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Bank Capital Requirements

Regulatory Capital Surcharge for Global Systemically Important Banks

SUMMARY

On July 19, 2011, the Basel Committee on Banking Supervision (the "*BCBS*")[1] issued a consultative document setting forth a requirement for a new common equity capital surcharge on certain global systemically important banks ("*G-SIBs*").[2] A summary of the surcharge proposal was announced on June 25, 2010 in a short press release by the Group of Governors and Heads of Supervision of the BCBS.[3] The July 29 consultative document now describes the proposal in significantly more detail. The main elements of the surcharge proposal are as follows:

- G-SIBs would be subject to an additional progressive Common Equity Tier 1 ("*CET1*") surcharge, referred to in the consultative document as a "*loss absorbency requirement*" ranging from 1% to 3.5% over the Basel III 7% CET1 requirement.
- The exact amount of the surcharge depends on a bank's placement in one of five "*buckets*" (requiring a 1%, 1.5%, 2%, 2.5% and 3.5% surcharge, respectively) based on the bank's global systemic importance under the proposal's methodology.
- To determine the level of the surcharge – that is which G-SIB bucket, if any, a bank is placed into – the proposal relies predominantly on a quantitative "*indicator-based approach*" comprised of five broad categories: cross-jurisdictional activity; size; interconnectedness; substitutability; and complexity.
- The results of the indicator-based approach may be adjusted, to a limited extent and in rare circumstances, to reflect supervisory judgment.
- The surcharge requirement will be phased in with the Basel III capital conservation and countercyclical buffers, beginning in January 1, 2016 and becoming fully effective on January 1, 2019.
- The proposal contemplates that the top bucket requiring the highest 3.5% surcharge will initially be empty in order to provide a disincentive for G-SIBs to increase materially their global systemic importance in the future.
- Under the proposal, final decisions concerning the applicability and implementation of the surcharge in general and with respect to particular institutions are no longer to be left to national

supervisory authorities but are to be made jointly at an international level by the Financial Stability Board (the "*FSB*")[4] and national authorities, in consultation with the BCBS.

Initially, all G-SIBs will be selected from the group of 73 major international banks from which the BCBS collected data in January, 2011 (the "*BCBS Bank Sample*"); under the BCBS's current application of the proposal's methodology, 28 banks would be designated as G-SIBs requiring a capital surcharge – that is, fall into one of the five buckets based on the results of the quantitative indicator-based approach. The consultative document, however, does not explicitly name such banks (and therefore does not describe which bucket they would be assigned under the proposal's methodology), or provide the quantitative cut-off scores of the indicator-based approach which would lead a bank institution to be assigned into one of the particular buckets.

In addition, the surcharge proposal contemplates eventually expanding the surcharge methodology to a wider group of systemically important financial institutions, including financial market infrastructures, insurance companies, and other non-bank financial institutions that are not part of a banking group structure.

The press release accompanying the consultative document on the surcharge proposal requests that any comments on the surcharge proposal be submitted by August 26, 2011.

G-SIB SURCHARGE PROPOSAL

The stated purpose of the G-SIB surcharge is macroprudential in nature – that is, it is meant to address "cross-border negative externalities created by G-SIBs…".[5] The consultative document explicitly states that the other Basel III reforms, including the capital conservation and countercyclical buffer, are microprudential in nature and are not sufficient to protect the financial system from G-SIB spill-over risks. Furthermore, the BCBS explicitly acknowledges that CET1 is the most costly type of capital for institutions to raise but, in part, justifies its use by indicating that using CET1 to meet the surcharge requirement will "help level the playing field in the banking sector by reducing the funding advantages of G-SIBs that arise from expectations of public sector support".[6]

Quantitative Indicator-Based Measurement Approach

The surcharge proposal's indicator-based measurement approach to designating G-SIBs and assigning them to surcharge buckets is based on evaluating the impact of a failure of a bank on the wider financial system by first calculating a quantitative "*indicator-based score*" using data collected from banks.[7] A bank's indicator-based score is, in essence, a weighted ratio with the bank's size and level of participation in certain activities and amount of certain assets, as applicable, as the numerator and the aggregate total of such factors with respect to all the banks in the BCBS Bank Sample as the denominator; the greater the ratio, the higher the global systemic importance of the bank.

