemming from a perceived government guarantee.
7. Systemically important banks operate in an anti-competitive market where artificial barriers to entry stifle competition and innovation.
8. Systemically important banks are "Too Big to Jail."
9. Increased capital requirements have no effect on bank lending or the real economy.
10. U.S. GAAP treatment of derivatives netting arrangements hides risks of U.S. banks.

1. MYTH: SYSTEMICALLY IMPORTANT BANKS IN THE UNITED STATES ARE "TOO BIG."

- **REALITY: The U.S. banking system is smaller and less concentrated than banking systems in other developed countries.**
- **The U.S. banking system is small (117% of GDP) compared to the banking systems in other developed countries.**

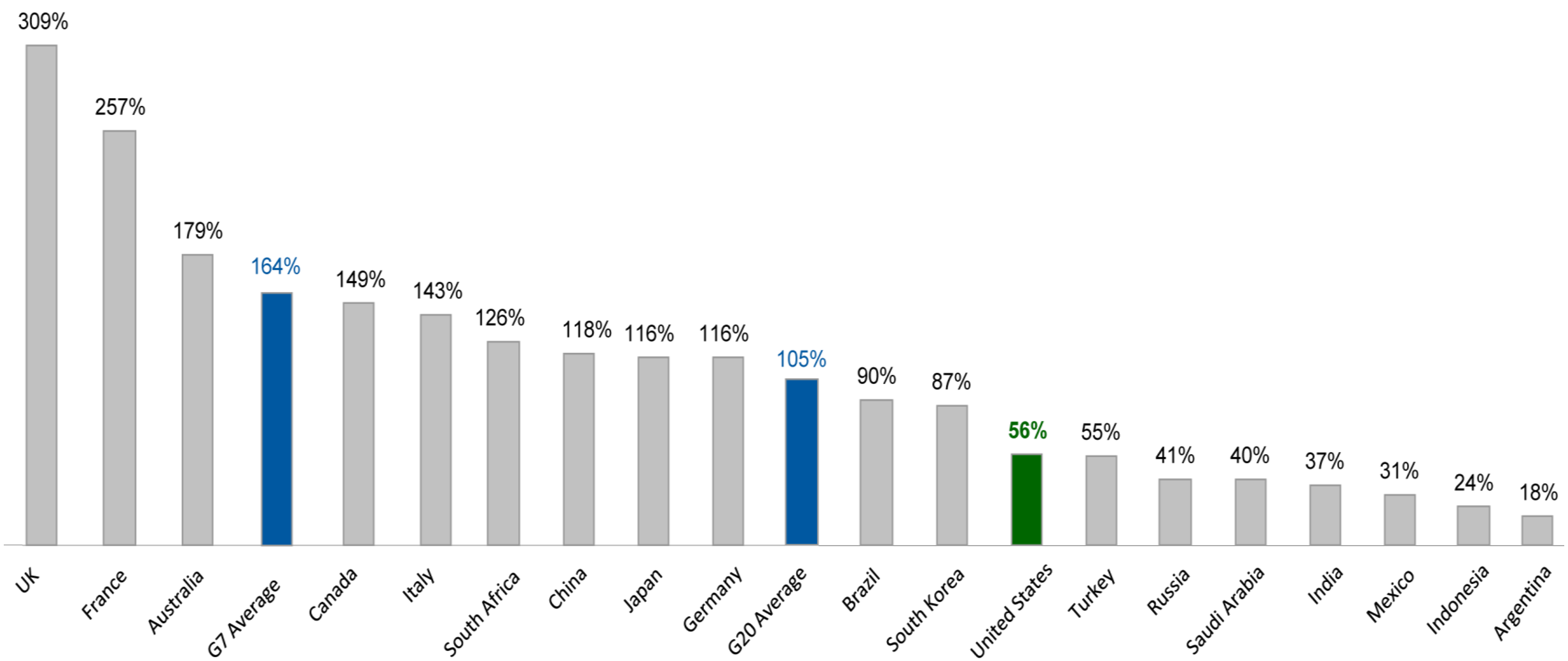


Source: The Clearing House, *Scaled to Serve: The Role of Commercial Banks in the U.S. Economy* (July 2012).

1. MYTH: SYSTEMICALLY IMPORTANT BANKS IN THE UNITED STATES ARE "TOO BIG." (CONT'D)

- **The U.S. banking system is far less concentrated relative to other developed countries.**
  - The 12 largest commercial banks operating in the U.S. account for 62% of total U.S. commercial banking assets, less than the 70% overall concentration level claimed by critics.

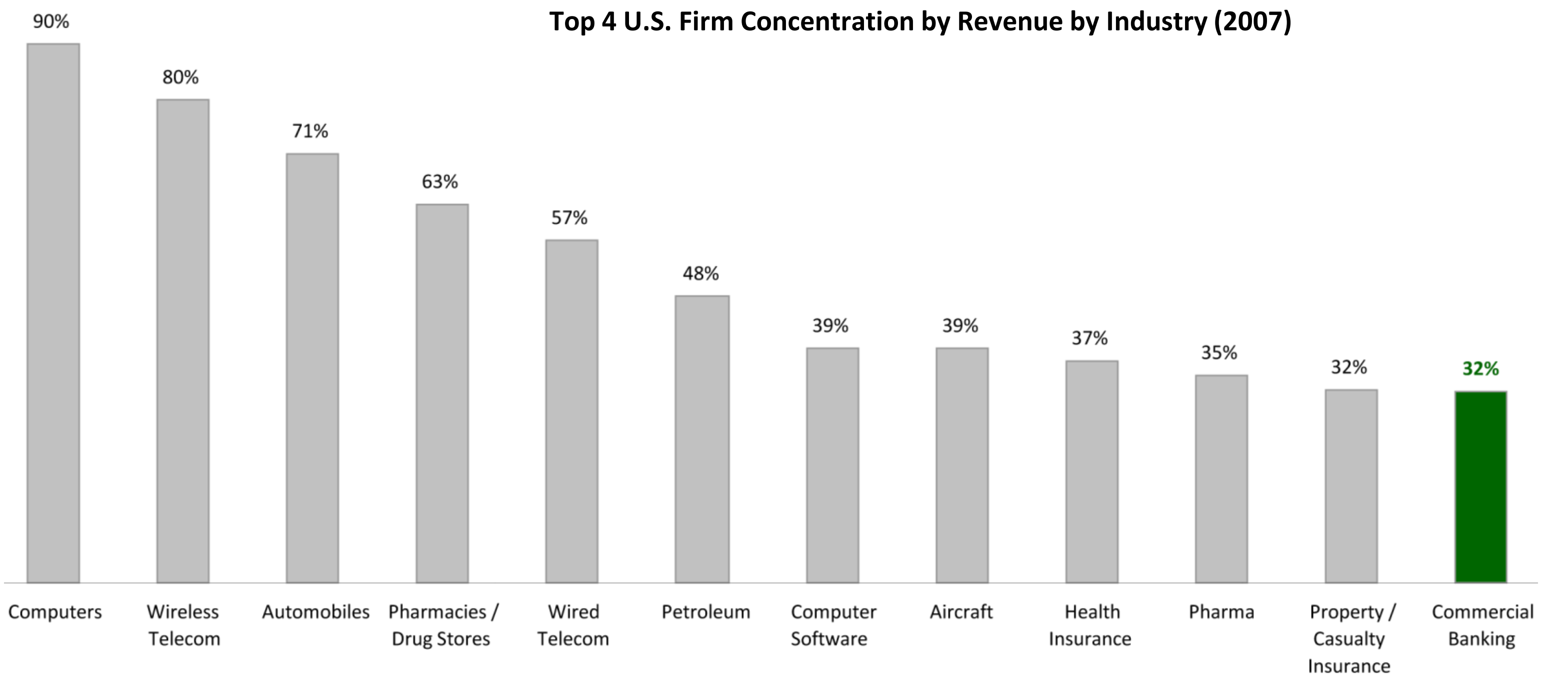
Top 5 Banks by Assets as a Percent of GDP by Country (2011)



Source: The Clearing House, *Scaled to Serve: The Role of Commercial Banks in the U.S. Economy* (July 2012).

1. MYTH: SYSTEMICALLY IMPORTANT BANKS IN THE UNITED STATES ARE "TOO BIG." (CONT'D)

- **The top four U.S. commercial banks account for only 32% of the industry's revenue. In other U.S. industries there is much greater concentration:**
  - Wireless telecom: 80%
  - Auto manufacturing: 71%
  - Petroleum refining: 48%



Source: The Clearing House, *Scaled to Serve: The Role of Commercial Banks in the U.S. Economy* (July 2012).

2. MYTH: SYSTEMICALLY IMPORTANT BANKS PROVIDE LITTLE VALUE TO OUR ECONOMY AND THEIR BREAK-UP WOULD HAVE MINIMAL IMPACT ON AMERICA'S GLOBAL COMPETITIVENESS.

- **REALITY: Systemically important banks provide significant social value through economies of scale and scope.**
- **Large banking organizations can achieve revenue and cost synergies through economies of scale and scope. These benefits reduce the costs of finance for society as a whole.**
- **The largest U.S. banks deliver benefits that amount to $50-$110 billion annually for companies, consumers, and governments.[1]**
  - Reducing unit costs by spreading fixed costs over a large customer base particularly for infrastructure and technology:
    - **Economies of scale: $20-$45 billion annually.**
  - The provision of a broad set of products and services in an integrated and comprehensive manner provides added benefits to customers:
    - **Economies of scope: $15-$35 billion annually.**
  - A large customer base is important to gain the critical mass necessary for faster adoption of innovation:
    - **Spread of technology: $15-$30 billion annually.**
- **Capping the asset size of each of the four largest U.S. banks at $1 trillion could impose a $79 billion loss in social benefits.[2]**

1 The Clearing House, *Understanding the Economics of Large Banks* (Nov. 2011).

2 Wheelock, David and Paul Wilson, *Do Large Banks have Lower Costs? New Estimates of Returns to Scale for U.S. Banks,* Working Paper 11-27, Federal Reserve Bank of St. Louis (revised May 2011).

2. MYTH: SYSTEMICALLY IMPORTANT BANKS PROVIDE LITTLE VALUE TO OUR ECONOMY AND THEIR BREAK-UP WOULD HAVE MINIMAL IMPACT ON AMERICA'S GLOBAL COMPETITIVENESS. (CONT'D)

- **Leading experts believe breaking up large banks would make the financial system less stable and sacrifice social utility.**
  - **Nobel-Prize Winning Economist Paul Krugman:** *"Breaking up big banks wouldn't really solve our problems, because it's perfectly possible to have a financial crisis that mainly takes the form of a run on smaller institutions. In fact, that's precisely what happened in the 1930s, when…the wave of small-bank failures was a catastrophe for the wider economy. The same would be true today." Financial Reform 101*, THE NEW YORK TIMES (Apr. 1, 2010).
  - **Former Treasury Secretary and NEC Director Larry Summers**: *"Most observers who study this believe that to try to break banks up into a lot of little pieces would hurt our ability to serve large companies, and hurt the competitiveness of the United States…They believe that it would actually make us less stable. Because the individual banks would be less diversified and, therefore, at greater risk of failing because they wouldn't have profits in one area to turn to when a different area got in trouble. And most observers believe that dealing with the simultaneous failure of many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment."* Interview with Jeffrey Brown of the PBS NewsHour (Apr. 20, 2010).
  - **Federal Reserve Bank of New York President and CEO William Dudley**: *"With respect to size limitations, it is important to recognize that a new and much reduced size threshold could sacrifice socially useful economies of scale and scope benefits."* Remarks at The Clearing House's Second Annual Business Meeting and Conference (Nov. 15, 2012).

