July 13, 2018

Bank Capital Requirements

Basel Committee Issues Revised G-SIB Assessment Framework

On July 5, the Basel Committee on Banking Supervision issued a **revised framework**[1] that updates and replaces its **2013 framework**[2] used to identify global systemically important banks ("*G-SIBs*") and impose higher capital requirements on those banks. In the preface to the revised framework, the Basel Committee reconfirms the "fundamental structure" of the previous framework—contending that there is "general recognition that the G-SIB framework is meeting its primary objective of requiring systemically important banks to hold higher capital buffers and providing incentives for G-SIBS to reduce their systemic importance."[3]

The revised framework finalizes most of the changes to the 2013 framework that were proposed in **March 2017**,[4] including (1) the introduction of a new indicator for secondary capital markets activity in the substitutability category, (2) the expansion of the regulatory scope of consolidation to include insurance subsidiaries, (3) amendments to the definition of cross-jurisdictional indicators, and (4) the addition of a requirement that banks disclose the indicators used in their "final" G-SIB calculations, which may require restatement in some cases. Notably, however, the Basel Committee did not remove the cap imposed on the maximum impact of the substitutability category on a bank's overall score, as proposed in March 2017, or further address the potential introduction of a new indicator for short-term wholesale funding, which was presented as an "issue for discussion" in the March 2017 proposal.[5] The Basel Committee notes in the preface to the revised framework that, in its next review of the framework, it "will pay particular attention to alternative methodologies for the substitutability category, so as to allow the cap to be removed at that time."[6]

The revised assessment framework also includes a transition schedule to "help ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital-raising, while still supporting lending to the economy."[7] The transition schedule, which is summarized in a table at the end of this memorandum, provides that the revised assessment methodology will take effect in 2021, based on year-end data from 2020, and that the corresponding capital surcharge requirements based on the revised methodology will apply from January 1, 2023.[8]

The Basel Committee has committed to complete its next review of the G-SIB assessment methodology by 2021.[9]

Key Changes to the Assessment Methodology and Framework

Changes to the 2013 assessment methodology include the following (each of which was finalized largely as proposed in 2017):

- ***Introduction of a new indicator in the substitutability category.*** Within the substitutability category, the revised framework includes a new indicator on trading volume intended to capture banks' market making (which the Basel Committee describes as assuming the risk of holding securities in order to provide "liquidity immediacy" for clients) and agency-based trading, both of which the Basel Committee believes would be "difficult to substitute" in the event of a G-SIB's failure.[10] To accommodate this addition, the revised assessment framework reduces the weight of the underwriting indicator from 6.67% to 3.33% and the new trading volume indicator is weighed at 3.33%.
  - The Basel Committee notes that, in contrast to the other categories in which multiple indicators are weighted equally within the category, this split of the weight previously allocated solely to the underwriting indicator "reflects the complementary role of the trading volume indicator, which is to capture potential disruptions in the provision of liquidity in the secondary market for some exposures, while the underwriting indicator captures liquidity in the primary market."[11] The effect of the new trading volume indicator is reflected in the table below.

Indicator Within the Substitutability Category	**Indicator Weight in the 2013 Framework**	**Indicator Weight in the 2018 Framework**
Payments	6.67	6.67
Custody	6.67	6.67
Underwriting	6.67	**3.33**
Trading Volume	n/a	**3.33**

- ***Expansion of the regulatory scope of consolidation to include insurance subsidiaries.*** The revised framework extends the scope of consolidation by including exposures from insurance subsidiaries in the following categories: size (in the total exposures indicator); interconnectedness (in the intra-financial system assets, intra-financial system liabilities, and securities outstanding indicators); and complexity (in the notional amount of over-the-counter derivatives and level 3 assets indicators, but not the trading and available-for-sale securities indicator). This change is intended to address both the potential "inconsistency in the systemic assessment of banking groups across jurisdictions"[12] resulting from the fact that some member jurisdictions do not require G-SIBs to include insurance subsidiaries in their regulatory scope of consolidation, as well as the identified gap at the macroprudential level resulting from the fact that neither the G-SIB nor the global systemically important insurers ("*G-SII*") frameworks capture insurance subsidiaries of banking groups.[13] In the United States, the same basis of consolidation is used for accounting and regulatory purposes, and the Federal Reserve's U.S. G-SIB surcharge rule accordingly does *not* exclude insurance subsidiaries from the regulatory scope of consolidation.

