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The Federal Reserve Proposes Super-Equivalent Capital Surcharge for Global Systemically Important Banks

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The Federal Reserve Board recently proposed for public comment amendments to its risk-based capital rule that would impose a risk-based capital surcharge on eight US global systemically important banks ("G-SIBs"). In general, the proposed G-SIB surcharge would be higher than the G-SIB surcharge agreed to by the Basel Committee. However, the Federal Reserve Board estimates that all eight of the G-SIBs would meet the G-SIB surcharge when fully phased in. The proposed surcharge would not apply to US bank holding companies controlled by foreign banking organizations, although the Federal Reserve Board requested comment on that aspect of the Proposal. If adopted as proposed, it would become fully effective on January 1, 2019.

Overview

On December 9, 2014, the Board of Governors of the Federal Reserve System ("Federal Reserve Board") approved for public comment a proposed rule (the "Proposal") imposing a risk-based capital surcharge that would apply to eight US G-SIBs.[1] The Proposal is based on an international standard adopted by the Basel Committee on Banking Supervision (the "Basel Committee") in November 2011 (after considering comments received on a proposal issued in July 2011) and further refined since that time. The Proposal would amend the Federal Reserve Board's risk-based capital rules and was issued under Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which generally requires the Federal Reserve Board to subject large bank holding companies to enhanced prudential standards. However, the Federal Reserve Board has delayed for future consideration whether to include the G-SIB surcharge as a

[1] See the proposed rule published in the Federal Register at: http://www.gpo.gov/fdsys/pkg/FR-2014-12-18/pdf/2014-29330.pdf.

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component of its capital planning and CCAR programs, which require banking organizations to meet minimum capital requirements under stressed circumstances.

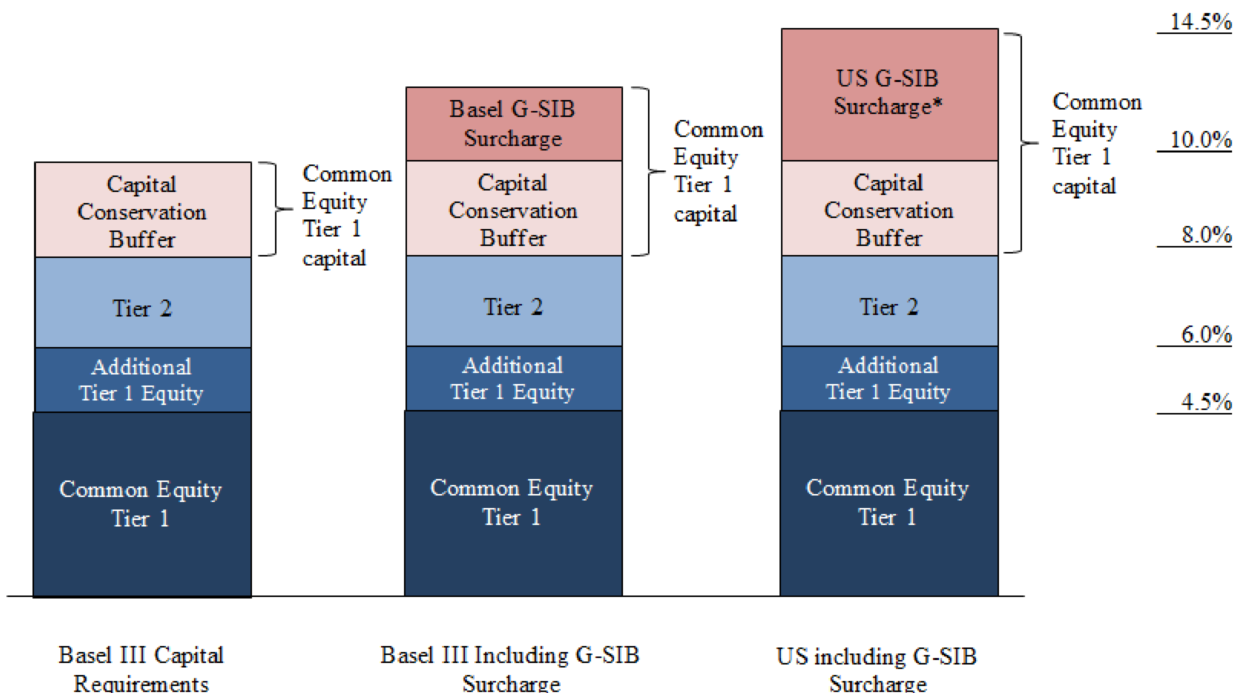
The proposal consists of two basic parts: (1) the identification of a G-SIB and (2) the calculation of the G-SIB surcharge amount.