3. MYTH: A NETWORK OF SMALLER BANKS COULD PROVIDE THE SAME SERVICES AS LARGE UNIVERSAL BANKS.

- **REALITY: Smaller institutions lack the requisite resources to replicate services currently offered by the largest banks.**
- **The geographic penetration and reach of the largest banks offers retail customers continuous mobile access across the globe.**
- **Key custodial services can only be offered by institutions with substantial scale:**
  - Processing of certain domestic assets, such as U.S. Treasury securities.
  - Providing cross-border custody and settlement services to pension funds, mutual funds, and other investors.
  - Sophisticated and costly IT platforms enable global reporting and compliance and enhance investor oversight. Smaller banks would not generate the volumes necessary to make investments in such technology worthwhile.
  - Scope across related products – such as cash-management products – allows cross-subsidiarization to keep margins low. Lower-volume institutions would not be economically viable.

Source: The Clearing House, *Understanding the Economics of Large Banks* (Nov. 2011).

3. MYTH: A NETWORK OF SMALLER BANKS COULD PROVIDE THE SAME SERVICES AS LARGE UNIVERSAL BANKS. (CONT'D)

- **Large banks, especially those with > $500 billion in assets, play a unique role in cash management activities for middle-market companies, large corporations, and other smaller banks.**
  - Higher volumes enable investments into tailored and flexible cash management systems that automate time-consuming processes, reduce discrepancy rates, increase visibility of cash positions, and improve liquidity and risk management. This translates into lower overhead for customers.
  - Broad international footprints allow large banks to provide cross-border cash management and currency coverage that smaller banks cannot. Integrated IT platforms enable customers to monitor and transact payments globally.
  - Larger balance sheets allow the largest banks to meet short-term liquidity needs of multiple companies simultaneously and on short notice, both in the U.S. and abroad.
- **Banks with > $500 billion in assets provide truly global lending products, currently accounting for 88% of total international lending from the U.S.**
  - Ability to offer international loans and lines of credit depends on significant geographic reach. A single large bank can more effectively organize and maintain necessary correspondent service in different regions, while enhancing customers' visibility of cash and debt positions across their footprint.
  - Larger balance sheets enable large banks to offer multicurrency loans or inspire confidence from correspondent banks, reducing cost of foreign credit to customers.
  - By combining product scope with geographic reach, large global banks serve as a "one-stop shop" for companies abroad and can offer expertise and advisory services for those beginning to enter foreign markets.

Source: The Clearing House, *Understanding the Economics of Large Banks* (Nov. 2011).

3. MYTH: A NETWORK OF SMALLER BANKS COULD PROVIDE THE SAME SERVICES AS LARGE UNIVERSAL BANKS. (CONT'D)

- **Large banks are uniquely suited to participate in capital markets activity, with banks > $500 billion in assets accruing the most benefits for customers. For the largest or most complex deals, forcing customers to use a network of banks would substantially impact deal speed, execution risk, and the ability to reach consensus on terms.**
  - Large, diversified balance sheets allow for higher concentration limits, which may increase the amount of credit offered.
  - Sizable debt issuances can be held longer before syndication or in the event that the market is disrupted or the sale is postponed. Larger banks can also support larger equity offerings, which require that banks buy back any part of the offering not sold.
  - Expertise across multiple equity and debt products and in syndicated lending give the largest banks sophisticated deal-structuring capabilities which optimizes integrated financing options while accounting for cost, risk, and flexibility.
  - International presence in multiple geographic markets helps the largest banks find low-cost financing, potentially by splitting an issuance across multiple markets or forming a syndicate with banks from multiple countries.

Source: The Clearing House, *Understanding the Economics of Large Banks* (Nov. 2011).

4. MYTH: SYSTEMICALLY IMPORTANT BANKS WERE THE PRIMARY CAUSE OF THE FINANCIAL CRISIS.

- **REALITY: The crisis was caused by a multitude of factors, including government housing policies and weak mortgage-lending standards.**
- **The primary drivers of the 2008 financial crisis were:**
  - Loose monetary policy, which set the stage for excessive borrowing, leverage, and risk-taking;
  - Government policies to promote home ownership, which led to collapsing mortgage-lending standards;
  - Failures in financial regulation and supervision; and
  - Misjudgments about the risk associated with financial products.
- **Repeal of Glass-Steagall's prohibition on banks affiliating with securities firms did not cause and was not a contributing factor to the crisis.**
  - Allowing banks and securities firms to become affiliated under a same "financial holding company" (FHC) was not a cause of the crisis.
  - The large firms that failed in the recent crisis were not FHCs: Bear Stearns, Lehman Brothers, and Merrill Lynch were stand-alone investment banks; AIG, Countrywide, and Washington Mutual were thrift holding companies.
  - FHCs are regarded as safer than stand-alone investment banks – during the crisis, the government effectively required the largest remaining stand-alone investment banks to convert to FHCs. Monoline lenders fared just as poorly.

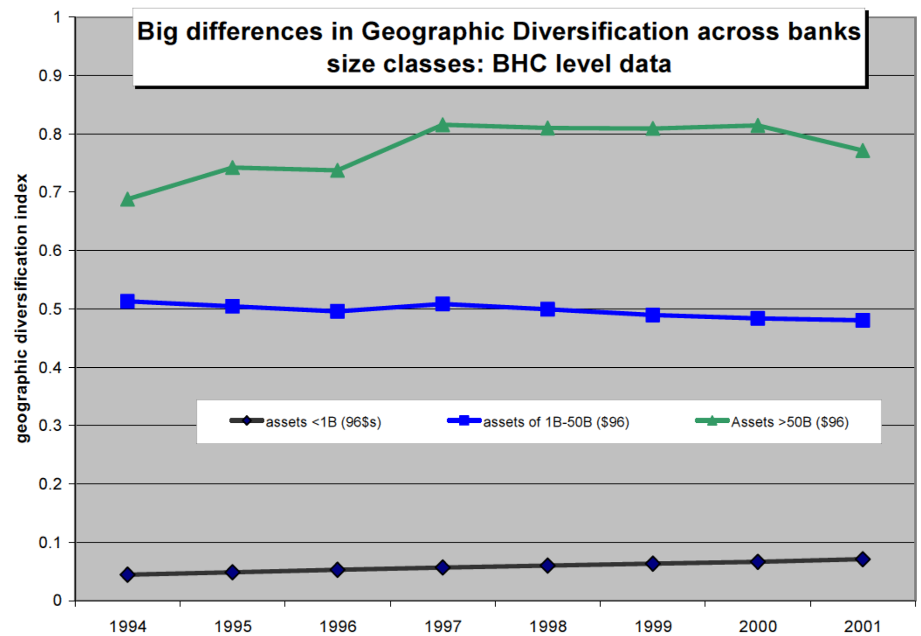
4. MYTH: SYSTEMICALLY IMPORTANT BANKS WERE THE PRIMARY CAUSE OF THE FINANCIAL CRISIS. (CONT'D)

- **Leading experts refute the value of re-imposing Glass-Steagall.**
  - **Federal Reserve Bank of New York President and CEO William Dudley:** *"In my opinion, there are shortcomings to reimposing Glass-Steagall-type activity restrictions or strict size limits. With respect to Glass-Steagall, it is not obvious to me that the pairing of securities and banking businesses was an important causal element behind the crisis. In fact, independent investment banks were much more vulnerable during 2008 than the universal banking firms which conducted both banking and securities activities."* Remarks at The Clearing House's Second Annual Business Meeting and Conference (Nov. 15, 2012).
  - **Federal Reserve Chairman Ben Bernanke**: *"I don't think Glass-Steagall by itself would solve our problems because we had commercial banks losing money on regular loans and we had investment banks losing money on speculative securities trades, so separating that wouldn't have saved Lehman Brothers and it wouldn't have protected a number of banks that had problems."* Testimony to Joint Economic Committee (Apr. 14, 2010).

5. MYTH: NARROW BANKING AND COMMUNITY BANKS ARE LESS RISKY THAN SYSTEMICALLY IMPORTANT BANKS.

- **REALITY: No one type of bank is "inherently" less risky than any other. However, large banks offering a broad range of services provide a stabilizing influence on the global banking system.**

- **Revenues, assets, and liabilities are spread across different market segments, enabling resilience in the face of market or asset stress.**
  - Large banks derive more of their revenues from fees and commissions, driven by sources other than interest income.
  - Larger banks are also better able to integrate **geographic** diversity. The ability to distribute risk across regions is especially important as global business cycles become increasingly variable.



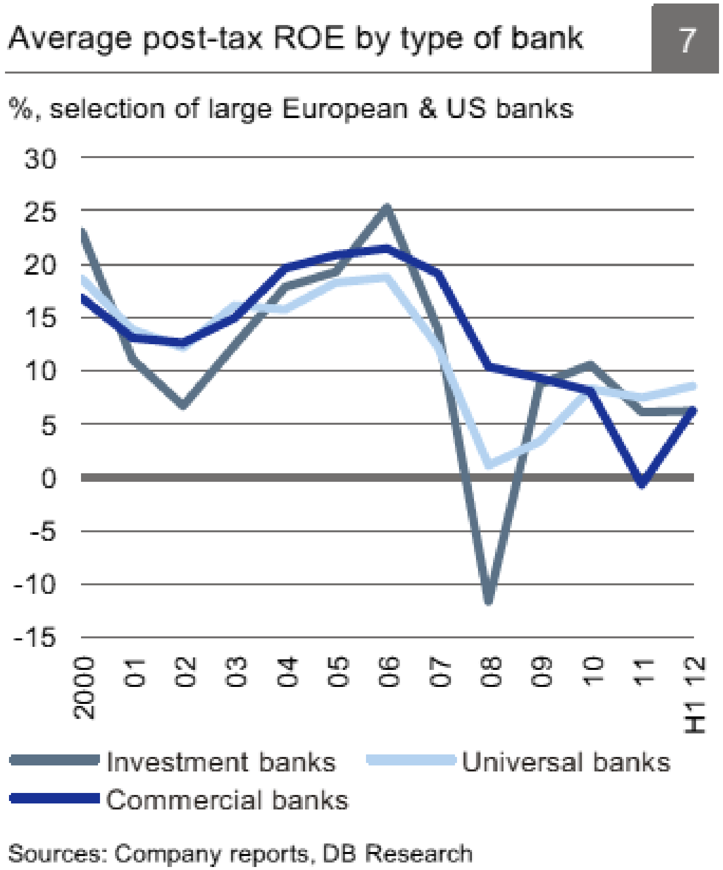
Source: DB Research, *Universal Banks: Optimal for Clients and Financial Stability* (Nov. 20, 2012).

Graphic: Morgan, Donald and Katherine Samolyk, *Geographic Diversification in Banking and its Implications for Bank Portfolio Choice and Performance*, BIS Working Paper (Feb. 2003).

5. MYTH: NARROW BANKING AND COMMUNITY BANKS ARE LESS RISKY THAN SYSTEMICALLY IMPORTANT BANKS. (CONT'D)

— Larger banks function as a crucial stabilizing force during periods of severe downturn, maintaining profitability and minimizing volatility despite losses in certain lines of business.