- ***Amendment to the definition of cross-jurisdictional indicators.*** In light of recent enhancements to the collection of consolidated banking statistics that allow the Basel Committee to capture derivatives liabilities on a consolidated basis, the revised framework now includes these liabilities in the cross-jurisdictional liabilities indicator (and the corresponding derivatives assets in the cross-jurisdictional claims indicator). Previously, limitations in the collection of BIS consolidated banking statistics only captured derivatives liabilities at the "solo level" (the individual entity level, rather than the consolidated level) based on local accounting rules. This change brings the definition of the cross-jurisdictional indicators in harmonization with the BIS consolidated banking statistics metric. As noted in the preface to the revised framework, the precise definition of the indicators can be found in the reporting template and instructions that the sample banks use to supply their indicator data to the Basel Committee's data hub.[14]

- ***Addition of a requirement that banks disclose the indicators used in their "final" G-SIB calculations, which may require restatement in some cases.*** The 2013 framework required banks to disclose their 12 indicator scores no later than four months after the financial year-end, and in any case, no later than the end of July. However, because the G-SIB assessment and data quality review of this information is performed by the Basel Committee from June to August, under the 2013 framework banks may have been required to report two or more rounds of data before their indicator scores were considered final. The revised framework modifies the disclosure requirements to require banks to publicly disclose updated scores for the 13 indicators "if the data used to calculate the G-SIB scores differ from the figures previously disclosed" in accordance with the Pillar 3 requirements and timelines. If revised public disclosure of "final" indicator scores is required, banks are required to make these disclosures in "the financial quarter immediately following the finalisation of the Basel Committee's G-SIB score calculation."[15] Banks are required to note in their initial disclosure of the 13 indicator scores that those "figures are subject to revision and restatement."[16]

- ***Guidance on bucket migration and associated higher surcharges.*** The revised framework clarifies that a bank may immediately apply the lower capital surcharge when its G-SIB score declines such that the bank is in a lower capital surcharge bucket. Previously, the framework was silent on the timing of the application of a lower capital surcharge bucket in the event of a "downward bucket migration," i.e., when a bank's G-SIB score declines to a level such that the bank becomes subject to a lower capital surcharge. To provide "strong incentives for banks to reduce their systemic importance," the Basel Committee adopted this guidance as proposed to allow banks to immediately apply the lower capital surcharge in "circumstances where the G-SIB score falls," subject to national discretion.[17] The revised framework maintains the requirement that a bank must meet higher capital surcharge requirements resulting from an upward bucket migration within 12 months in order to avoid capital distribution constraints under the capital buffer framework.[18] In the United States, the Federal Reserve's U.S. G-SIB surcharge rule already reflects the new guidance on bucket migration: U.S. G-SIBs have 12 months to satisfy higher surcharges but become subject to lower surcharges immediately.[19]

Proposed Items Not Included in the Revised Framework

- ***Elimination of the cap currently applied to the substitutability category.*** The revised framework retains the cap on the maximum potential impact of the substitutability category on a bank's overall score, which had a greater impact than the Basel Committee intended on banks that are significant providers of payment, underwriting and asset custody services.[20] Although the Basel Committee stated in the March 2017 proposal that the cap "reduc[es] banks' incentives to become less systemically important" and should be removed to restore the "linear relationship between concentration and the G-SIB substitutability category score,"[21] the Basel Committee does not discuss its rationale for retaining the substitutability cap. The Basel Committee does, however, note that it "will pay particular attention to alternative methodologies for the substitutability category" during its next review of the assessment methodology in 2021 "so as to allow the cap to be removed at that time."[22] The U.S. G-SIB surcharge rule finalized by the Federal Reserve in 2015 also includes this cap on the substitutability category under its "Method 1" score.[23]

