July 26, 2013

Bank Capital Requirements

Basel Committee Updates Framework for Assessing a Common Equity Surcharge on Global Systemically Important Banks

SUMMARY

The Basel Committee on Banking Supervision (the "*BCBS*")[1] recently issued a revised framework (the "*Revised G-SIB Framework*") for assessing a common equity surcharge on certain designated global systemically important banks ("*G-SIBs*")[2] that updates and replaces the framework for assessing the G-SIB capital surcharge issued by the BCBS in November 2011 (the "*Prior G-SIB Framework*").[3] The Revised G-SIB Framework largely maintains the Prior G-SIB Framework's indicator-based approach for determining when a capital surcharge will be applied and does not change the calibration of the surcharge. However, the Revised G-SIB Framework makes several noteworthy changes to, and clarifies important aspects of, the Prior G-SIB Framework, including:

- **Methodology for Determining Sample Banks**. The Revised G-SIB Framework establishes formal criteria for determining the sample of banks used to determine a bank's indicator-based systemic importance score ("*systemic importance score*"). The sample of banks used to determine the denominator for purposes of calculating each bank's systemic importance score will consist of (i) the 75 "largest" global banks as determined by the Basel III leverage ratio exposure measure (the "*Exposure Measure*"), (ii) banks designated as G-SIBs in the previous year and (iii) other banks added using supervisory judgment (collectively, the "*Bank Sample*").
- **Removal of Wholesale Funding Ratio Indicator**. The Revised G-SIB Framework replaces the wholesale funding ratio indicator with a "securities outstanding" indicator. Under the Prior G-SIB Framework, the wholesale funding ratio generally measured the portion of a bank's liabilities that were not funded by retail funding. The new "securities outstanding" indicator aims to measure the amount of debt securities, commercial paper and certificates of deposits a bank has outstanding, as well as the book value of its equity and its equity market capitalization.
- **Cap on the Substitutability Category**. The Revised G-SIB Framework will cap the maximum potential impact of the substitutability/financial institution infrastructure category because the BCBS has found that it 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 terms of the cap will not be disclosed until the cutoff score and bucket thresholds are disclosed in November 2013.

- **Disclosure Requirements for Certain Large Banks**. Under the Revised G-SIB Framework, banks having an Exposure Measure exceeding €200 billion (or an equivalent amount), as well as banks designated as G-SIBs in the previous year, will need to disclose publicly their scores for the 12 indicators used to determine banks' systemic importance scores. The Revised G-SIB Framework contemplates that national supervisors would implement these disclosure requirements by January 2014. The Prior G-SIB Framework did not have similar disclosure requirements.
- **Updates to Denominators and Timing**. The Prior G-SIB Framework would have updated the denominators every three years. The Revised G-SIB Framework will update the denominator on an annual basis. According to the BCBS, this change was made to reduce potentially large changes in systemic importance scores simply as a result of an update to the denominator and to neutralize the impact of exchange rate movements.
- **Timing of Cutoff Scores and Bucket Thresholds**. Under the Revised G-SIB Framework, the BCBS will publish the cutoff score and bucket thresholds in November 2013 based on year-end 2012 Bank Sample financial data, one year earlier than under the Prior G-SIB Framework. The BCBS will also disclose the denominators in November 2013 based on year-end 2012 data. As a result, there will be a revised draft list of G-SIBs published in November 2013. The updated list of G-SIBs that will be subject to a G-SIB surcharge starting on January 1, 2016 (and updated denominators used to determine such surcharge) will be published in November 2014.
- **Consequences of Empty Bucket Becoming Populated**. The Prior G-SIB Framework provided for an initially empty top bucket requiring a 3.5% surcharge. If that bucket became populated, the Prior G-SIB Framework provided that a new empty bucket would be added with a higher surcharge requirement but did not specify the surcharge requirement. The Final G-SIB Framework retains this general structure but clarifies that any additional empty buckets that are added would receive an additional capital surcharge of 1% over the previous highest bucket.

As under the Prior G-SIB Framework, the surcharge requirement under the Revised G-SIB Framework will be phased-in in parallel with the Basel III capital conservation and countercyclical buffers, beginning on January 1, 2016 and becoming fully effective on January 1, 2019.