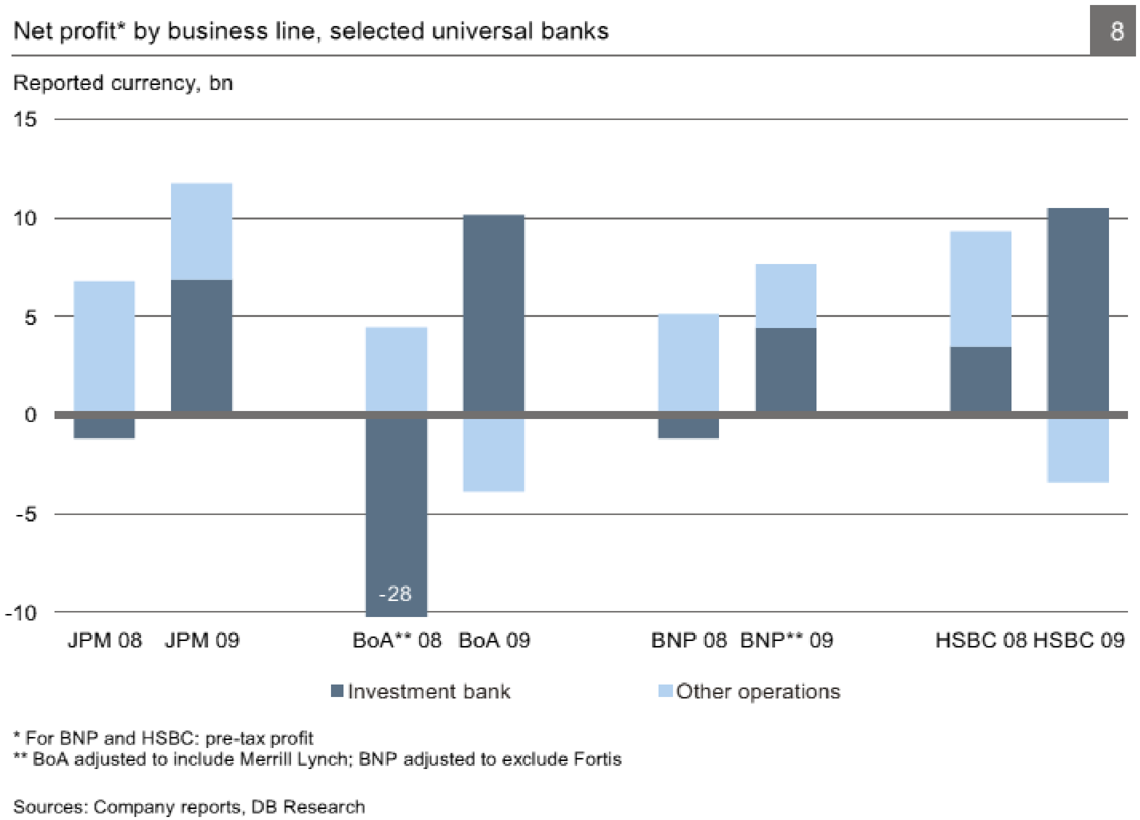
- **Average post-tax return on equity is most stable among large diversified banks, in both boom times and during economic stress.**



Source: DB Research, *Universal Banks: Optimal for Clients and Financial Stability* (Nov. 20, 2012).

5. MYTH: NARROW BANKING AND COMMUNITY BANKS ARE LESS RISKY THAN SYSTEMICALLY IMPORTANT BANKS. (CONT'D)

- **Severe losses can be smoothed with profits from other business lines. Specialized, narrower institutions may enjoy more upside but are also exposed to extreme downside risk.**



Source: DB Research, *Universal Banks: Optimal for Clients and Financial Stability* (Nov. 20, 2012).

5. MYTH: NARROW BANKING AND COMMUNITY BANKS ARE LESS RISKY THAN SYSTEMICALLY IMPORTANT BANKS. (CONT'D)

- **Large banks can achieve revenue synergies that smaller, specialized banks may forego.**
  - Cross-selling and cross-referencing between different business units.
  - Sophisticated products developed for large corporate clients can be offered to middle-market companies at comparatively reduced cost (e.g., derivatives for hedging risk).
  - Business lines can refer clients to advisory services or other products that are also in the bank.
  - Significant economies of scale related to IT systems, treasury, and research are achieved by spreading costs across larger revenue base.
- **More reliable and cost-effective customer profiling reduces risk while minimizing costs.**
  - As a "one-stop shop" for an entire spectrum of financial needs, universal banks collect centralized customer profiles that consolidate data on credit history, P&L, balance sheets, and individuals' income and asset characteristics.
  - Narrower institutions may only collect this information in fragments, requiring reliance on external sources and increasing costs borne by customers while reducing reliability of the data.

Source: DB Research, *Universal Banks: Optimal for Clients and Financial Stability* (Nov. 20, 2012).

5. MYTH: NARROW BANKING AND COMMUNITY BANKS ARE LESS RISKY THAN SYSTEMICALLY IMPORTANT BANKS. (CONT'D)

- **As banks become smaller and less diverse, they become more volatile.**
  - Approximately 450 small banks (< $1 billion) failed between 2009 and 2012, all due to losses on lending.[1]
  - Banks with > $10 billion in assets fully repaid TARP funds in about 1 year, and generated $24 billion positive return to date on investment.[2]
  - Meanwhile, smaller banks continue to hold outstanding TARP investments – over 200 small banks (< $100 million in assets) have yet to pay back Treasury capital purchases.[3]

1 FDIC data.
2 Wilson, Linus and Yan Wu, *Escaping TARP,* Journal of Financial Stability, 8.1 (Nov 1., 2012).
3 Office of the Special Inspector General for the Troubled Asset Relief Fund, *Quarterly Report to Congress* (Jan. 30, 2013).

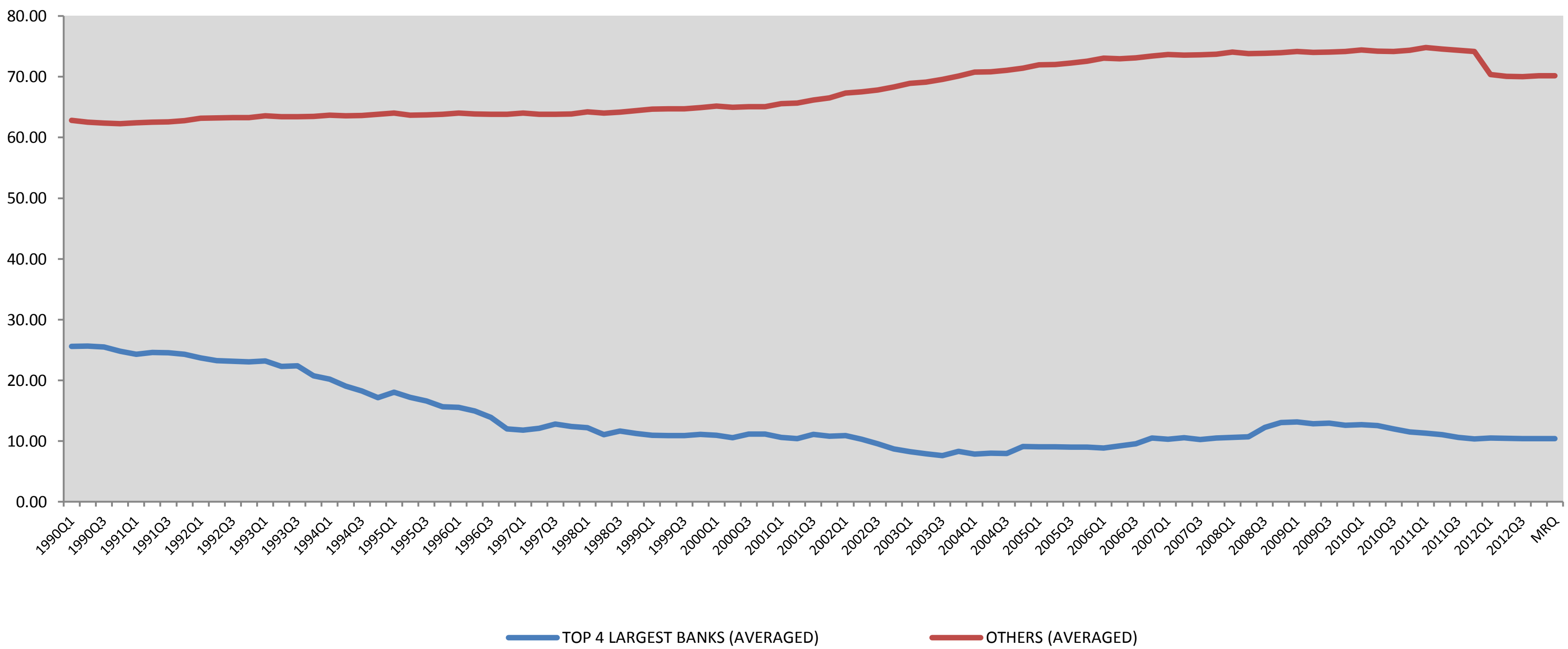
5. MYTH: NARROW BANKING AND COMMUNITY BANKS ARE LESS RISKY THAN SYSTEMICALLY IMPORTANT BANKS. (CONT'D)

- **U.S. banks have long been subject to significant activity limitations.**
  - For example, Section 16 of Glass-Steagall remains in force and prohibits national banks from engaging in what are regarded as riskier securities activities.
- **U.S. banks have long been subject to restrictions on transactions with affiliates.**
  - Sections 23A and 23B of the Federal Reserve Act impose strict qualitative and quantitative limits on transactions between an insured bank and its affiliates.
  - These limits ensure that Federal deposit insurance does not fund activities outside the bank.
- **There is wide recognition that a financial system comprised solely of smaller banks would not be safer.**
  - **Former Treasury Secretary Robert Rubin:** *"If you broke up the banks…the risk isn't going to go away. The systemic risk, the TBTF risk, will simply move."* CNBC Interview (Feb. 7, 2013).
  - **Director of Financial Regulation Studies at the Cato Institute Mark Calabria:** *"Breaking up banks would likely result in a system that is more fragmented and less diversified. Note that companies doing a single line of business, such a Fannie Mae, generally performed worse during the crisis, not better, than did companies that were more diversified…History does not suggest that a banking system characterized by small undiversified banks is a safe one. Returning to the banking system of the 1920s and '30s would not be an improvement." An End to Bailouts*, NATIONAL REVIEW (Jan. 28, 2013).

5. MYTH: NARROW BANKING AND COMMUNITY BANKS ARE LESS RISKY THAN SYSTEMICALLY IMPORTANT BANKS. (CONT'D)

- **Smaller banks make a much greater amount of risky real estate loans as a percentage of other loans.**

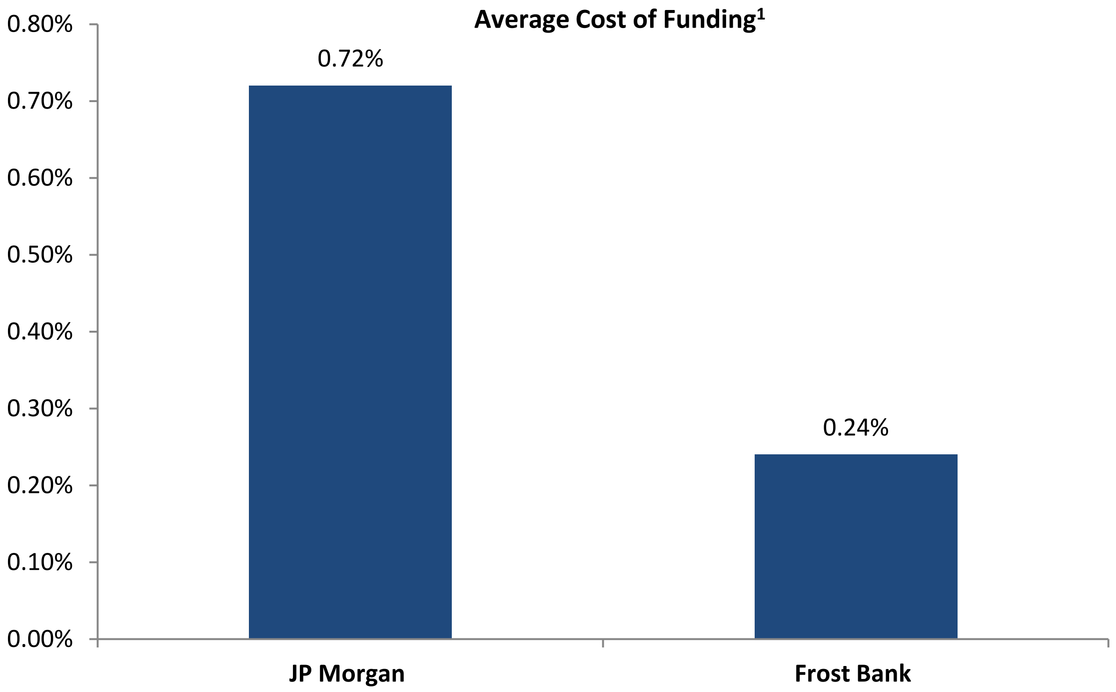
High Risk Real Estate Loans as Percentage of Total Domestic Loans



Source: SNL Financial.