- The identification of a G-SIB: The proposal will require all US bank holding companies ("BHCs") with $50 billion or more in consolidated assets to calculate their systemic importance based on a list of 12 indicators that fall within five broad categories. If a BHC meets a certain "G-SIB threshold," which eight BHCs would meet based on data as of December 31, 2013, it will be required to hold additional common equity Tier 1 capital in accordance with its systemic risk profile. This additional capital requirement is called the "G-SIB surcharge."
- The calculation of the G-SIB surcharge amount: The G-SIB surcharge will be an addition to the capital conservation buffer, which essentially requires a BHC to hold additional high-quality capital (i.e., common equity Tier 1 capital) above the minimum requirement in order to not be subject to limitations on capital distributions and certain discretionary bonus payments. The eight G-SIBS would be subject to an initial surcharge ranging between 1.0% and 4.5% depending on their individual systemic risk exposure. In contrast, under the Basel Committee methodology, the largest initial surcharge would be only 2.5%.

The stated goal of the G-SIB surcharge is to internalize the negative externalities posed by G-SIBs and the perception that they are too-big-to-fail, protect the financial system from spillover risks due to a G-SIB's failure, and correct for competitive distortions created by the G-SIB banks' systemic nature.[2] The G-SIB surcharge, if adopted as proposed, would become effective on the same timeline as the capital conservation buffer and thus would be phased in beginning in 2016 and would become fully effective on January 1, 2019.

[2] See 79 Fed. Reg. 75473 at 75474-75 (Dec. 18, 2014) published at: http://www.gpo.gov/fdsys/pkg/FR-2014-12-18/pdf/2014-29330.pdf.

G-SIB Minimum Surcharge in Addition to Basel III Capital Requirements



Background

Section 165 of the Dodd-Frank Act generally directs the Federal Reserve Board to establish enhanced prudential standards, including enhanced capital requirements, for BHCs with $50 billion or more in consolidated assets in order to prevent risks to global financial stability. This proposal would enhance the risk-based capital requirements applicable to G-SIBs with the goal of reducing their likelihood of default and furthering their ability to continue operations even in times of financial distress.

The proposed G-SIB surcharge reflects efforts by international supervisory bodies to improve the financial stability of global systemically important financial institutions, beginning with recommendations issued by the Financial Stability Board ("FSB") in 2010 that directed the Basel Committee to develop an assessment methodology to identify G-SIBs. The FSB has identified thirty global systemically important banks using the framework developed by the Basel Committee. The FSB publishes an updated list of G-SIBs annually (most recently in November 2014).

The Identification of a G-SIB

Like the Basel Committee framework, the Proposal specifies five broad categories correlated with systemic risk (size, interconnectedness, cross-jurisdictional activity, substitutability and complexity) that comprise 12 systemic risk indicators (e.g., volume of cross-jurisdictional claims and assets under custody) to identify whether a BHC would be considered a G-SIB. All US BHCs with total consolidated assets of $50 billion or more currently report information regarding these indicators on the Federal Reserve Board's FR Y-15 report. In general, for each indicator, each BHC would calculate its share of the aggregate total amount reported by 75 of the largest international banking organizations. The

aggregate data would be collected by the Basel Committee and published by the Federal Reserve Board. Each indicator would be weighted and multiplied by 10,000 in order to be expressed in "basis points" (or "bps"), and the sum of the amounts for each indicator would determine whether a BHC is a G-SIB based on whether the sum exceeds a specified threshold.