DISCUSSION – CHANGES, CLARIFICATIONS, AND REMAINING ISSUES

Under both the Revised G-SIB Framework and the Prior G-SIB Framework, the G-SIB surcharge methodology determines whether a bank qualifies as a G-SIB and assesses a progressive Common Equity Tier 1 ("*CET1*") surcharge of between 1% and 3.5%[4] on each G-SIB based on a bank's systemic importance score. The actual calculation of the systemic importance score is based on a bank's score in five "*categories*" of indicators (that is, cross jurisdictional activity, size, interconnectedness, substitutability/financial institution infrastructure and complexity); the categories, with the exception of the size category, are further sub-divided into 12 specific indicators in total. A bank's systemic importance score is calculated for each indicator by dividing the bank's raw measured amount relating to that indicator by the aggregate raw measured amount summed across all banks in the Bank Sample relating to that indicator. The resulting fraction is then weighted and all the weighted indicator scores are added to calculate a bank's systemic importance score, subject to a degree of supervisory judgment.[5]

Although the Revised G-SIB Framework largely retains the fundamental elements of the Prior G-SIB Framework, it nevertheless makes several notable changes to, and clarifies important aspects of, the Prior G-SIB Framework. Certain of these key changes and clarifications are discussed below.

Bank Sample. The Bank Sample is a key component of the G-SIB framework. Banks included in the Bank Sample are subject to the reporting requirements and are eligible for designation as G-SIBs. Further, the denominator of any indicator score is the amount for that indicator summed across all banks in the Bank Sample. The Prior G-SIB Framework provided that the Bank Sample comprised a group of 73 banks but did not disclose a methodology for determining the sample beyond noting that the banks were chosen "from the world's largest banks on the basis of size and supervisory judgment".[6] The Revised G-SIB Framework introduces criteria for determining the Bank Sample, which consist of: (i) banks that are the 75 largest global banks as determined by banks' year-end Exposure Measures; (ii) banks that were designated as G-SIBs in the previous year (unless supervisors agree there is a compelling reason to exclude them); and (iii) banks that are added to the Bank Sample by supervisors using supervisory judgment, subject to certain criteria, which are currently under consideration by the BCBS. As under the Proposed G-SIB Framework, the size of the Bank Sample under the Revised G-SIB Framework will be reviewed and potentially adjusted every three years.

Indicator Definitions. The following indicator definitions have been updated in the Revised G-SIB Framework:

- **Wholesale Funding Ratio**. The wholesale funding ratio, which under the Prior G-SIB Framework was one of the three indicators in the interconnectedness category, has been replaced by a "securities outstanding" indicator. The cover note accompanying the Prior G-SIB Framework provided that the BCBS had tentatively agreed to replace the wholesale funding indicator with "all marketable securities issued by banks." However, the "securities outstanding" indicator is not limited under the Revised G-SIB Framework to marketable securities. It includes items designed to measure the amount of debt securities, commercial paper and certificates of deposits a bank has outstanding as well as the book value of its equity and its equity market capitalization. In addition, the BCBS did not limit this measure to securities with a maturity of one year or less, as it had suggested it was considering in the cover note accompanying the Prior G-SIB Framework.[7]
- **Trading and Available-for-Sale Indicator**. The trading and available-for-sale indicator of the complexity category now excludes assets that are high-quality liquid assets ("*HQLA")* for the purposes of the liquidity coverage ratio under the Basel III liquidity framework. According to the BCBS, the change reflects the aim of the indicator to identify only those assets that may suffer a fire sale discount if sold during a period of severe market stress.

Cap on Substitutability. The Revised G-SIB Framework will cap the degree to which the substitutability/financial institution infrastructure category (the "*substitutability category*") of indicators may affect a bank's systemic importance score. The substitutability category was not capped under the Prior G-SIB Framework. The BCBS indicated that this change was made because the substitutability category was having a greater impact on systemic importance scores than the BCBS had intended. The amount of the cap will be fixed and disclosed later this year, at the same time as the disclosure of the cutoff score and bucket thresholds. The BCBS will review the cap as part of the first three-year review of the G-SIB surcharge methodology and indicated that "[r]evisions to the methodology may allow it to be removed at that time."[8]

Disclosure Requirements. All banks with an overall size exceeding €200 billion,[9] as measured by the Exposure Measure, as well as all banks that have been classified as G-SIBs in the previous year or added to the Bank Sample by supervisory judgment, must make publically available each of their indicator scores. This requirement was not contained in the Prior G-SIB Framework, and is notable because it will affect banks that have not been designated as G-SIBs. This requirement initially applies to financial year ends that fall in the period between July 1, 2013 and June 30, 2014 and to each subsequent financial year end of affected banks. Banks will be required to make this disclosure no later than four months after their financial year end, and in any case, no later than the end of July of each year. National supervisors may permit banks with June 30 financial year ends to report indicator values based on December 31 positions as opposed to financial year-end positions. Disclosures required under the Revised G-SIB Framework must also either be included in affected banks' published financial statements or linked to on the banks' websites or on banks' publicly available regulatory reports.