The actual calculation of the indicator-based score is arrived at by breaking out five quantitative "*categories*", with each category assigned an equal 20% weight. The categories are: (i) cross-jurisdictional activity; (ii) size; (iii) interconnectedness; (iv) substitutability; and (v) complexity of the bank. Four of these categories, in turn, are each composed of either two or three equally weighted "*indicators*", which refer to specific types of activities that BCBS associates with global systemic importance.[8]

The maximum score in any category (that is, if the bank accounted for all of the activities in that category and the rest of the BCBS Bank Sample accounted for none) is normalized at 1; therefore, the maximum possible indicator-based score (that is, if the BCBS Bank Sample consisted of only one bank) is 5. For each indicator (with the exception of the wholesale funding indicator) an "*indicator score*" is calculated by dividing the bank's raw measured amount relating to that indicator (the "*bank indicator amount*") by the aggregate raw measured amount summed across all banks in the BCBS Bank Sample relating to that indicator (the "*sample aggregate indicator amount*"). The resulting fraction is then weighted by the indicator weighting within each category.[9] Then, all the weighted indicator scores are added to calculate a bank's indicator-based score.[10] The following table summarizes the indicators and their respective weighting.

Category (and weighting)	**Individual Indicator**	**Indicator Weighting**
Cross-Jurisdictional Activity (20%)	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Size (20%)	Total exposures as defined for use in the Basel III leverage ratio	20%
Interconnectedness (20%)	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Wholesale funding ratio	6.67%
Substitutability (20%)	Assets under custody	6.67%
	Payments cleared and settled through payment systems	6.67%
	Values of underwritten transactions in debt and equity markets	6.67%
Complexity (20%)	OTC derivatives notional value	6.67%
	Level 3 assets	6.67%
	Trading book value and Available for Sale value	6.67%

Categories and Indicators

Cross-Jurisdictional Activity. This category is meant to measure the extent of a bank's activities outside its home or headquarters jurisdiction based on the two indicators described below. The BCBS believes that the systemic international impact from a bank's distress increases as its share in cross-jurisdictional assets and liabilities increases.

- *Cross-Jurisdictional Claims.* The bank indicator amount for this indicator consists of the sum of three components: (i) claims by bank offices on obligors in other jurisdictions; (ii) claims by bank offices located in jurisdictions that do not contain the bank's headquarters ("*local offices*") on local borrowers in a currency other than the one of the location; and (iii) claims by local offices on local borrowers in the local currency. All such claims[11] are measured on an ultimate risk basis, meaning that it is the jurisdiction of the ultimate risk bearer (such as a guarantor) for the claim that must be taken into account, not that of the immediate borrower. The bank indicator amount excludes all intra-office claims.[12]
- *Cross-Jurisdictional Liabilities.* This indicator is intended to cover the liabilities of all offices of the same bank to entities outside of their home country. The bank indicator amount for this indicator consists of the following components: (i) total foreign liabilities (aggregated for all offices); less (ii) liabilities vis-à-vis related offices (aggregated for all offices); [13] plus (iii) local liabilities in local currency.[14]

Size. Size is the only category that contains only one indicator. The bank indicator amount for the size indicator is the bank's exposure measure, as used to calculate the leverage ratio under Basel III. Generally speaking, the exposure measure under such Basel III ratio is the sum of a bank's on-balance sheet assets and certain off-balance sheet items.

Interconnectedness. The interconnectedness category is composed of three indicators, all of which seek to measure the degree to which a bank is financially intertwined with other financial institutions. The BCBS takes the view that the network of contractual obligations among financial institutions increases the likelihood of distress at one institution causing systemic effects. The many references to financial institutions appear to refer to all financial institutions, not just to large and interconnected ones.

- *Intra-financial system assets.* The bank indicator amount for this indicator is the sum of the following: (i) lending to financial institutions (including un-drawn committed lines); (ii) holdings of securities issued by other financial institutions; (iii) net mark to market reverse repurchase agreements; (iv) net mark to market securities lending to financial institutions; and (v) net mark to market over-the-counter ("*OTC*") derivatives with financial institutions.[15]
- *Intra-financial system liabilities.* The bank indicator amount for this indicator is the sum of the following: (i) deposits by financial institutions (including undrawn committed lines); (ii) securities issued by the bank that are owned by other financial institutions;[16] (iii) net mark to market repurchase agreements; (iv) net mark to market securities borrowing from financial institutions; and (v) net mark to market OTC derivatives with financial institutions.
- *Wholesale funding ratio.* The ratio is calculated by dividing the bank's total liabilities less retail funding by that bank's total liabilities. Retail funding consists of retail deposits, including certificates of deposit, and debt securities that are held by retail customers. The indicator score is determined by normalizing the bank's wholesale funding ratio by the average wholesale funding ratio across the BCBS Bank Sample, resulting in units that are comparable to the other indicator scores.