- ***Introduction of a new indicator for short-term wholesale funding.*** In the March 2017 proposal, the Basel Committee included, as an "issue for discussion," the introduction of a new indicator for short-term wholesale funding as a new, fourth indicator in the interconnectedness category.[24] The Basel Committee does not address the potential role, if any, of a short-term wholesale funding indicator in the revised framework, nor does it note whether this item is still under consideration or may be reconsidered as part of the next review of the assessment methodology in 2021.

Proposed Transition Period

To provide banks with "a certain degree of consistency with the 2013 G-SIB assessment methodology" and to provide member jurisdictions' regulatory authorities "with the time to implement the changes in their respective regulatory frameworks," the annual G-SIB scores determined by the Basel Committee will continue to be based on the July 2013 assessment framework until 2021, when the revised assessment methodology is to take effect based on end-2020 data.[25] The resulting capital requirements will be applied in January 2023. The operational timetable is set forth in the table below.

Year of Assessment	Methodology of Reference	Data Used in Assessment	Applicability of Capital Requirement
2018	Current (published July 2013)	End-2017	January 1, 2020
2019	Current (published July 2013)	End-2018	January 1, 2021
2020	Current (published July 2013)	End-2019	January 1, 2022
2021	Revised (published in July 2018)	End-2020	January 1, 2023

Reaffirming Periodic Review and Refinement

In the revised framework, the Basel Committee reaffirmed its commitment to review the methodology, "including the indicator-based measurement approach itself and the cutoff/threshold scores," every three years "in order to capture developments in the banking sector and any progress in methods and approaches for measuring systemic importance."[26] The revised framework provides that, by 2021, the Basel Committee will complete its next cycle of review of the assessment methodology, with a particular focus, as noted above, on "alternative methodologies for the substitutability category, so as to allow the cap to be removed at that time."[27] In its next review, the Basel Committee "will also pay particular attention to branches" and will again review the selection of banks included in its sample. The Basel Committee notes in the revised framework that it will review "structural changes in regional arrangements," such as the European Banking Union, independently from the three-year review cycle as actual changes are made.[28]

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ENDNOTES

[1] Basel Committee on Banking Supervision, *Global Systemically Important Banks – Revised Assessment Methodology and the Higher Loss Absorbency Requirement*, at 1 (July 2018), https://www.bis.org/bcbs/publ/d445.pdf (the "Revised Assessment Framework").

[2] Basel Committee on Banking Supervision, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (July 2013), www.bis.org/publ/bcbs255.pdf (the "2013 framework"). For additional information regarding prior versions of the Basel G-SIB framework, see our client memoranda *Bank Capital Requirements: Basel Committee Updates Framework for Assessing a Common Equity Surcharge for Global Systemically Important Banks* (July 26, 2013), https://sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements.pdf, and *Bank Capital Requirements: Basel Committee Issues Final Rule Regarding Common Equity Surcharge for Global Systemically Important Banks* (November 10, 2011), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_11-10-11.pdf.

For information on the U.S. implementation of the Basel-based G-SIB capital surcharge, see our client memoranda *Bank Capital Requirements: Federal Reserve Proposes Rule Establishing Common Equity Surcharge on U.S. Global Systemically Important Banks* (December 14, 2014), https://sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_12_14_14.pdf, and *Bank Capital Requirements: Federal Reserve Approves Final Common Equity Surcharge for U.S. Global Systemically Important Banks* (July 29, 2015), https://sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_7_29_2015.pdf.

[3] Revised Assessment Framework, at 1.