Consequences of the Empty Highest Bucket Becoming Populated**.** Like the Prior G-SIB Framework, the Revised G-SIB Framework includes an empty bucket with a G-SIB surcharge of 3.5% in order to provide a disincentive for G-SIBs to increase materially their global systemic importance. The Revised G-SIB Final Framework provides that if the 3.5% bucket should become populated a new vacant bucket will be added to maintain incentives for banks to avoid becoming even more systemically important. In addition, it clarifies that the new bucket will be equal in size (in terms of systemic importance scores) to each of the currently existing buckets and the G-SIB surcharge for the new bucket will be 1% higher than that of the then existing highest bucket (for example, 4.5%). The G-SIB surcharge for each additional bucket (above the 4.5% bucket), would increase in increments of 1%. Accordingly, if a G-SIB were placed into the bucket providing for a 4.5% surcharge, for example, then a new bucket would be added providing for a 5.5% surcharge.

Timing considerations**.** The timing of implementation of the G-SIB surcharge framework under the Revised G-SIB Framework is fairly complex and has been changed in several important respects as described below.

- Under the Revised G-SIB Framework, the cutoff systemic importance score (above which a bank would be subject to a G-SIB surcharge) and the threshold scores for each of the surcharge buckets will be fixed based on data reported by the current BCBS Sample Banks as of 2012 year-end and will be disclosed by November 2013. The cutoff and threshold scores under the Prior G-SIB Framework were disclosed one year later (namely, November 2014).
- The denominators used to calculate the indicator scores will also be disclosed in November 2013 based on 2012 year-end data, and will be updated and disclosed annually thereafter based on financial data from the previous year-end reported by banks in the Bank Sample (which itself is updated annually). This represents a change from the Prior G-SIB Framework, which contemplated that the denominators would be revised every three years.

- The updated list of G-SIBs that will be subject to a G-SIB surcharge starting on January 1, 2016 (and updated denominators used to determine such surcharge) will be published in November 2014.
- As under the Prior G-SIB Framework, the cutoff score and bucket thresholds will be reviewed every three years. The BCBS will also continue to monitor data quality and issue further guidance to ensure consistency of reported data.

ADDITIONAL CONSIDERATIONS

- **U.S. Implementation.** Federal Reserve Governor Tarullo stated earlier this month (and prior to the publication of the Revised G-SIB Framework) that "after the [BCBS] has completed final methodological refinements to its framework for capital surcharges on banking organizations of global systemic importance, [the Federal Reserve] will issue a notice of proposed rulemaking to implement this framework in the United States".[10] In light of these remarks and given that the BCBS has now issued the Revised G-SIB Framework, the Federal Reserve seems likely to publish its notice of proposed rulemaking in the near future, although the precise timing remains uncertain.
- **Application to non-bank entities.** The Prior G-SIB Framework indicated that the FSB was "reviewing" how to extend the G-SIB framework to a wider group of systemically important financial institutions, including financial market infrastructures, insurance companies[11] and other non-bank financial institutions that are not part of a banking group structure. In the introduction to the Revised G-SIB Framework, the BCBS stated that the FSB is now "in the process" of implementing this extension.
- **Leverage ratio exposure measure.** The Exposure Measure is a key component in calculations under the G-SIB surcharge methodology. For example, inclusion in the Bank Sample is based largely on a bank's Exposure Measure, as is the requirement to disclose indicator scores. Even more importantly, the size category in the systemic importance score calculation is entirely based on the Exposure Measure. The BCBS recently published a proposal (the "*BCBS Leverage Proposal*") significantly amending the way that the Exposure Measure is calculated. The BCBS Leverage Proposal, if adopted and implemented, is likely to significantly expand the Exposure Measure for certain banks.[12] The BCBS has clarified that the Exposure Measure under the G-SIB framework is intended to match the Exposure Measure under the Basel III capital framework. Therefore, to the extent the BCBS makes changes to the Basel III capital framework based on the BCBS Leverage Proposal and national supervisors adopt such changes, there may be a significant impact on certain banks' size indicator scores and on whether banks are included in the Bank Sample or are required to make disclosures of their indicator scores.
- **Instruments to meet the G-SIB surcharge.** The Revised G-SIB Framework states that the BCBS will continue to review whether contingent capital may be used to meet the G-SIB surcharge requirement and continues to support the use of contingent capital to meet any G-SIB surcharge requirements imposed by national supervisors that are in excess of those required under the Revised G-SIB Framework.