Substitutability. The surcharge proposal implements the substitutability category of systemic importance by indentifying as indicators three specific types of financial services. The BCBS believes that distress at a major provider of these financial services may cause systemic effects.

- *Custody.* The bank indicator amount is the value of assets that a bank holds as custodian.[17]
- *Payments.* The bank indicator amount is the value of the bank's payments sent through all the main payments systems of which it is a member.
- *Underwriting.* The bank indicator amount is the annual value of debt and equity instruments underwritten by the bank.

Complexity. The surcharge proposal identifies business, structural, and operational complexity of a bank as a factor in the costs and time needed to resolve the bank, and therefore a factor in the systemic impact of a bank's failure. However, the BCBS has chosen to define complexity through types of financial activities and types of assets that it believes are indicative of bank complexity.

- *OTC derivatives.* The bank indicator amount is the notional or nominal amount[18] of OTC derivatives. OTC derivatives are those not cleared through a central counterparty. Instruments of all types and risk categories must be included in this amount, including foreign exchange, interest rate, equity commodities, CDS and unallocated contracts.
- *Level 3 assets.* The bank indicator amount is the reported value of those assets whose fair value, under applicable accounting principles such as those set forth in FAS 157 under U.S. GAAP for assets that are held for sale, including loans, cannot be determined using observable measures, such as market prices.
- *Trading book and available for sale.* The bank indicator amount is the total value of the bank's securities held in the trading book or classified in the available for sale category.

Supervisory Judgment

Although the surcharge proposal allows an overlay of supervisory judgment over the indicator-based score in determining the G-SIB surcharges, it raises several high bars to its application.[19] To begin with, the surcharge proposal imposes the principle that "judgment should only be used to override the indicator-based measurement approach in exceptional cases".[20] Supervisory judgment must focus on the impact of a bank's distress, and may not focus on the probability of distress or on the effectiveness of a relevant jurisdiction's resolution process.

The surcharge proposal identifies several ancillary quantitative indicators that may only be used to support the supervisory judgment overlay. The ancillary indicators are grouped into categories as follows:

- Cross-jurisdictional activity
    - Non-domestic revenue as a proportion of total revenue.
    - Cross-jurisdictional claims and liabilities as a proportion of total assets and liabilities.
- Size
    - Gross or net revenue of the bank.
    - Equity market capitalization.

- Substitutability/Degree of Market Participation
    - Gross mark to market value of repo, reverse repo, and securities lending transactions.
    - Gross mark to market OTC derivatives transactions.
- Complexity
    - Number of jurisdictions in which a bank maintains its subsidiary and branch operations.

In addition to the ancillary quantitative indicators, the surcharge proposal provides a limited role for qualitative judgment that captures information that cannot be easily quantified.[21]

The Systemic Importance Score and National Authorities

The surcharge proposal's process of incorporating the indicator-based score and supervisory judgment into a final global systemic importance score appears to contemplate that, in certain instances, surcharge decisions with respect to banks will no longer be the sole purview of national regulators, but rather of the FSB, home and host national authorities, and the BCBS.[22]

More particularly, the surcharge proposal contemplates that every year, after the mechanical application of the indicator-based approach to each G-SIB (and presumably potential G-SIB), home and host country supervisors may propose adjustments to the indicator-based score of individual banks based on supervisory judgment. For example, a regulator in a European country could raise a challenge to the appropriateness of the indicator-based score of a United States chartered bank that had operations in that European country. Furthermore, the surcharge proposal also seems to leave open the possibility that challenges to the indicator-based score may be raised not only by the bank's home or host supervisor, but even by a supervisor in another country entirely, albeit taking into account the views of the bank's home and major host supervisors. Application of qualitative judgment to the indicator-based score has a "reverse national bias". If the home country supervisor argues for a lower surcharge, it would be subject to "higher standards of proof and documentation" than an argument for a higher requirement. Similarly, a proposed increase in a bank's surcharge originating from a national authority that is not the bank's home supervisor would also be subject to higher standards.