6. MYTH: SYSTEMICALLY IMPORTANT BANKS HAVE AN UNFAIR FUNDING ADVANTAGE STEMMING FROM A PERCEIVED GOVERNMENT GUARANTEE.

- **REALITY: Dodd-Frank eliminates government guarantees and market perception is changing accordingly.**
- **Average funding cost deferential depends on the mix of liabilities.**
  - Banks that fund themselves mostly with deposits face lower funding costs on average.

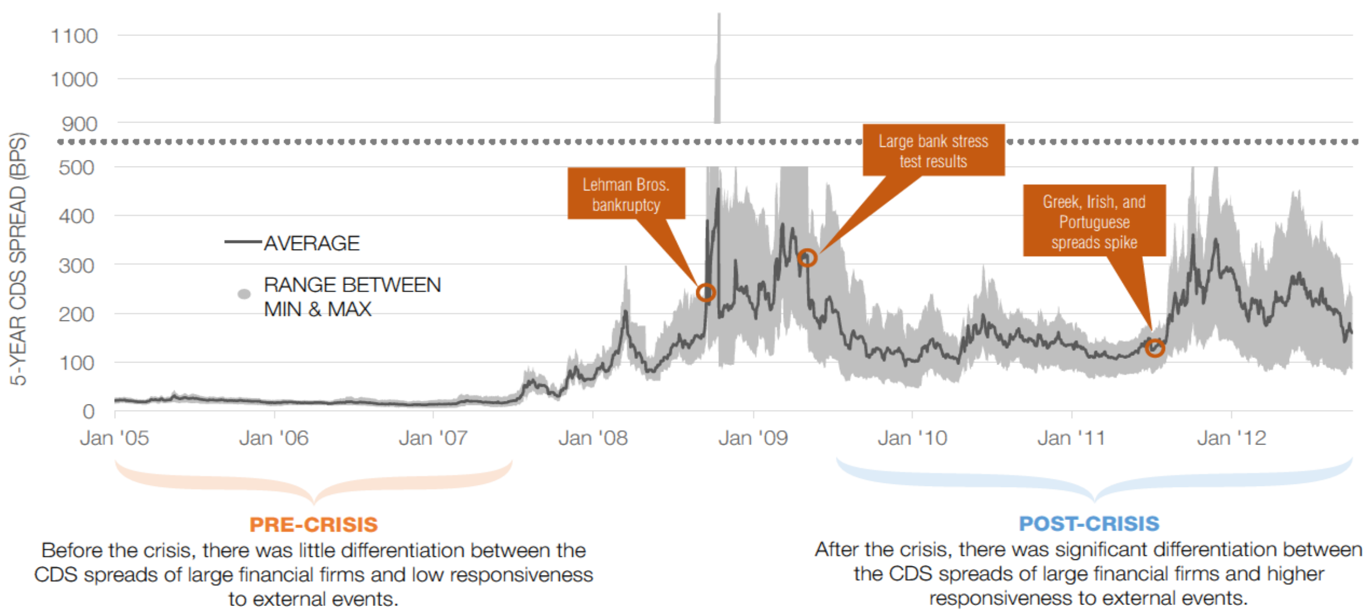


1 Reilly, David, *An Antidote for the Too-Big-Bank Subsidy*, THE WALL STREET JOURNAL (Mar. 10, 2013).

6. MYTH: SYSTEMICALLY IMPORTANT BANKS HAVE AN UNFAIR FUNDING ADVANTAGE STEMMING FROM A PERCEIVED GOVERNMENT GUARANTEE. (CONT'D)

- **Even if there is a funding cost differential, other factors besides TBTF are at play – e.g. a liquidity premium associated with the size of debt issuances of large banks.**
- **Recent market data indicates that market perception about TBTF is subsiding.**
  - Large bank CDS spreads are responding to macroeconomic events, as opposed to relatively little variance before the crisis.

Large U.S. Bank 5-Year CDS Spreads



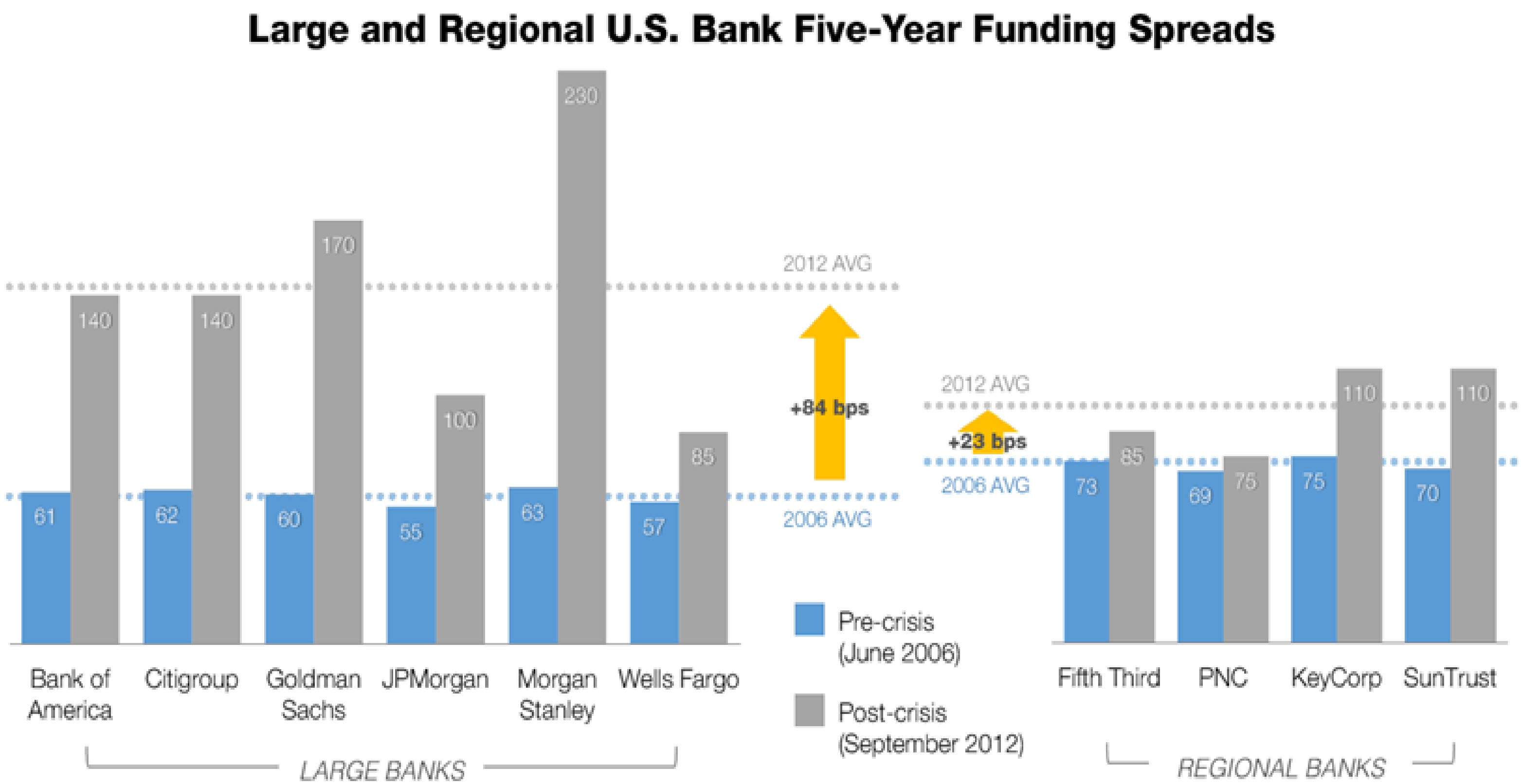
NOTE: INCLUDES BANK OF AMERICA, CITIGROUP, GOLDMAN SACHS, JPMORGAN, MORGAN STANLEY, WELLS FARGO.

SOURCE: BLOOMBERG.

Graphic: U.S. Department of the Treasury, *Strengthening Our Financial System* (Dec. 17, 2012).

6. MYTH: SYSTEMICALLY IMPORTANT BANKS HAVE AN UNFAIR FUNDING ADVANTAGE STEMMING FROM A PERCEIVED GOVERNMENT GUARANTEE. (CONT'D)

— Borrowing costs for the largest banks have increased more dramatically than for smaller institutions.



Graphic: U.S. Department of the Treasury, *Strengthening Our Financial System*, (Dec. 17 2012).

6. MYTH: SYSTEMICALLY IMPORTANT BANKS HAVE AN UNFAIR FUNDING ADVANTAGE STEMMING FROM A PERCEIVED GOVERNMENT GUARANTEE. (CONT'D)

- **As Dodd-Frank implementation progresses, the market will perceive all banks as resolvable without government support.**
  - **Federal Reserve Chairman Ben Bernanke**:

    "The subsidy is coming because of market expectations that the government would bail out these firms if they failed. Those expectations are incorrect." Testimony to Senate Banking Committee (Feb. 26, 2013).

    "[Title II is] working [at addressing improper market perceptions]...For example, even though U.S. banks are stronger financially than European banks, frequently U.S. banks have wider credit default swap spreads, indicating a higher probability of actual failure because of the differences between the U.S. and Europe in terms of perceived government support." Testimony to Senate Banking Committee (Feb. 26, 2013).
  - **Former FDIC Chairman Sheila Bair:** *"[Title II] is a powerful, new tool that we didn't have before.... the tools are there to end too big to fail…You can see the rating agencies have started down-grading large banks."* Interview on the The Diane Rehm Show, NPR (Sept. 26, 2012).

7. MYTH: SYSTEMICALLY IMPORTANT BANKS OPERATE IN AN ANTI-COMPETITIVE MARKET WHERE ARTIFICIAL BARRIERS TO ENTRY STIFLE COMPETITION AND INNOVATION.

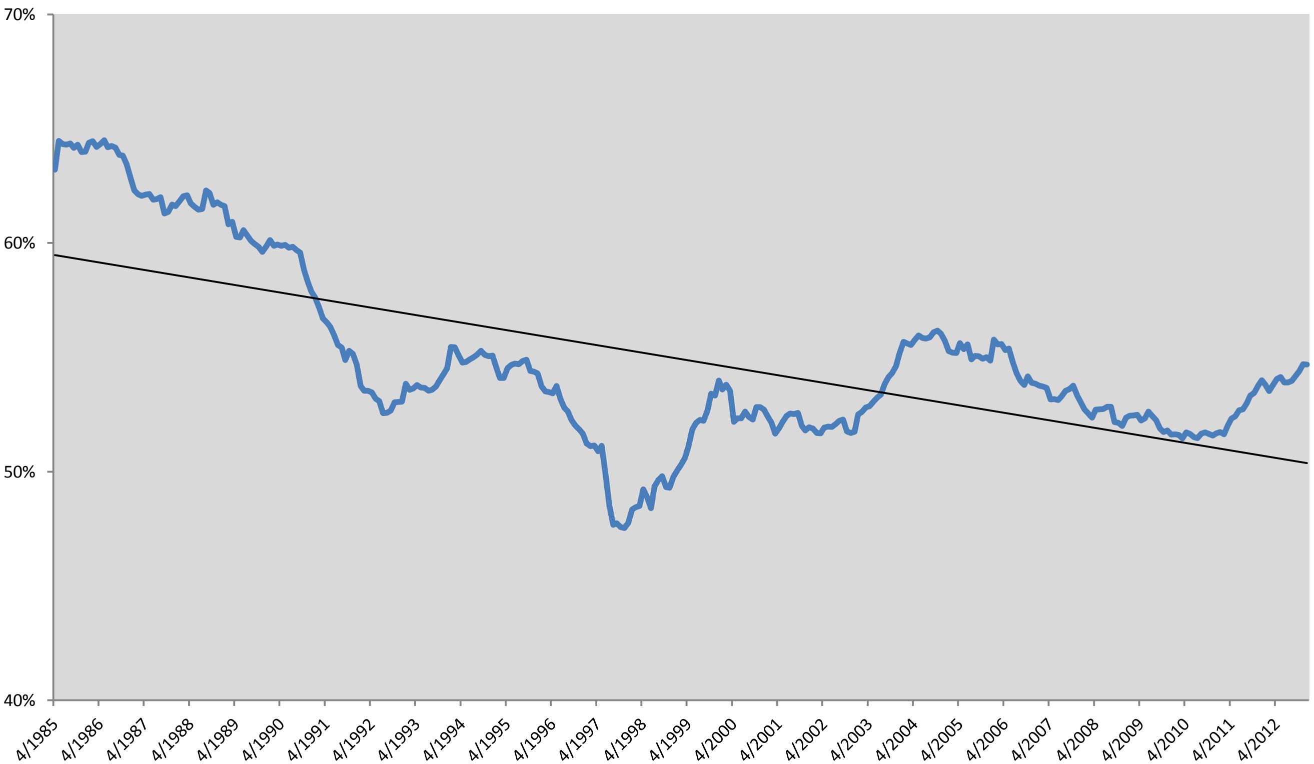
- **REALITY: The U.S. banking system is competitive. The U.S. requires a diverse banking system – banks of all sizes are needed to serve different types of customers with distinct products and services.**
- **The lifting of branch restrictions and loosening of interstate banking laws have resulted in steadily increasing competition in credit markets.**
- **Over the past 10 years, small banks' share of small business lending has increased as a percentage of total lending.** [1]

1 SNL Financial.

7. MYTH: SYSTEMICALLY IMPORTANT BANKS OPERATE IN AN ANTI-COMPETITIVE MARKET WHERE ARTIFICIAL BARRIERS TO ENTRY STIFLE COMPETITION AND INNOVATION. (CONT'D)

- **The share of commercial and industrial lending by the largest banks declined from approximately 65% in the 1980s to 58% in the 1990s. This share declined even further to 53% by December 2012.**

Share of Large Banks in C&I Lending by Commercial Banks
(% of total lending)



Source: Federal Reserve Economic Data, C&I Lending by Commercial Bank.