Computing the Applicable G-SIB Surcharge

Once a BHC is designated as a G-SIB under the methodology described above, it would be required to further calculate its G-SIB surcharge under two methods, Method 1 and Method 2, each of which is described below. A G-SIB's surcharge would be the higher of the two amounts determined under the two methods.

Under Method 1, a BHC's "systemic risk" score would be calculated using exposure in the same five categories described above (i.e., the same as the Basel Committee framework). A BHC's score determines the amount of the G-SIB surcharge under Method 1, as reflected in the table below.

G-SIB Surcharge Based on Method 1

METHOD 1 SCORE (BPS)	METHOD 1 SURCHARGE
Less than 130	0.0 percent (no surcharge)
130 – 229	1.0 percent
230 – 329	1.5 percent
330 – 429	2.0 percent
430 – 529	2.5 percent
530 – 629	3.5 percent
630 or greater	3.5 percent plus 1.0 percentage point for every 100 bps increase in score

Under Method 2, the formula replaces the measure for substitutability with a measure for short-term wholesale funding. Short-term wholesale funding encompasses various forms of funding including wholesale brokered deposits, securities financing transactions and repurchase agreements, and is generally viewed as constituting a significant source of funding for large broker-dealers. The stated reason for measuring short-term wholesale funding is that such funding may make a G-SIB vulnerable to liquidity runs, and Method 2 thereby better addresses a G-SIB's susceptibility to failure and more effectively requires a G-SIB to internalize the externalities it imposes on the financial system (although the Basel Committee has previously taken into account the fact that such funding can also be addressed through liquidity regulation).

The calculation of a firm's short-term wholesale funding score relies on various components for measuring liquidity that are used in the recently finalized rules that require large banking organizations to meet a quantitative liquidity coverage ratio. In general, the short-term wholesale funding measure would be calculated by dividing the average of a BHC's short-term wholesale funding amount by its average risk-weighted assets ("RWA") (using the total RWA associated with the lower of the BHC's risk-based capital ratios as calculated under the standardized and advanced approaches and reported on the FR Y-9C report) and multiplying that amount by a fixed factor. (The Federal Reserve Board intends to amend the FR Y-15 report to collect information regarding a BHC's reliance on short-term wholesale funding.) Of note, different forms of short-term wholesale funding are weighted differently based on remaining maturity, counterparty and collateral type in order to take into account the various risks associated with each form as set forth on the table below.

Short-Term Wholesale Funding Weightings

COMPONENTS OF SHORT-TERM WHOLESALE FUNDING	REMAINING MATURITY OF 30 DAYS OR LESS	REMAINING MATURITY OF 31 TO 90 DAYS	REMAINING MATURITY OF 91 TO 180 DAYS	REMAINING MATURITY OF 181 TO 365 DAYS
Secured funding transaction secured by a level 1 liquid asset	25 percent	10 percent	0 percent	0 percent
(1) Secured funding transaction secured by a level 2A liquid asset; and (2) Unsecured wholesale funding where the customer or counterparty is not a financial sector entity or a consolidated subsidiary of a financial sector entity; and (3) Brokered deposits and brokered sweep deposits provided by a retail customer or counterparty; and (4) Covered asset exchanges involving the future exchange of a level 1 liquid asset for a level 2A liquid asset; and (5) Short positions where the borrowed security is either a level 1 or level 2A liquid asset	50 percent	25 percent	10 percent	0 percent
(1) Secured funding transaction secured by a level 2B liquid asset; and (2) Covered asset exchanges and short positions (other than those described above)	75 percent	50 percent	25 percent	10 percent
(1) Unsecured wholesale funding where the customer or counterparty is a financial sector entity or a consolidated subsidiary thereof; and (2) Any other component of short-term wholesale funding	100 percent	75 percent	50 percent	25 percent