After adjustments are proposed by such national authorities, the BCBS will develop recommendations for the FSB regarding the systemic importance score of each bank, and the process will end with the "FSB and national authorities, in consultation with the BCBS [making] final decisions" regarding each bank's systemic importance score. How this process will work in practice is unclear in a number of respects, as discussed below.

Initial G-SIB Designation and Bucketing

The surcharge proposal establishes a threshold systemic importance score, determined as described above, above which a bank is treated as a G-SIB with a resulting capital surcharge. The BCBS plans to group G-SIBs into five different categories, or buckets, with increasing loss absorbency surcharges applicable to each higher bucket.[23] The highest bucket is supposed to be currently empty and is intended to provide banks with incentives to avoid becoming more systemically important. If a bank's systemic importance score exceeds the score range of the fourth bucket, that bank will be placed in the empty top bucket, and a new empty bucket with a currently unspecified higher surcharge will be created. It is not clear if new empty buckets with increasingly higher surcharges would be created indefinitely to the extent that G-SIBs populate previously empty buckets. The magnitude of the surcharge for each bucket is as follows:[24]

Bucket	Score Range*	Minimum Additional Loss Absorbency surcharge (CET1 as a percentage of risk-weighted assets)
5 (empty)	D-	3.5%
4	C-D	2.5%
3	B-C	2.0%
2	A-B	1.5%
1	Cut-off Point-A	1.0%

*Scores equal to one of the boundaries are assigned to the higher bucket.

The consultative document does not currently set forth a proposed threshold systemic importance score or the quantitative parameters of the buckets.[25] The surcharge proposal states that as a result of applying its methodology to the BCBS Bank Sample, 27 banks would currently be designated as G-SIBs based on the indicator-based score alone and an additional bank would be designated based on supervisory judgment. Neither the 73 banks in the BCBS Bank Sample, the identity of the 28 banks, nor the bucket into which they would currently be assigned is set forth in the consultative document. G-SIBs will be placed in buckets that broadly correspond to a cluster analysis of their systemic importance scores. The BCBS also states that the size of the buckets was determined so as to avoid "cliff effects", but it did not make clear in what manner. The BCBS stresses that the surcharge proposal sets out minimum surcharges; national jurisdictions are free to impose even higher surcharges.

Incorporation into the Capital Conservation Buffer and Sanctions

The surcharge will be implemented through an extension of the Basel III capital conservation buffer. The Basel III conservation buffer, consisting of 2.5% of risk-weighted assets, is divided into four bands; if banks fall through the bands within the buffer zone, they are subject to increasingly severe limitations on capital distributions. Although not spelled out explicitly, it appears that if a surcharge is applied, the capital conservation buffer of a G-SIB would expand, but still be divided into four equal bands, with the surcharge allocated proportionally across the four bands.[26] Thus, a G-SIB in the 2.5% surcharge bucket would have a CET1 ratio requirement of up to 9.5% on a fully phased-in basis – that is, the 4.5% Basel III minimum *plus* the 2.5% capital conservation buffer *plus* the 2.5% G-SIB surcharge.[27] In this example, the 4.5%-9.5% expanded CET1 buffer would be divided into four bands of 1.25% of CET1 each. If a G-SIB were to fall below the required minimum into the first band of the capital conservation buffer as adjusted by the G-SIB surcharge, the capital distribution limitations of the conservation buffer would apply and the G-SIB would be only be permitted to distribute 60% of its earnings. It would only be permitted to distribute 40%, 20%, or none of its earnings, if it were to fall into the other bands of the adjusted capital conservation buffer.[28]

The implication of the surcharge proposal is that if a G-SIB breaches the full expanded capital conservation buffer (for example, 9.5% of CET1, on a fully phased-in basis, in the case of a G-SIB in the 2.5% surcharge bucket), it will be required to agree a capital remediation plan to return to compliance over a timeframe to be established by its national supervisor. It would appear therefore that the application of the surcharge and the consequences of breaching it would essentially turn the full capital conservation buffer, as expanded by the surcharge, into a requirement for affected G-SIBs.