8. MYTH: SYSTEMICALLY IMPORTANT BANKS ARE "TOO BIG TO JAIL."

- **REALITY: No institution is above the law.**
- **The DOJ has recently reaffirmed that "[n]o corporate entity, not matter how large, is immune from prosecution."** [1]
- **The U.S. Attorneys' Manual expressly identifies "collateral consequences" as a factor that should be weighed in making charging decisions.**
  - This approach, which is consistent with indictment standards that have been in place for many years through multiple Administrations, rightly takes into account the impact that criminal prosecutions can have on innocent persons not involved in any wrong-doing.
- **Criminal penalties against a company can have severe negative consequences for innocent employees, customers, shareholders, and the economy.**
  - The indictment of Arthur Andersen resulted in closure of the company, 28,000 lost jobs, and further consolidation in the already-concentrated accounting industry. The conviction was overturned by the U.S. Supreme Court, but there was no recourse for the lost jobs and industry consolidation.
- **Law enforcement has regularly brought criminal charges directly against employees of large financial institutions suspected of illegal activity or behavior.**
- **Criminal prosecution is not the only tool. The government has a variety of other tools available to use against banks, including:**
  - Deferred prosecution and non-prosecution agreements, cease and desist agreements, memoranda of understanding, civil money penalties, and suspension or removal of officers and employees (including managers who oversee employees engaged in criminal conduct, even if the managers did nothing criminal themselves).

1 Letter from Judith Appelbaum, Principal Deputy Assistant Attorney General, U.S. Department of Justice, to Senator Sherrod Brown (Feb. 27, 2013).

9. MYTH: INCREASED CAPITAL REQUIREMENTS HAVE NO IMPACT ON BANK LENDING OR THE REAL ECONOMY.

- **REALITY: Higher capital results in lower economic output.**
- **There is an optimal level of capital that considers the positive benefits of greater loss absorbency and the negative impact on economic growth.**
- **Some academics (Modigliani and Miller) suggest that the proportion of equity and debt does not impact a firm's overall funding costs.**
  - However, this argument requires idealized conditions that do not hold in reality. Tax policy, deposit insurance, the cost of raising capital, informational asymmetries, transitional effects, and shadow banking alternatives are factors that would result in Modigliani and Miller not holding.
- **In banking, empirical evidence demonstrates that increasing capital requirements results in higher interest rates for loans or contraction in the supply of bank loans, resulting in lower economic output.**
  - Calomiris et al.: 10% increase in the capital ratio requirement led to a 9% contraction in supply of bank credit.[1]
  - Hanson et al.: 10% increase in capital requirements could lead to a 25-45 basis point impact on loan rates.[2]
  - Van den Heuvel: Capital requirements lead to a permanent loss in consumption, even accounting for reduced costs of bank supervision that may result.[3]
  - Calomiris: Capital increases come at the cost of banking activity, especially those that are large or sudden.[4]
  - A forthcoming TCH-Oxford Economics study finds that capital and liquidity regulations under Basel III result in increased bank lending rates of 0.7% to 1.1% and a reduction in GDP of 0.6% and 1%.

1 Calomiris, Charles, Shekhar Aiyar, and Tomasz Wieladek, *Does Macro-Pru Leak? Empirical Evidence from a UK Natural Experiment* (Nov. 2011).
2 Hanson, Samuel, Anil Kashyap, and Jeremy Stein, *A Macroprudential Approach to Financial Regulation*, Journal of Economic Perspectives, 25.1 (Winter 2011).
3 Van den Heuvel, Skander, The *Welfare Cost of Bank Capital Requirements* (Nov. 2011).
4 Calomiris, Charles, *How to Regulate Bank Capital*, National Affairs (Winter 2012).

10. MYTH: U.S. GAAP TREATMENT OF DERIVATIVES NETTING ARRANGEMENTS HIDES RISKS OF U.S. BANKS.

- **REALITY: U.S. GAAP provides a more accurate depiction of liquidity and credit risk than IFRS, particularly when coupled with new accounting disclosure requirements.**
- **Net presentation provides a more accurate picture of an entity's liquidity and credit risk.**
  - Net presentation is a more accurate presentation of liquidity risk since liquidity risk is driven by cash collateral and ongoing margin requirements which are calculated on a net basis, not a gross basis.
  - Concerns about unenforceability of master netting arrangements are unfounded. Derivatives are executed under an ISDA master netting arrangement and, as a result, the enterprise's counterparty credit risk for these derivatives is equal to the net fair value across all positions with the respective counterparty. We are not aware of any instances in which the close-out netting provisions of the ISDA Master Agreement were found to be unenforceable.
- **New U.S. accounting disclosure requirements for derivatives and other financial instruments provide additional information regarding the gross amounts of these contracts.**
  - Beginning in the first quarter of 2013, analysts will be able to compare both the net and gross amounts of these instruments across institutions, regardless of whether the institutions follow U.S. (U.S. GAAP) or international (IFRS) accounting standards.
  - Financial institutions subject to U.S. GAAP will disclose in the footnotes to their financial statements a table that reconciles the net amounts of derivatives, repurchase agreements, and securities borrowing/lending arrangements presented on the balance sheet to the gross amounts of these contracts.
  - The information will be provided for the current period and all prior periods presented in the financial statements.

10 Realities Surrounding Systemically Important Banks

1. The U.S. banking system is smaller and less concentrated than banking systems in other developed countries.
2. Systemically important banks provide significant social value through economies of scale and scope.
3. Smaller institutions lack the requisite resources to replicate services currently offered by the largest banks.
4. The crisis was caused by a multitude of factors, including government housing policies and weak mortgage-lending standards.
5. No one type of bank is "inherently" less risky than any other. However, large banks offering a broad range of services provide a stabilizing influence on the global banking system.
6. Dodd-Frank eliminates government guarantees and market perception is changing accordingly.
7. The U.S. banking system is competitive. The U.S. requires a diverse banking system – banks of all sizes are needed to serve different types of customers with distinct products and services.
8. No institution is above the law.
9. Higher capital results in lower economic output.
10. U.S. GAAP provides a more accurate depiction of liquidity and credit risk than IFRS, particularly when coupled with new accounting disclosure requirements.

10 Reforms to End Taxpayer Bailouts

In the aftermath of the financial crisis, a broad consensus emerged among policymakers and throughout the financial industry that the following reforms were needed to end TBTF and eliminate taxpayer exposure to losses at financial institutions:

1. Establish a resolution regime that allows systemically important banks to fail in a manner that is orderly and does not impose costs on taxpayers or give rise to systemic consequences.
2. Prohibit taxpayer bailouts and ensure that taxpayers do not pay to resolve failed institutions.
3. Require systemically important banks to prepare/plan ahead for their orderly resolution.
4. Eliminate the government's ability to rescue individual institutions while preserving its ability to manage and limit systemic risk in a crisis.
5. Establish regulatory requirements that promote financial stability and provide incentives to limit imprudent or risky behavior.
6. Require greater levels of loss absorbing capital at banks.
7. Impose credit exposure limits and disincentives for undue interconnectedness among financial institutions.
8. Require enhanced liquidity standards and sound liquidity risk management requirements.
9. Establish better *ex ante* macro-prudential tools to identify and monitor potential sources of systemic risk.
10. Reform executive compensation to provide greater transparency and ensure that incentives are appropriately risk-based.

1. ESTABLISH A RESOLUTION REGIME THAT ALLOWS SYSTEMICALLY IMPORTANT BANKS TO FAIL IN A MANNER THAT IS ORDERLY AND DOES NOT IMPOSE COSTS ON TAXPAYERS OR GIVE RISE TO SYSTEMIC CONSEQUENCES.

- **Dodd-Frank's Title II Orderly Liquidation Authority establishes a regime for resolving a troubled institution whose failure under traditional resolution regimes (e.g., Bankruptcy Code) might have serious adverse effects on U.S. financial stability.**
  - Title II would be invoked only if resolution under the Bankruptcy Code and existing bank resolution regimes would not prevent serious adverse systemic consequences. DFA § 203(a)(2), (b).
  - Title II would rarely be used, and the pre-Dodd-Frank resolution mechanisms would continue to be the preferred method for handling failures.
  - Title II provides a critically important "safety valve" for use in extraordinary circumstances where failure under pre-Dodd-Frank mechanisms poses significant adverse systemic risks.
- **As recently informed by TCH's November 2012 Resolution Simulation Exercise, a large complex banking organization can fail and be resolved by the FDIC under Title II in a manner that:**
  - Imposes losses on the SIFI's shareholders and creditors (and not taxpayers);
  - Allows the insured bank and other critical operating subsidiaries to continue to do business and serve customers without interruption;
  - Holds accountable culpable management; and
  - Preserves financial stability by preventing runs, cascading defaults on derivatives/fire sales of collateral, and financial panic.