* * *

ENDNOTES

1 The BCBS is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries at the end of 1974.

2 The updated framework is set forth in a document titled Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement.

3 BCBS, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement, November 4, 2011. For additional information regarding the Prior G-SIB Framework and related issues see Sullivan & Cromwell LLP's memoranda to clients titled Basel Committee Issues Final Rule Regarding Common Equity Surcharge for Global Systemically Important Banks (November 10, 2011), available at www.sullcrom.com/Bank-Capital-Requirements-11-10-2011 and Regulatory Capital Surcharge for Global Systemically Important Banks (July 26, 2011), available at www.sullcrom.com/bank-capital-requirements-07-26-2011/.

4 The highest bucket, that is, the 3.5%, bucket, is intentionally left vacant to discourage the largest G-SIBs from becoming more systemically important.

5 For additional information regarding the manner in which systemic importance scores are calculated under the Prior G-SIB Framework, see Sullivan & Cromwell LLP's memorandum to clients titled Basel Committee Issues Final Rule Regarding Common Equity Surcharge for Global Systemically Important Banks (Nov. 10, 2011), available at http://www.sullcrom.com/Bank-Capital-Requirements-11-10-2011/.

6 Prior G-SIB Framework, ¶ 53.

7 BCBS, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement – Cover Note (Nov. 4, 2011), ¶ 17.

8 Revised G-SIB Framework, ¶ 19, fn.10.

9 This amount is determined using exchange rates applicable at the financial year end.

10 The Revised G-SIB Framework contemplates that national reporting and disclosure requirements based on the Revised G-SIB Framework be implemented by January 2014. For more detail regarding Governor Tarullo's remarks, see Sullivan & Cromwell LLP's memorandum to clients titled Federal Reserve Board Governor Tarullo Previews Rulemakings that Will Establish More Rigorous Capital Requirements for Largest U.S. Banking Organizations, July 3, 2013, *available at* www.sullcrom.com/Bank_Capital_Rules_7_03_13.

11 On July 18, 2013, the International Association of Insurance Supervisors ("*IAIS*") published a methodology for assessing global systemically important insurers ("*GSIIs*"). *See* Global Systemically Important Insurers: Initial Assessment Methodology (July 18, 2013), *available at* www.iaisweb.org/view/element_href.cfm?src=1/19151.pdf. On that same day, the Financial Stability Board published a list of GSIIs, which consisted of Allianz SE, American International Group, Inc., Assicurazioni Generali S.p.A, Aviva plc, Axa S.A., MetLife, Inc., Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc. and Prudential plc. *See* Financial Stability Board, Communication on GSIIs (July 18, 2013), *available at* www.financialstabilityboard.org/publications/r_130718.pdf.

12 BCBS, Consultative Document: Revised Basel III leverage ratio framework and disclosure requirements (June 2013). For more detail on BCBS's recent proposed changes to the Exposure Measure, please see our memorandum to clients titled Basel Committee Publishes Consultative Document Proposing Changes to Exposure Measure and Disclosure Requirements, June 27, 2013, *available at* www.sullcrom.com/basel_iii_leverage_ratio_framework/.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from John Castro (+1-212-558-4417; castrojoh@sullcrom.com) in our New York office.

CONTACTS

New York

Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Elizabeth T. Davy	+1-212-558-7257	davye@sullcrom.com
Michael T. Escue	+1-212-558-3721	escuem@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Andrew R. Gladin	+1-212-558-4080	gladina@sullcrom.com
Erik D. Lindauer	+1-212-558-3548	lindauere@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Camille L. Orme	+1-212-558-3373	ormec@sullcrom.com
Donald J. Toumey	+1-212-558-4077	toumeyd@sullcrom.com
Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com
Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com
Wendy M. Goldberg	+1-212-558-7915	goldbergw@sullcrom.com
Jiang Liu	+1-212-558-3093	liujia@sullcrom.com
Joel Alfonso	+1-212-558-1655	alfonsoj@sullcrom.com
Simon Rasin	+1-212-558-4492	rasins@sullcrom.com

Washington, D.C.

Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
Andrea R. Tokheim	+1-202-956-7015	tokheima@sullcrom.com
William F. Kroener III	+1-202-956-7095	kroenerw@sullcrom.com

J. Virgil Mattingly	+1-202-956-7028	mattinglyv@sullcrom.com
Los Angeles		
Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Stanley F. Farrar	+1-310-712-6610	farrars@sullcrom.com
Tokyo		
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com