Phase-In, Periodic Review and Refinement

The surcharge will be phased in in parallel with the capital conservation and capital buffers, namely beginning on January 1, 2016 and becoming fully effective on January 1, 2019.[29] The exact mechanics of the phase-in requirements are somewhat unclear. By analogy to the other Basel III capital conservation and countercyclical buffers phase-in provisions, however, this would presumably mean that that an equal *pro rata* portion of the applicable G-SIB's surcharge for a particular institution would be implemented each year starting on January 1, 2016 with full implementation by January 1, 2019. The cut-off systemic importance measurement (and, presumably, though not explicitly stated, the cut-off measurement for each bucket) will be fixed no later than January 1, 2014 in anticipation of the January 1, 2016 implementation. National jurisdictions are expected to incorporate the rules set forth in the surcharge proposal into legislation by January 1, 2015. It is not clear whether the surcharge proposal requires that national jurisdictions enact specific legislation to implement its requirements, or whether the surcharge proposal may be implemented through regulatory rulemaking by national authorities.

With respect to the U.S., the Federal Reserve has, for practical purposes, made the Basel III capital requirements effective immediately by generally conditioning dividend increases and expansion applications on immediate compliance therewith. It remains to be seen whether the Federal Reserve will adopt a similar approach with respect to the G-SIB surcharge.

Bank systemic importance scores will be updated annually based on new data applied to the numerator (meaning changes in the bank indicator amounts).[30] If a G-SIB is moved into a higher bucket as a result of the annual systemic importance measurement process, it will be required to meet the higher surcharge requirement within 12 months. If two banks merge, and the resulting bank becomes a candidate for a different treatment under the G-SIB framework, this will be captured through the annual systemic importance measurement process. Other aspects of the surcharge assessment system will be reviewed less frequently. The cut-off score and the threshold scores for the surcharge buckets will be initially fixed for three to five years, and then reviewed. Further, the entire methodology, including the indicator-based measurement approach, will be reviewed every three to five years in order to capture developments in the banking sector and any progress in the technology to measure systemic importance. The entire BCBS Bank Sample will also be reviewed every three to five years, along with the merits of collecting data for non-BCBS banks. [31]

Instruments To Meet Surcharge Requirement

The surcharge proposal requires that the surcharge be met with CET1. The surcharge proposal excludes bail-in debt and other instruments that absorb losses only at the point of non-viability and notes that going-concern contingent capital with a "high-trigger" merits more detailed considerations. The consultative document outlines the pros and cons of using contingent capital that meets certain "straw man" criteria set out in an Annex thereto, and states BCBS' support for the use of such contingent capital to meet additional capital surcharges that may be imposed by national regulators.[32]

Interaction with Other Elements of the Basel III Framework

The BCBS also states that the surcharge will be applied to G-SIBs at the consolidated group level. However, the surcharge proposal does not rule out the option for the host jurisdictions of subsidiaries to apply the requirements at the individual legal entity or consolidated level within their jurisdiction. It is unclear whether the proposal intends that the surcharge at these subsidiary levels should be the same or different than the G-SIB surcharge for the ultimate parent.

Data Collection Issues and Future Guidance

The efficient and equitable calculation of the bank indicator amounts and the sample aggregate bank indicator amounts used in calculating the systemic importance score depend on a cross-jurisdictional uniform aggregated database. The BCBS acknowledges that "the data used to construct the indicator-based measurement approach may not be sufficiently reliable or complete". The BCBS therefore plans to address any outstanding data quality issues before implementation of the surcharge, and re-apply the indicator-based approach using updated data before implementation. The BCBS also plans to issue further guidance on the definitions of the indicators, standardizing reporting across the BCBS Bank Sample and addressing data that are currently difficult to collect or not publically available.[33] The BCBS also expects national jurisdictions to prepare a framework in which banks will be able to provide high quality data for the indicator-based approach, and will provide reporting guidance for this purpose.

OBSERVATIONS AND IMPLICATIONS

Impact on Bank Business Models

The G-SIB surcharge proposal could have profound implications for the business models of the world's leading banks. Among other things, the program could promote the "originate to distribute" approach, encourage agency activities and discourage acquisitions (including acquisitions of troubled or failed institutions) and organic expansion. Further, the indicator-based approach may very well have the effect of discouraging banks from engaging in one or more of the activities measured by the indicators at the margin, especially when a particular bank's score is at or near a threshold between buckets, in order to avoid entering into a higher surcharge bucket. As such, the incentive effects of the surcharge proposal likely go well beyond discouraging institutions from further expanding in a way that would trigger the currently empty 3.5% surcharge bucket.

Objective(s) of the G-SIB Surcharge

Although the stated objective of the G-SIB surcharge is to deal with "macroprudential" issues, there are also indications that the program is designed to offset a perceived competitive advantage of banks that may still be deemed "too big to fail".