1. ESTABLISH A RESOLUTION REGIME THAT ALLOWS SYSTEMICALLY IMPORTANT BANKS TO FAIL IN A MANNER THAT IS ORDERLY AND DOES NOT IMPOSE COSTS ON TAXPAYERS OR GIVE RISE TO SYSTEMIC CONSEQUENCES. (CONT'D)

- **Title II is consistent with, and not a departure from, longstanding U.S. policy of having special resolution regimes for financial companies.**
  - Insured depository institutions are resolved under the Federal Deposit Insurance Act.
  - Broker-dealers are resolved under the Securities Investor Protection Act.
  - Insurance companies are resolved under special resolution regimes under applicable state law.
- **Title II is consistent with the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions,* which has been endorsed by the G-20.**
  - The FSB *Key Attributes* recommend that G-20 member states move further in the direction of formalizing Title II OLA-type powers, rather than traditional bankruptcy-based mechanisms.
  - The FDIC and the Bank of England have been working together to develop resolution strategies that could be applied to largest financial institutions headquartered in the U.S. and the UK, and in December 2012 issued a joint paper discussing how a "top-down" or "single point of entry" strategy could be implemented in a cross-border context.
- **Enhancements to the existing Bankruptcy Code (e.g., a new "Chapter 14") designed to better facilitate the resolution of a financial company would be sensible as a supplement to, but not as a replacement for, Title II.**

1. ESTABLISH A RESOLUTION REGIME THAT ALLOWS SYSTEMICALLY IMPORTANT BANKS TO FAIL IN A MANNER THAT IS ORDERLY AND DOES NOT IMPOSE COSTS ON TAXPAYERS OR GIVE RISE TO SYSTEMIC CONSEQUENCES. (CONT'D)

- **There is wide recognition that Title II is a critical tool for ending TBTF.**
  - **Former FDIC Chairman Sheila Bair:** *Title II "is a powerful, new tool that we didn't have before…the tools are there to end too big to fail…You can see the rating agencies have started down-grading large banks."* Interview on the Diane Rehm Show, NPR (Sept. 26, 2012).
  - **FRB Governor Jerome Powell:** *"The market needs to believe – and it needs to be the case – that every private financial institution can fail and be resolved under our laws without imposing undue costs on society. The current reform agenda is designed to accomplish just that…it is intended to minimize the externalities from failure by making it possible to resolve a large financial institution without taxpayer exposure and without uncontainable disruption…My own view is that the framework of current reforms is promising, and should be given time to work."* Remarks at the Institute of International Bankers 2013 Washington Conference (Mar. 4, 2013).
  - **Bank of England Deputy Governor Paul Tucker and FDIC Chairman Martin Gruenberg:** *"The 'too big to fail' problem must be cured. We believe it can be and that serious progress is being made. Evidence can be seen in the joint paper released by [the FDIC and Bank of England]…which outlines a resolution strategy for large and complex financial companies."* Joint editorial: *When Global Banks Fail, Resolve Them Globally*, FINANCIAL TIMES (Dec. 10, 2012).
  - **Former FRB Chairman Paul Volcker:** *"I don't think people understand how much effort has gone into – and this legitimately takes a couple of years – by the FDIC itself alongside the Federal Reserve in figuring out how to apply [Title II] in practice."* Remarks at NABE Conference (Mar. 4, 2013).

2. PROHIBIT TAXPAYER BAILOUTS AND ENSURE THAT TAXPAYERS DO NOT PAY TO RESOLVE FAILED INSTITUTIONS.

- **Dodd-Frank *explicitly* prohibits taxpayer bailouts. DFA § 214(c).**
  - Title II provides simply, expressly, and categorically that "[t]axpayers shall bear no losses from the exercise of any authority under [Title II]."
- **Title II provides for a source of fully secured and temporary liquidity funding that the FDIC may obtain from the Treasury Department in order to lend to a failed SIFI in a Title II resolution. DFA §§ 204(d), 210(n).**
  - The FDIC has stated that the agency would not expect to resort to this liquidity backstop unless private market funding proves unavailable. The availability of a public funding backstop should help ensure the availability of private funding.
  - The temporary liquidity would allow the bank and other operating subsidiaries of the failed holding company to continue to do business and serve customers until the institution can be sold (in whole or in parts) or privately recapitalized in an orderly manner.
- **The temporary liquidity funding must, by law, be repaid from the assets of the failed SIFI, and any shortfall is ultimately repaid through assessments on the entire SIFI industry. DFA § 214(b).**
  - Temporary liquidity support is secured by all unencumbered assets and takes first priority ahead of ***all*** unsecured creditors.
  - If the assets of the failed SIFI prove inadequate to fully repay the temporary funding, the FDIC can impose "clawback" assessments on certain creditors that may have received payments in excess of the amounts that they would have received under Chapter 7 of the Bankruptcy Code. For any remaining shortfall, the statute requires the FDIC to recover it by imposing risk-based assessments on all SIFIs.

3. REQUIRE SYSTEMICALLY IMPORTANT BANKS TO PREPARE/PLAN AHEAD FOR THEIR ORDERLY RESOLUTION.

- **Dodd-Frank requires bank holding companies (BHCs) with $50 billion or more in assets to submit rapid resolution and bankruptcy plans to the FRB and FDIC every year. DFA § 165(d).**
- **The plans – called "living wills" – paint a highly-specific picture of the business entities and operational models of each BHC and give regulators a deeper and more comprehensive understanding of these institutions. In particular, each plan is required to contain:**
  - Strategic analyses of the plan's components;
  - Description of specific actions the company proposes to take in resolution; and
  - Description of organizational structure, material entities, interconnections and interdependences, and management information systems.
- **If the plans do not meet credibility standards, the FDIC and FRB may jointly impose sanctions including:**
  - Heightened capital and/or liquidity requirements;
  - More stringent leverage limits;
  - Restrictions on growth, activities or operations; and
  - Forced divestiture of assets or operations.

4. ELIMINATE THE GOVERNMENT'S ABILITY TO RESCUE INDIVIDUAL INSTITUTIONS WHILE PRESERVING ITS ABILITY TO MANAGE AND LIMIT SYSTEMIC RISK IN A CRISIS.

- **Dodd-Frank significantly curtails the federal government's ability to provide financial assistance to individual distressed companies. DFA Title XI.**
  - During the 2008 financial crisis, government authorities relied on Section 13(3) of the Federal Reserve Act to provide assistance to distressed institutions.
  - As a result of Title XI reforms, any future assistance under Section 13(3) may only be provided through "broad-based" programs or facilities and can only be provided to solvent institutions. Any program structured for a single and specific company is now prohibited. However, the legal authority to provide government assistance through broad-based programs preserves the government's ability to address systemic risk in extraordinary circumstances.
  - Title XI also significantly increases Congressional oversight over the Federal Reserve's programs, imposing substantial new transparency and reporting requirements and requiring GAO audits of Federal Reserve activities.
  - Title XI also eliminated the FDIC's authority to provide assistance to banks outside of receivership, pursuant to Section 13(c)(4)(G) of the Federal Deposit Insurance Act (so-called "open bank assistance"). As a result, the FDIC now must first place a bank into resolution or receive Treasury Department and Congressional approval prior to providing any such assistance aimed at preserving financial stability.
  - **U.S. Department of Treasury Undersecretary for Domestic Finance Mary Miller:** *"Regulators face new limitations on emergency authorities employed during the crisis. The Federal Reserve can no longer provide direct support to individual institutions." Strengthening Our Financial System*, TREASURY NOTES BLOG (Dec. 21, 2012).

5. ESTABLISH REGULATORY REQUIREMENTS THAT PROMOTE FINANCIAL STABILITY AND PROVIDE INCENTIVES TO LIMIT IMPRUDENT OR RISKY BEHAVIOR.

- **Large banks are subject to additional capital surcharges to effectively discourage them from increasing in size and complexity.**
  - Large banks are subject to capital requirements that are more stringent that those imposed on smaller banks and increase in stringency based on size and other factors. DFA § 165.
  - The largest banks will face a CET1 surcharge of between 1% and 2.5% (and possibly as high as 3.5%) based on their size and complexity. Basel Committee on Banking Supervision, *G-SIB Assessment Methodology* (Nov. 2011).
  - Large banks subject to these surcharges will hold minimum capital levels that are 14% to 36% higher than the required minimum for smaller banks.
  - **Federal Reserve Bank of New York President and CEO William Dudley:** *"The new Basel regime explicitly adjusts capital requirements upward based on size, complexity, interconnectedness, global exposure and substitutability—attributes that are proxies for the negative externalities generated by failure. If a bank is deemed a global systemic financial institution or G-SIFI, then it will have to hold a greater amount of capital relative to its risk-weighted assets compared to a less systemic institution."* Remarks at The Clearing House's Second Annual Business Meeting and Conference (Nov. 15, 2012).

5. ESTABLISH REGULATORY REQUIREMENTS THAT PROMOTE FINANCIAL STABILITY AND PROVIDE INCENTIVES TO LIMIT IMPRUDENT OR RISKY BEHAVIOR. (CONT'D)

- **Dodd-Frank limits the aggregate size of any one banking organization.**
  - Dodd-Frank prohibits a financial company from acquiring or merging with another company if consolidated liabilities of resulting organization would exceed 10% of consolidated liabilities of all financial companies. DFA § 622. The FRB has a de facto prohibition in place against any meaningful acquisitions by the largest banks.
  - This supplements an existing statutory provision that prohibits any single bank from controlling 10% or more of total U.S. deposits. 12 U.S.C. § 1842(d); see also DFA § 623.
- **Dodd-Frank empowers the FRB to prohibit bank transactions that would increase systemic risk.**
  - In considering whether to approve any M&A transaction, the FRB must consider the extent to which the transaction would result in greater or more concentrated risks to financial stability. DFA § 604(d).
- **FDIC insurance assessment scheme disproportionately taxes large banks.**
  - Dodd-Frank required the FDIC to change its assessment system for deposit insurance coverage from one based on domestic deposits to one based on consolidated total assets. DFA § 331.
  - This change shifts much of the cost of deposit insurance from small and mid-sized banks that rely heavily on deposits for funding to large banks that often have multiple sources of funding that reduce risk to the FDIC.
  - Specifically, the change results in insured depository institutions with $10 billion or more in assets bearing approximately 80% of the burden for deposit insurance, up from approximately 70% under the old methodology.
  - This change represents a direct departure from the overriding statutory mandate that the FDIC assessment should be risk-based and therefore represents a special tax on the largest banks.

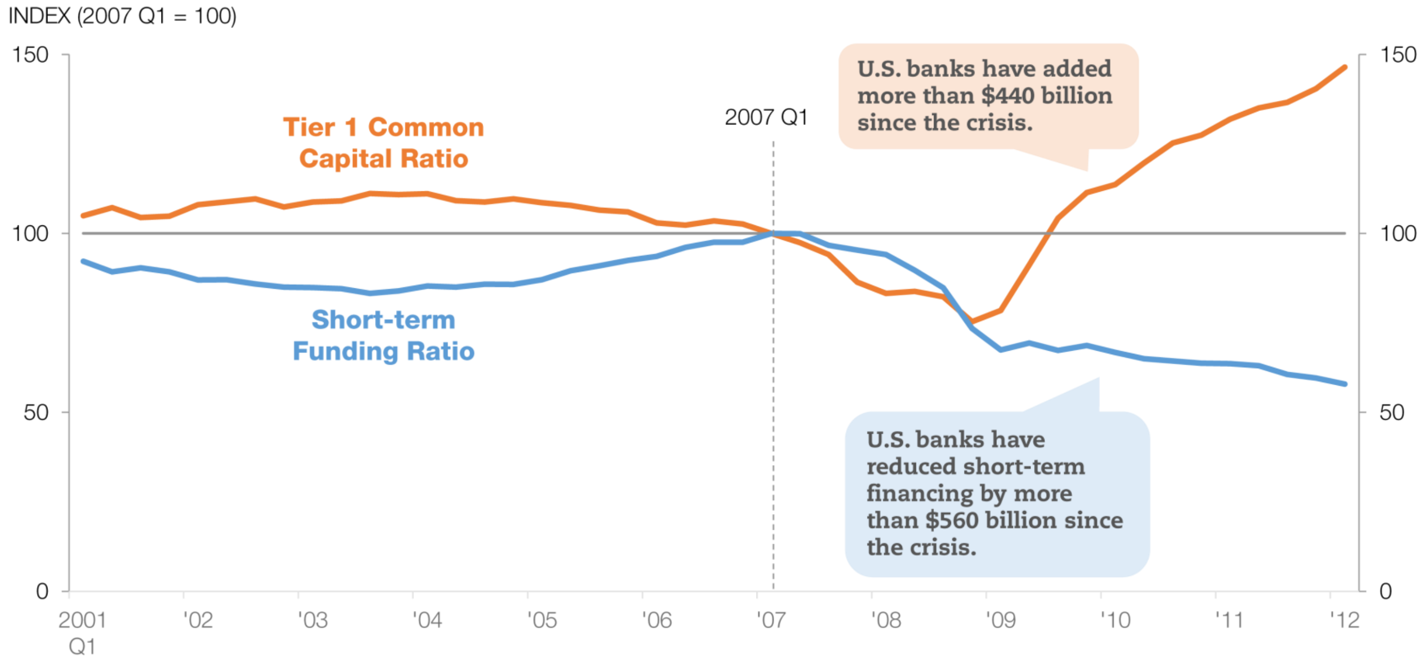
5. ESTABLISH REGULATORY REQUIREMENTS THAT PROMOTE FINANCIAL STABILITY AND PROVIDE INCENTIVES TO LIMIT IMPRUDENT OR RISKY BEHAVIOR. (CONT'D)

- **Large banking organizations are subject to stringent enhanced prudential standards and early remediation requirements that do not apply to smaller banking organizations.**
  - Dodd-Frank requires the FRB to establish enhanced prudential standards for risk-based capital requirements and leverage limits, liquidity requirements, overall risk management requirements, resolution plan and credit exposure reporting, and concentration/credit exposure limits. DFA § 165.
  - In addition, Dodd-Frank authorizes the FRB to establish additional standards regarding contingent capital, enhanced public disclosures, short-term debt limits, and any other prudential standards the FRB determines to be appropriate. DFA § 165.
  - Dodd-Frank also requires the FRB to establish requirements to provide for the early remediation of financial distress of a large banking group in order to minimize the possibility that the company will become insolvent and pose a risk to U.S. financial stability. DFA § 166.