A BHC would then add the measure for short-term wholesale funding to the sum of the indicators of the measures calculated under Method 1, other than substitutability, and then double that amount. (The basis for doubling the sum is not entirely clear from the Proposal.) A BHC's score determines the amount of the G-SIB surcharge under Method 2, as reflected in the table below.

G-SIB Surcharge Based on Method 2

METHOD 2 SCORE (BPS)	METHOD 2 SURCHARGE
Less than 130	0.0 percent (no surcharge)
130 – 229	1.0 percent
230 – 329	1.5 percent
330 – 429	2.0 percent
430 – 529	2.5 percent
530 – 629	3.0 percent
630 – 729	3.5 percent
730 – 829	4.0 percent
830 – 929	4.5 percent
930 – 1029	5.0 percent
1030 – 1129	5.5 percent
1130 or greater	5.5 percent plus 0.5 percentage point for every 100 bps increase in score

Impact on Banks and Other Topics of Consideration

Under the Proposal, eight firms would meet the G-SIB threshold. These firms have previously been identified by the FSB as Bank of America, Citigroup, JPMorgan Chase, Goldman Sachs, Morgan Stanley, Wells Fargo, Bank of New York Mellon and State Street Corporation. The Federal Reserve Board indicated that there is a substantial gap between the least systemic of these eight BHCs and the BHC that is ninth most systemic.

The Federal Reserve Board estimates that the amount of the G-SIB surcharge as calculated under Method 2 would range between 1.0% and 4.5% based on 2013 data. This compares to a range of 1.0% to 2.5% as calculated under the Basel Committee framework. Overall, the use of Method 2 is expected to result in a surcharge that is 1.8x the amount of the surcharge calculated under the Basel Committee framework (Method 1). The Federal Reserve Board noted that some other countries (Norway, Switzerland and Sweden) have also adopted surcharges that exceed the requirements established by the Basel Committee. (At least one country appears to have implemented a G-SIB surcharge in line with the method adopted by the Basel Committee.) A wholesale funding ratio had been included as an indicator in the Basel Committee's July 2011 consultative document, and although other countries have apparently not included a measure for short-term wholesale funding in their G-SIB surcharges, Federal Reserve Board officials intend to urge the Basel Committee to include reliance on short-term wholesale funding when the Basel framework is revised.

The G-SIB surcharges are calculated using "bands" rather than a continuous function to facilitate transparency and enable the G-SIBs (and others) to better anticipate the size of the surcharge for future periods. The bands are intended to be sufficiently large so that modest year-to-year changes in a BHC's systemic indicators would not lead to a move from one band to another. As noted above, the Federal Reserve Board expects that all of the G-SIBs would meet the minimum requirement by the time of full implementation. On the other hand, since it would take a large change to move from a higher band to a lower band (especially for a BHC at or above the middle of a band), it is uncertain whether the framework would provide a large enough incentive for G-SIBs to reduce reliance on short-term wholesale funding or otherwise reduce their systemic footprints.

Federal Reserve Board staff also highlighted that the G-SIB surcharge is only one of many steps taken to limit reliance on short-term wholesale funding and otherwise address the perceived risks posed by G-SIBs, including leverage limits, short-term liquidity requirements, stress testing and risk management requirements. Forthcoming regulations include a longer-term liquidity requirement known as the net stable funding ratio ("NSFR") and total loss absorbency requirements. Other initiatives to address reliance on short-term wholesale funding may also be forthcoming. In the past, the Office of the Comptroller of the Currency has also indicated that it is considering whether to apply a capital surcharge to globally significant national banks.