A Complete Database Does Not Exist

As discussed above, the calculation of the systemic importance score depends on the existence of a cross-jurisdictional uniform aggregated database. Creating a database that fits these requirements and earns the confidence of the industry and the markets will involve substantial challenges, including uniformity, currency conversion, and different treatments across accounting regimes. At present, it is not clear whether the BCBS and the national regulators will be successful in creating such a database for all the indicators by the time the surcharge will be implemented. If they are unsuccessful, the calculation of one or more of the indicators may be impractical.

Roles and Process in Systemic Importance Score Determination

Various aspects regarding the actual process for determining the final systemic importance score of banks remain unclear based on the language of the consultative document, including:

- It appears, though it's not explicitly stated, that if no national authority proposes an adjustment to a bank's indicator-based score based on supervisory judgment, the bank's indicator-based score will be that bank's systemic importance score.
- The consultative document does not set out a clear notice and response process for national authorities in the event that certain national authorities propose an adjustment based on supervisory judgment, and other national authorities wish to respond.
- Perhaps most importantly, the consultative document does not specify the mechanics of how the FSB, the BCBS, and the national regulators are to resolve any differences of opinion in applying supervisory judgment to a bank's systemic importance score.

Potential Issues Regarding Indicators

The quantitative indicators set out in the surcharge proposal raise a number of issues, including whether it is appropriate to include them in a measurement of systemic importance, how they should be weighted, and whether they disadvantage certain types of banks, including:

- The indicators under categories other than size in many cases will correlate with size, thus potentially creating a duplicative effect that may distort size as a component of a bank's score.
- The BCBS did not provide any explanation for its choice to weight all indicators within each category equally. Because inclusion as an indicator and weighting within the indicator-based approach will have an effect on the incentives of banks, there is a question as to whether it is appropriate to weight all the indicators in one category equally, or whether a more graduated approach would be preferable.
- The use of the Basel III exposure measure to calculate the bank indicator amount for the size indicator raises outstanding questions in regard to that measure relating to netting and off-balance sheet exposures. [34]
- The "assets under custody" and "payments cleared and settled through payment systems" indicators that are included in the substitutability category will disproportionately affect a small number of banks that specialize in those activities.
- Applying an equal weighting to the intra-financial system assets and intra-financial system liabilities indicators in the "interconnectedness" category may not be appropriate, as a bank with extensive liabilities to other financial institutions would generally be a greater systemic threat if it experienced distress.
- The lack of substitutability of the "values of underwritten transactions" indicator is also not obvious at first glance. For example, in past financial crises, underwriting functions were easily replicated or purchased when investment banks failed.
- The inclusion of the trading book securities value and available for sale securities value indicator in the complexity category raises the issue that those two balance sheet categories of securities sometimes overlap.
- Given the surcharge proposal's stated concerns regarding issues revealed during the crisis by illiquid assets funded by short term liquid liabilities, the appropriateness of the use of the wholesale funding ratio indicator in light of the various liquidity components of the Basel III framework is unclear.

Consolidated Application With No Offset for Subsidiary Application

As discussed above, the surcharge proposal states that the surcharge will be applied to G-SIBs at the consolidated group level, but does not rule out the option for the host jurisdictions of subsidiaries to apply the requirements at the individual legal entity or consolidated level within their jurisdiction. Given the trend towards more intense supervision of local subsidiaries of multinational banks, the interplay between capital requirements at the group level and at subsidiary levels is unclear and could result in unitended consequences.

Other Issues

Other issues of note include:

- In addition to the capital surcharge, the consultative document appears to suggest that the BCBS is continuing to consider other prudential measures for global systemically important financial institutions ("*G-SIFIs*"), such as large exposure restrictions and liquidity measures. No timeframe is provided for when such proposals may be forthcoming.[35]

- Section 165 of the Dodd-Frank Act requires the Federal Reserve to adopt rules (which are expected shortly) subjecting U.S. bank holding companies with more than $50 billion in total consolidated assets to "more stringent" capital requirements. Exactly how U.S. regulators will implement and harmonize the surcharge proposal with the requirements of Section 165 of the Dodd-Frank Act remains to be seen.
- Many indicators used in determining the indicator-based score rely on accounting definitions. These include Level 3 assets and trading book securities and available for sale securities. The BCBS and national authorities should ensure the definitions of these indicators are consistent notwithstanding any differences among applicable accounting regimes such United States GAAP and IFRS.
- The BCBS did not explain why, when supervisory judgment is applied in determining the systemic importance score, views on the quality of the policy/resolution framework within a jurisdiction should not play a role, even though it would appear that a sound resolution framework would prevent, or at least mitigate, systemic effects.[36]
- As discussed above, the entire methodology of the surcharge proposal will be reviewed every three to five years in order to capture developments in the banking sector and any progress in the technology to measure systemic importance. Given rapid changes in the banking industry and the relative newness of the surcharge methodology, it is not clear that these reviews will be sufficiently frequent.