6. REQUIRE GREATER LEVELS OF LOSS ABSORBING CAPITAL AT BANKS.

- **Dodd-Frank and Basel III capital reforms require large banking organizations to maintain higher levels and greater quality of capital. As a result of (and in anticipation of) these reforms, U.S. banks currently hold substantially more capital than pre-crisis levels, and these capital levels likely will continue to increase as Basel III reforms are implemented.**

Tier 1 Capital Ratios and Short-term Funding for the U.S. Banking Industry

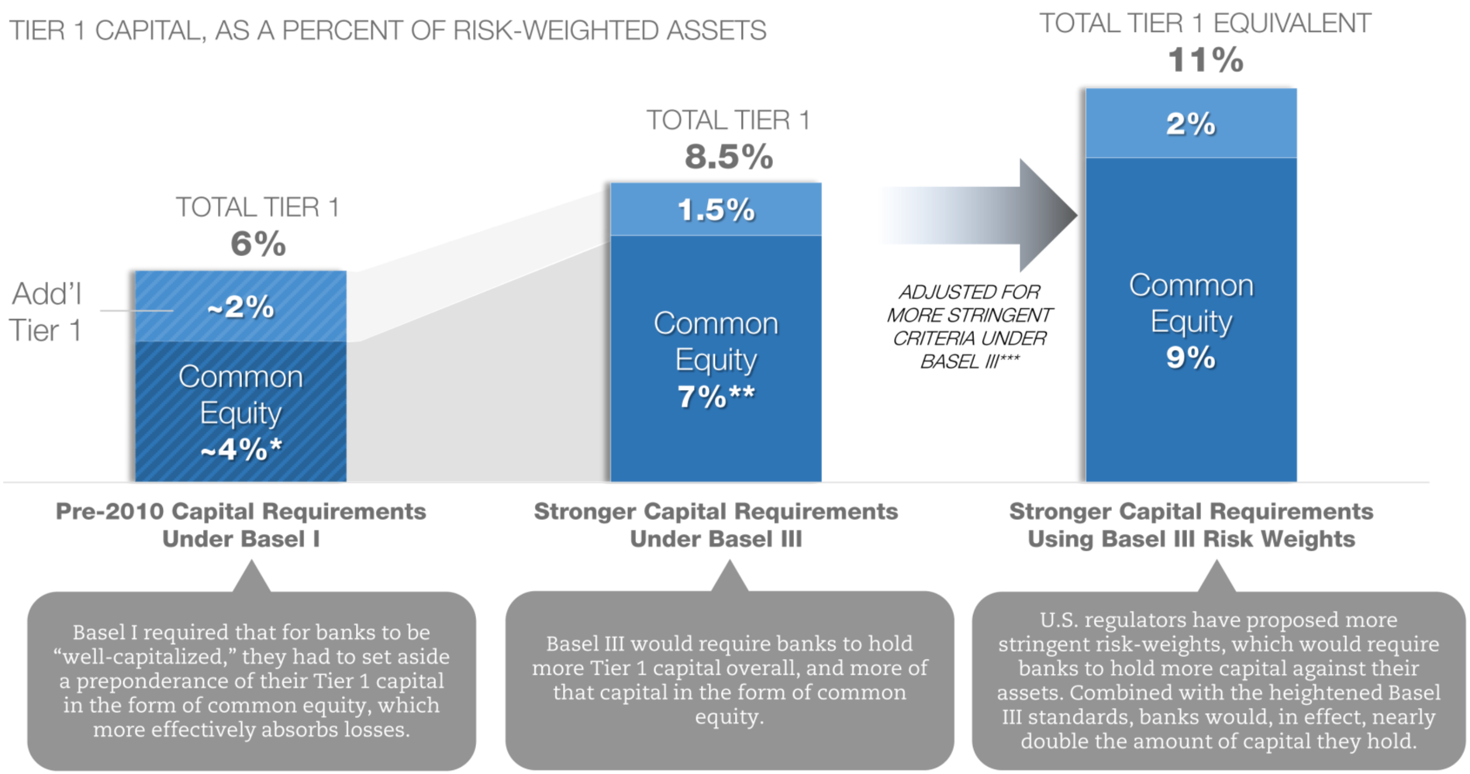


SOURCE: FEDERAL RESERVE (Y-9C, FLOW OF FUNDS), HAVER ANALYTICS, TREASURY/FSOC ANALYSIS.

Graphic: U.S. Department of the Treasury, *Strengthening Our Financial System* (Dec. 17, 2012).

6. REQUIRE GREATER LEVELS OF LOSS ABSORBING CAPITAL AT BANKS. (CONT'D)

- **The largest U.S. banks hold substantially higher-quality capital than was required under pre-crisis Basel I standards.**



* FOR ILLUSTRATIVE PURPOSES. THE 2009 SUPERVISORY CAPITAL ASSESSMENT PROGRAM (SCAP) STRESS TEST REQUIRED COVERED FIRMS TO MEET A QUANTITATIVE 4 PERCENT TIER 1 COMMON CAPITAL RATIO. PREVIOUSLY, REGULATIONS REQUIRED THAT FIRMS' TIER 1 CAPITAL BE PREDOMINANTLY MADE OF COMMON EQUITY, BUT DID NOT SPECIFY REQUIRED LEVELS. ** INCLUDES BOTH A 4.5% MINIMUM AND A 2.5% CAPITAL CONSERVATION BUFFER. *** INCLUDING BOTH CHANGES IN RISK-WEIGHTS AND INCREASED DEDUCTIONS. THE ADJUSTMENT FOR RISK WEIGHTED ASSETS REFLECTS THE AVERAGE OF DISCLOSED BASEL I AND BASEL III RISK WEIGHTED ASSETS FOR BANK OF AMERICA, WELLS FARGO, CITIGROUP AND JPMORGAN AS OF SEPTEMBER 2012. OTHER BANKS MAY SEE DIFFERENT CHANGES.

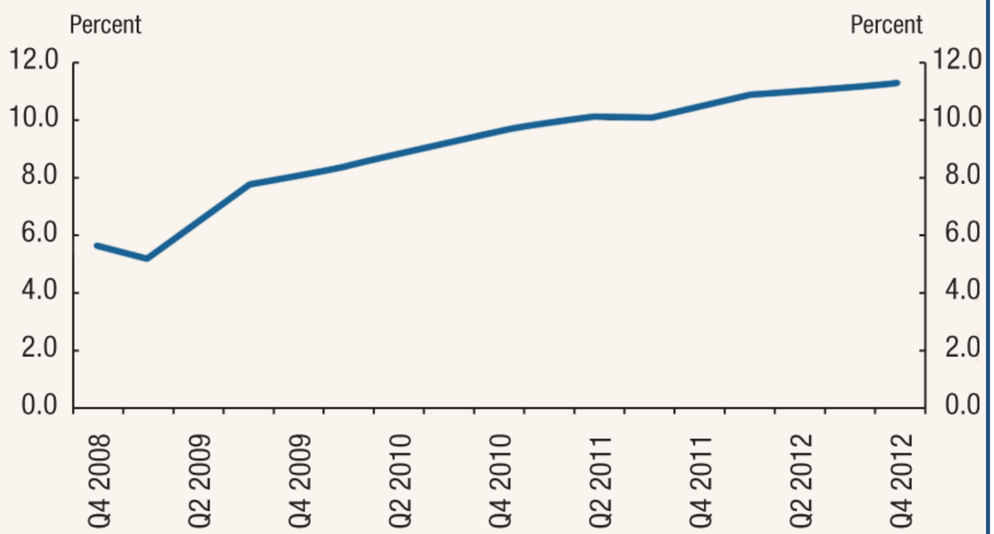
SOURCE: COMPANY FILINGS AND TREASURY ANALYSIS.

Graphic: U.S. Department of the Treasury, *Strengthening Our Financial System* (Dec. 17, 2012).

6. REQUIRE GREATER LEVELS OF LOSS ABSORBING CAPITAL AT BANKS. (CONT'D)

- **The 18 largest U.S. banks have increased their holding of the highest-quality capital by almost 100% since 2008.**

Figure A. Tier 1 common equity ratio of the 18 CCAR bank holding companies



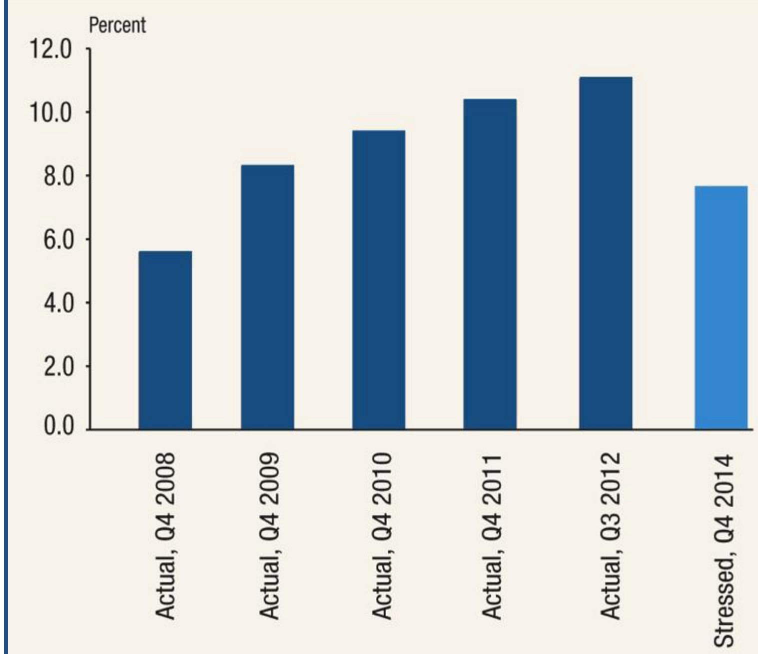
Note: Aggregate capital ratio for 18 participating BHCs, based on Y-9C filings. The tier 1 common ratio in the fourth quarter of 2008 includes the tier 1 common capital and risk-weighted assets for Ally Financial Inc. as of the first quarter of 2009, as Ally did not file a Y-9C report with the Federal Reserve in the fourth quarter of 2008.

Source: Board of Governors of the Federal Reserve System, *Comprehensive Capital and Analysis and Review, 2013: Assessment Framework and Results* (Mar. 2013).

6. REQUIRE GREATER LEVELS OF LOSS ABSORBING CAPITAL AT BANKS. (CONT'D)

- **The largest U.S. banks are equipped to weather severe financial stress.**
  - In the recent round of stress tests, the FRB subjected the balance sheets of the 18 largest BHCs to stressed and severely stressed macroeconomic scenarios – the results of which were published in March 2013.
  - Key assumptions for severe stress:
    - 5% decline in GDP (Q3 2012-Q4 2013)
    - 12% unemployment (Q3 2012-Q4 2013)
    - 50% decline in equity prices (Q3 2012-Q4 2013)
    - 20% decline in home and commercial real estate prices (Q3 2012-Q4 2014)
  - Even under these scenarios, aggregate capital ratios remain well above the levels seen during the crisis.

Figure 1. Historical and stressed tier 1 common ratio



Note: Aggregate capital ratios for 18 participating bank holding companies (BHCs). Post-stress estimates are supervisory estimates under the severely adverse scenario.