[4] The Basel Committee first published the G-SIB assessment framework in 2011, and committed to review and consider possible enhancements to the framework every three years to help the Basel Committee "ensure that the framework remains consistent with its objectives in light of any structural change to the global banking system or to banks' business models." Basel Committee on Banking Supervision, *Global Systemically Important Banks – Revised Assessment Framework*, at 2 (March 2017), http://www.bis.org/bcbs/publ/d402.htm (the "2017 Proposal"). Consistent with its three-year review cycle, in March 2017, the Basel Committee published a consultative document proposing changes to the assessment framework. *See* the 2017 Proposal, at 2.

[5] Revised Assessment Framework, at 1.

[6] Revised Assessment Framework, at 1.

[7] Revised Assessment Framework, at 13.

[8] Revised Assessment Framework, at 13 and Annex 3.

[9] Revised Assessment Framework, at 1 and Annex 3.

[10] 2017 Proposal, at 6. Because the revised assessment framework is largely an amendment and restatement of the 2013 framework, with little discussion of the changes it finalizes, we have drawn from the discussion of each change in the March 2017 proposal as background on the Basel Committee's rationale for finalizing new elements of the framework. For additional information on the March 2017 proposal, please refer to our client memorandum *Bank Capital Requirements: Basel Committee Proposes Changes to the G-SIB Capital Surcharge Assessment Framework* (April 6, 2017), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_04_06_2017.pdf.

[11] Revised Assessment Framework, at 4.

[12] Revised Assessment Framework, at 5.

[13] The Basel Committee deemed this a "gap at the macroprudential level," as neither the G-SIB nor the G-SII framework captured these entities. 2017 Proposal, at 5.

ENDNOTES (CONTINUED)

[14] Revised Assessment Framework, at 1 (footnote 2). The new definitions are reflected in the reporting instructions for end-2017 in Section 3.1 – Items Added, under 3.1.5 – Section 20: Cross-Jurisdictional Activity Items (which now indicates in parentheticals for each item "including derivatives activity").

[15] Revised Assessment Framework, at 10.

[16] Revised Assessment Framework, at 10.

[17] 2017 Proposal, at 9.

[18] Revised Assessment Framework, at 13.

[19] *See* 12 C.F.R. § 217.403(d).

[20] The 2013 framework included a cap on the maximum potential impact of the substitutability category on a bank's overall score. At that time, the Basel Committee found that the substitutability category was having a greater than intended impact on the assessment of systemic importance for "banks that are dominant in the provision of payment, underwriting and asset custody services." The Basel Committee set the cap at 500 basis points (which, when weighted at 20%, would have a maximum impact of 100 points on the overall score). This could "move a bank up by one bucket, but not more." 2017 Proposal, at 4. The Basel Committee noted in the 2013 framework that it would reconsider the cap during the first three-year review of the framework. 2013 framework, at 5-6.

[21] 2017 Proposal, at 5.

[22] Revised Assessment Framework, at 1, 9.

[23] *See* 12 C.F.R. § 217.404(b)(2).

[24] 2017 Proposal, at 14. The Federal Reserve's U.S. G-SIB surcharge rule includes two "Methods" for calculating the G-SIB surcharge score, the first of which, "Method 1," is consistent with the Basel Committee's methodology, and the second of which, "Method 2," replaces the substitutability category of the Basel framework with a short-term wholesale funding category. Under the U.S. framework, the Method 1 score is used to identify U.S. G-SIBs from among large bank holding companies, and the higher of a G-SIB's Method 1 and Method 2 scores is used to determine the applicable capital surcharge. *See* 12 C.F.R. § 217.404 (the Method 1 score) and 12 C.F.R. § 217.405 (the Method 2 score).

[25] Revised Assessment Framework, at 13. The March 2017 proposal provided that the revised framework would take effect in 2019 (based on 2018 data), with the resulting capital requirements applied in 2021. 2017 Proposal, at 9.

[26] Revised Assessment Framework, at 9.

[27] Revised Assessment Framework, at 9.

[28] Revised Assessment Framework, at 9.

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