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ENDNOTES

1 The BCBS is a committee of banking supervisory authorities which was established by the central bank governors of the Group of Ten countries at the end of 1974. On December 15, 2010, the BCBS released the final revised framework for strengthening international capital and liquidity regulation, officially identified by the Basel Committee as "*Basel III*" and set forth in two documents: *Basel III: A global regulatory framework for more resilient banks and banking systems and Basel III: International framework for liquidity risk measurement, standards and monitoring. See* S&C's memo to clients, dated December 31, 2010, titled "*Basel III Capital and Liquidity Framework: Basel Committee Issues Final Revisions to International Regulation of Bank Capital and Liquidity.*"

2 BCBS, "*Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*", July 19, 2011.

3 Group of Governors and Heads of Supervision of the BCBS, "*Measures for global systemically important banks agreed by the Group of Governors and Heads of Supervision*", June 25, 2011. *See* S&C's memo to clients, dated June 25, 2011 titled "*Bank Capital Requirements; Regulatory Surcharge for Global Systemically Important Banks*".

4 The FSB was established in April 2009 by the G-20 as the successor to the Financial Stability Forum founded in 1999 by the G-7 Finance Ministers.

5 *See* Paragraph 2 of the surcharge proposal.

6 *See* Paragraph 81 of the surcharge proposal.

7 *See* Paragraphs 14-17 of the surcharge proposal.

8 *See* Paragraphs 18-51 of the surcharge proposal.

ENDNOTES (continued)

9 Because each category is assigned a 20% weighting in the total indicator-based score, if a category consists of two indicators, each indicator from that category is weighted 10% in the total indicator-based score, and if it consists of 3 indicators, each indicator from that category is weighted 6.67% in the total indicator-based score. For example, the interconnectedness category contains three indicators, and therefore each indicator in the category is weighted 6.67% in respect of the total indicator-based score.

10 For example, the size indicator for a bank that accounts for 10% of the aggregate size of the BCBS Bank Sample would contribute 0.10 to the total indicator-based score for the bank. This is because the result of dividing the bank indicator amount by the sample aggregate indicator amount, 0.10, is multiplied by 20% of the maximum potential indicator-based score, which is 5, resulting in a calculation of 0.10(0.20 x 5) = 0.10. Similarly, a bank that accounts for 10% of aggregate cross-jurisdictional claims of the BCBS Bank Sample would receive a score of 0.05 in that indicator and contribute that amount to the total indicator-based score for the bank (because cross-jurisdictional claims are weighted 10% in the total indicator-based score). This is because the result of dividing the bank indicator amount by the sample aggregate indicator amount, 0.10, is multiplied by 10% of the maximum potential indicator-based score, which is 5, resulting in a calculation of 0.10(0.10 x 5) = 0.05.

11 Claims include deposits and balances placed with other banks, loans and advances to banks and non-banks, and holdings of securities and participations.

12 Banks already report the data underlying this measurement to the central banks of their home jurisdictions for the compilation of Bank for International Settlements ("*BIS*") consolidated international banking statistics quarterly. For further explanation of the data, definitions, and coverage, please see BIS Guidelines to the international consolidated banking statistics at http://www.bis.org/statistics/consbankstatsguide.pdf.

13 The definition and value for "total foreign liabilities" are drawn from the locational BIS banking statistics that banks report to their respective central banks and from the Statistical Annex of the BIS Quarterly Review (International Banking Market). For further explanation of the data, the definitions, and coverage, please see BIS Guidelines to the international locational banking statistics at http://www.bis.org/statistics/locbankstatsguide.pdf. The value of "liabilities vis-à-vis related offices" is drawn from the BIS Quarterly Review (International Banking Market).