The tier 1 common ratio in the fourth quarter of 2008 includes the tier 1 common capital and risk-weighted assets for Ally Financial Inc. as of the first quarter of 2009, as Ally was not a Y-9C filer in the fourth quarter of 2008.

Source: Board of Governors of the Federal Reserve System, *Dodd-Frank Act Stress Test 2013: Supervisory Stress Test Methodology and Results* (Mar. 2013).

6. REQUIRE GREATER LEVELS OF LOSS ABSORBING CAPITAL AT BANKS. (CONT'D)

- **The Basel Committee recently confirmed that the largest internationally active banks have demonstrated significant improvement in CET1 required minimum capital levels (as of June 30, 2012).[1]**
  - Average CET1 of internationally active banks with Tier 1 capital in excess of €3 billion was 8.5%, as compared with the Basel III minimum requirement of 7.0% (including the capital conservation buffer).
- **The FRB may require that the largest U.S. banks have even greater loss-absorption capacity.**
  - The FRB has indicated it might propose that large banks issue a minimum amount of long-term debt at the parent holding company in connection with ensuring that there is sufficient loss absorbing capacity for a Title II resolution.[2]

[1] Basel Committee on Banking Supervision, *Results of the Basel III Monitoring Exercise as of June 30, 2012* (Mar. 2013).

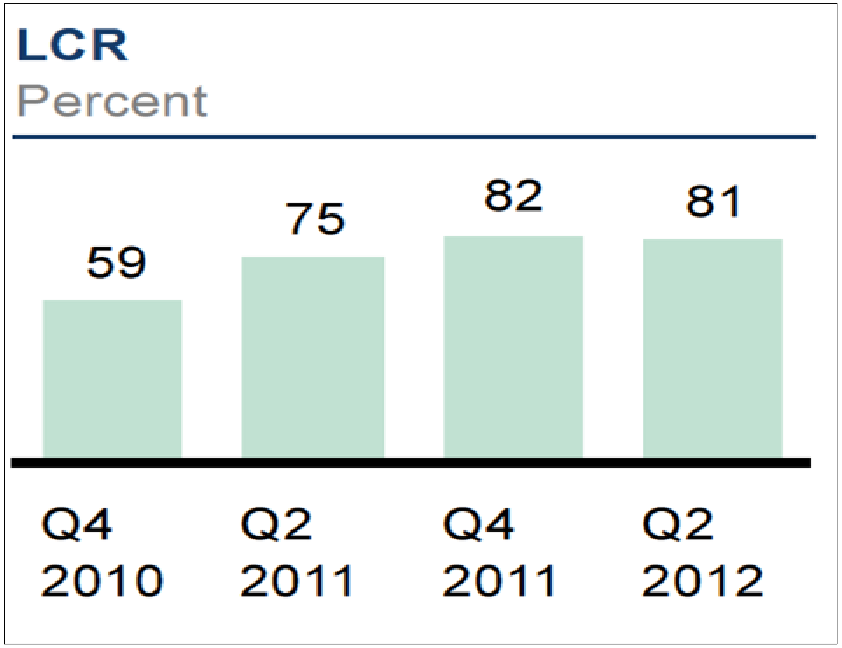
[2] Daniel Tarullo, Governor, Federal Reserve Board, Remarks at the Brookings Institute Conference on Structuring the Financial Industry to Enhance Growth and Stability (Dec. 4, 2012).

7. IMPOSE CREDIT EXPOSURE LIMITS AND DISINCENTIVES FOR UNDUE INTERCONNECTEDNESS AMONG FINANCIAL INSTITUTIONS.

- **The FRB has proposed a comprehensive credit exposure limit as part of Section 165.**
  - Dodd-Frank Section 165(e) imposes a 25% limit on aggregate single-counterparty credit exposures for firms with at least $50 billion in assets.
  - For exposures between firms with **at least $500 billion in assets**, the FRB has authority to impose a limit below 25% (and has proposed by rule a more stringent **10% limit**). Rules will be finalized after completion of ongoing FRB quantitative impact study.
  - The FRB has proposed similar rules for foreign banking organizations operating in the United States.
- **Dodd-Frank ensures that all credit exposure limits (including Section 23A affiliate transaction limits) cover traditional exposures (e.g., loans) as well as exposures arising from derivatives, repo, and securities lending transactions. DFA §§ 165(e), 608-610.**
- **The Basel Committee is developing a revised international standard for limits on large counterparty credit exposures.**
- **Under the Basel III liquidity coverage ratio, credit or liquidity lines between financial institutions are subject to more severe assumed drawdown and inflow rates designed to limit interconnectedness and contagion risk.**
- **Regulators are considering imposing a limit on the amount of debt one SIFI may hold of another SIFI to further limit interconnectedness.**

8. REQUIRE ENHANCED LIQUIDITY STANDARDS AND SOUND LIQUIDITY RISK MANAGEMENT REQUIREMENTS.

- **The Basel Liquidity Coverage Ratio (LCR) requires internationally active banks to maintain high-quality liquid assets to cover liquidity demands during a 30-day period of severe liquidity stress. Required ratio is 1:1, or 100%. Phase in begins in 2015.**
- **Since 2010, U.S. banks have increased their holdings of liquid assets.**
- **Updated LCR calibration will push U.S. industry liquidity levels even higher.**[1]

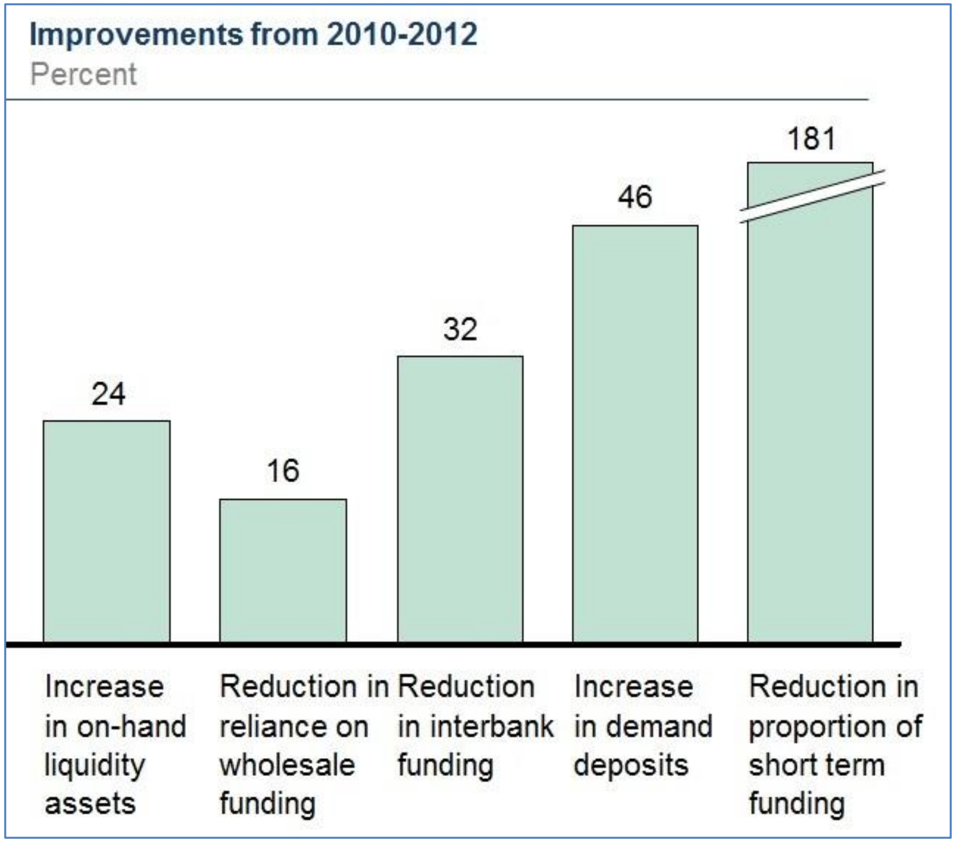


1 Stefan Ingves, Chairman, Basel Committee on Banking Supervision, Remarks at the 8th Annual High Level Meeting of the BCBS and the Financial Stability Institute (Jan. 24, 2013).

Graphic: The Clearing House, *U.S. Banking Industry Liquidity Update* (Dec.14, 2012).

8. REQUIRE ENHANCED LIQUIDITY STANDARDS AND SOUND LIQUIDITY RISK MANAGEMENT REQUIREMENTS. (CONT'D)

- **U.S. banks have significantly improved their *funding stability* since the end of 2010.**
  - **On-hand liquidity** as percentage of liabilities increased by **24%** or about **$600 billion**.
  - **Wholesale funding** reliance decreased by **16%** or about **$250 billion**.
  - **Demand deposits** increased by **46%** or about **$250 billion**.



Source: The Clearing House, *Net Stable Funding Ratio and Sound Practices in Long-Term Liquidity Management* (Forthcoming).

8. REQUIRE ENHANCED LIQUIDITY STANDARDS AND SOUND LIQUIDITY RISK MANAGEMENT REQUIREMENTS. (CONT'D)

- **Dodd-Frank imposes specialized liquidity governance and risk management requirements for large banks, overhauling the supervision of risk and liquidity through:**
  - Creation of risk management committees of their Boards of Directors, which would document and monitor enterprise-wide risk management practices based on banks' capital structures, risk profiles, complexity, and sizes.
- **Liquidity stress tests (CLAR) are being conducted by the FRB at the largest banks.**
- **New standards reduce risks to financial stability.**
  - **Federal Reserve Bank of New York President and CEO William Dudley:** "Since the crisis, a number of steps have been taken that reduce the vulnerability of the system to funding runs in short-term wholesale markets. Capital and liquidity requirements for large complex financial institutions have been raised sharply, the largest broker-dealers have become part of bank holding companies subject to additional regulation, and risk-weights on assets have been adjusted to better capture risks and to reduce the scope for regulatory capital arbitrage by banks." Remarks at the New York Bankers Association's 2013 Annual Meeting & Economic Forum (Feb. 1, 2013).

9. ESTABLISH BETTER EX ANTE MACRO-PRUDENTIAL TOOLS TO IDENTIFY AND MONITOR POTENTIAL SOURCES OF SYSTEMIC RISK.

- **Dodd-Frank establishes the Financial Stability Oversight Council (FSOC) to identify and monitor systemic risk. DFA § 111.**
  - FSOC is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the U.S. financial system.
  - FSOC can provide direction to, and request data and analyses from, the Office of Financial Research (OFR).
  - Among other things, FSOC is authorized to facilitate regulatory coordination; facilitate information sharing and collection; recommend stricter standards; and break up firms that pose a “grave threat” to financial stability.
- **Dodd-Frank establishes the OFR to facilitate the monitoring of systemic risk. DFA § 152.**
  - Dodd-Frank established OFR as a sub-department of the Treasury.
  - The primary function of the OFR is to support the FSOC and its member agencies in fulfilling their duty to promote financial stability and monitor systemic risk.

10. REFORM EXECUTIVE COMPENSATION TO PROVIDE GREATER TRANSPARENCY AND ENSURE THAT INCENTIVES ARE APPROPRIATELY RISK-BASED.

- **Key Dodd-Frank provisions have reformed executive compensation practices and tied compensation arrangements to firm performance.**
  - Section 951 gives shareholders the right to express views on executive compensation and also requires disclosures about and shareholder votes on so-called “golden parachute” payments to departing executives.
  - Section 956 requires that firms disclose incentive-based compensation structures for review by their regulators, who determine whether compensation level is appropriate relative to a firm’s financial health.
  - Section 954 requires firms to put policies in place that provide for the recovery (i.e., “clawback”) of excessive incentive-based compensation, including stock options, from current or former executive officers in connection with financial restatements.
  - Section 953 requires disclosure of CEO compensation versus performance metrics and median employee compensation metrics.

Conclusion

- No bank should be TBTF.
- Actual and prospective reforms are addressing the TBTF problem.
- Systemically important banks are much safer than they were.
- Additional proposed reforms may harm growth and stability rather than enhance it so costs/benefits should be carefully analyzed.

The Clearing House®

At the Center of Banking Since 1853