The Federal Reserve Board staff sought to address industry concerns that the augmented surcharge could put US banks at a competitive disadvantage by stating that strong capital can, in fact, be a competitive strength and that US G-SIBs had competed well in the past even though they have generally long been subject to higher capital requirements than their international competitors. Federal Reserve Board staff also noted the importance of achieving competitive equality between US G-SIBs and other US banking organizations.

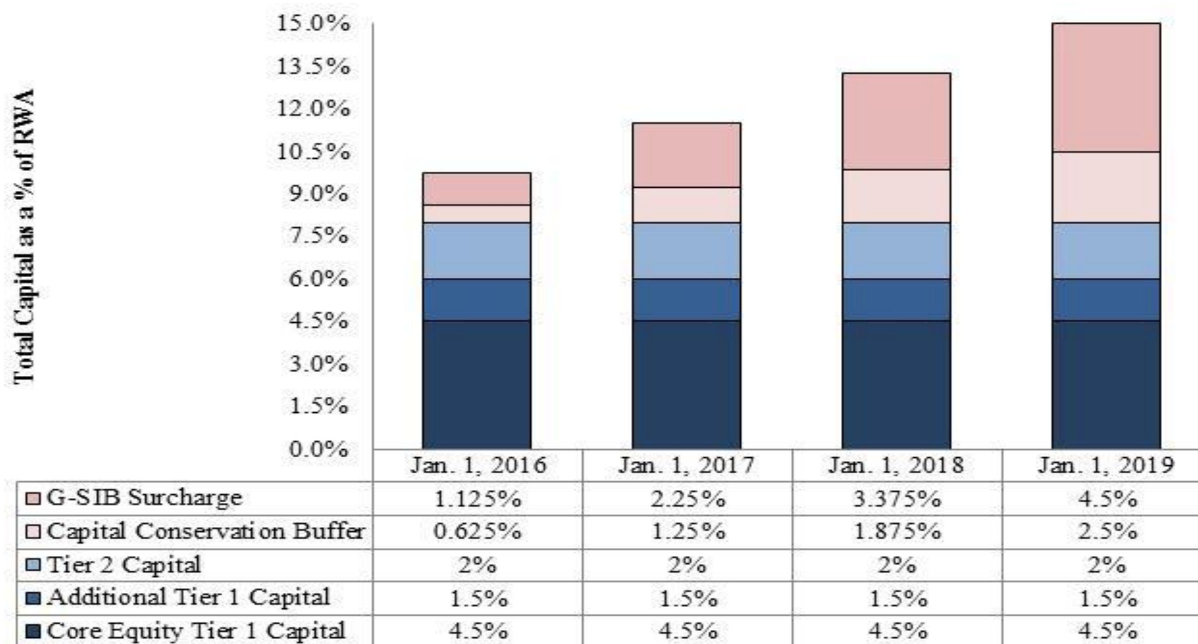
Timeline

The G-SIB surcharge, if implemented as proposed, would be implemented by the largest eight G-SIBs on a gradual basis with 25% by January 1, 2016, 50% in 2017, 75% in 2018, and full implementation in 2019, which is the same timeline as the capital conservation buffer. As noted above, in the future, the Federal Reserve Board will consider whether to

integrate some or all of the G-SIB surcharge into the post-stress minimum capital requirements in the capital plan and stress test rules.

Comments on the Proposal are due by March 2, 2015.

Timeline for Phase-in of G-SIB Surcharge



	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
G-SIB Surcharge	1.125%	2.25%	3.375%	4.5%
Capital Conservation Buffer	0.625%	1.25%	1.875%	2.5%
Tier 2 Capital	2%	2%	2%	2%
Additional Tier 1 Capital	1.5%	1.5%	1.5%	1.5%
Core Equity Tier 1 Capital	4.5%	4.5%	4.5%	4.5%

*Assuming highest G-SIB surcharge amount of 4.5%.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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