14 The definition and value for "local liabilities in local currency" are drawn from the BIS consolidated international banking statistics. *See* Endnote 12 *supra.*

15 Presumably this clause refers to "in the money" OTC derivatives while the identical reference in the intra-financial system liabilities indicator refers to "out of the money" OTC derivatives.

16 The BCBS will issue further guidance regarding the method for a bank to make a best estimate of the holders of its debt securities before the implementation of the surcharge proposal.

17 A custody relationship is the provision of safekeeping, reporting, processing of assets and/or the facilitation of the operational and administrative elements of related activities on behalf of customers in the process of their transacting and retaining financial assets. Such services are limited to the settlement of securities transactions, the transfer of contractual payments, the processing of collateral, the execution of foreign currency transactions, the holding of related cash balances and the provision of ancillary cash management services. Also included are the receipt of dividends and other income, client subscriptions and redemptions, scheduled distributions of client funds and the payment of fees, taxes and other expenses. Custodial services can furthermore extend to asset and corporate trust servicing, treasury, escrow, funds transfer, stock transfer and agency services, including payment and settlement services (excluding correspondent banking), trade financing, and depository receipts. *See* Paragraph 76 of *Basel III: International framework for liquidity risk measurement, standards, and monitoring.*

18 The notional or nominal amount is the gross nominal or notional value of deals concluded and not yet settled at the reporting date.

ENDNOTES (continued)

[19] *See* Paragraphs 56-64 of the surcharge proposal.

[20] *See* Paragraph 56 of the surcharge proposal.

[21] The only example given in the consultative document for when such judgment is appropriate is that of a major restructuring of a bank's operation.

[22] *See* Paragraphs 65-67 of the surcharge proposal. Although the surcharge proposal appears to require that full adoption in a home country include national regulators abdicating final decision making, the language is imprecise. Paragraph 65, in introducing these provisions, begins with a statement that "[t]he supervisory judgment or overlay can be incorporated using the following sequential steps to the score produced by the indicator-based measurement approach". (Emphasis added.)

[23] *See* Paragraphs 52-55 of the surcharge proposal.

[24] *See* Paragraphs 73-74 of the surcharge proposal.

[25] This information will be released before implementation begins.

[26] *See* Paragraphs 91-93 of the surcharge proposal.

[27] These calculations are before giving effect to a possible 2.5% countercyclical buffer, which if imposed could raise the required CET1 ratio to 12.0%.

[28] *See* S&C's memo to clients, dated December 31, 2010, titled "*Basel III Capital and Liquidity Framework: Basel Committee Issues Final Revisions to International Regulation of Bank Capital and Liquidity*" for a more detailed discussion of the capital conservation buffer.

[29] *See* Paragraph 97 of the surcharge proposal.

[30] It is unclear whether new data will also be applied to the denominator, namely the sample aggregate indicator amount, on an annual basis. The surcharge proposal states that the indicator-based score calibration will be based on the full BCBS Bank Sample and that all banks in that sample will be "monitored on an ongoing basis", but does not state whether that sample aggregate indicator amounts will be adjusted annually based on new data.

[31] *See* Paragraphs 68-72 of the surcharge proposal.

[32] *See* Paragraphs 80-87 of the surcharge proposal. The pros include elimination of agency problems (through debt discipline), shareholder discipline, contingent capital holder discipline, market information, and cost effectiveness. The cons include trigger failure, cost effectiveness, complexity, the possibility of a death spiral, adverse signaling, and negative shareholder incentives. The "straw man" criteria for contingent capital include (i) full conversion to CET1 when CET1 of the group falls below 7% of risk-weighted assets; (ii) a cap on the number of new shares that can be issued when the trigger is breached; (iii) maintenance of authorization to issue the relevant number of common shares in the event the trigger is breached; and (iv) conformance with all Basel III Tier 2 capital criteria. The common equity resulting from the conversion must be fully recognized as CET1 at the group level. *See* Annex 3 to the surcharge proposal.

[33] The BCBS solicits the views of market participants on any practical difficulties associated with producing accurate data on some of the proposed indicators used in the methodology.

[34] For more detail regarding the exposure measure, see S&C's memo to clients, dated December 31, 2010, titled "*Basel III Capital and Liquidity Framework: Basel Committee Issues Final Revisions to International Regulation of Bank Capital and Liquidity*".

[35] *See* Paragraph 7, footnote 3 of the surcharge proposal.

[36] The proposal does, however, suggest that national regulators could impose higher capital requirements if a G-SIB does not have an effective and credible recovery and resolution plan.

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