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Bank Capital Requirements

Federal Reserve Board Approves Final Common Equity Surcharge For U.S. Global Systemically Important Banks

SUMMARY

Last week, the Board of Governors of the Federal Reserve System (the "*Federal Reserve*") approved a Final Rule (the "*Final Surcharge Rule*")[1] establishing risk-based capital surcharges for the largest, most interconnected U.S. bank holding companies ("*BHCs*"). For these institutions, the Final Surcharge Rule implements the framework developed by the Basel Committee on Banking Supervision ("*BCBS*") (the "*Basel G-SIB Framework*") for assessing a common equity surcharge on global systemically important banks ("*G-SIBs*") as an extension of the capital conservation buffer that can only be satisfied with Common Equity Tier 1 ("*CET1*") capital (the "*G-SIB surcharge*").[2] G-SIBs not meeting the G-SIB surcharge requirements will face restrictions on dividends and certain executive compensation payments.

Under criteria detailed in the Final Surcharge Rule, the eight U.S. G-SIBs—Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup Inc., The Goldman Sachs Group, Inc., JPMorgan Chase & Co., Morgan Stanley, State Street Corporation, and Wells Fargo & Company—will be required to calculate their applicable G-SIB surcharge under two separate methods, adopting the higher of the two results. The first method ("*Method 1*"), which is consistent with the Basel G-SIB Framework, is based on the aggregation of a BHC's "systemic indicator scores" reflecting size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity relative to the other 75 largest U.S. and foreign banking organizations identified by the Basel Committee and any other banking organization included in the BCBS sample for a given year. The second method ("*Method 2*"), which is not part of the Basel G-SIB Framework, replaces the substitutability indicator with a measurement of the G-SIB's reliance on short-term wholesale funding ("*STWF*"). It is intentionally "calibrated to result in significantly higher surcharges" than those calculated using Method 1—a further example of the Federal Reserve implementing more stringent, or "super equivalent," requirements than under certain internationally-

agreed BCBS frameworks. Expected surcharges range from 1.0 percent to 4.5 percent of the U.S. G-SIB's risk-weighted assets (as opposed to generally 1.0 to 2.5 percent under the Basel G-SIB framework). In his remarks at the Federal Reserve meeting approving the Final Surcharge Rule, Michael Gibson, Director of the Division of Supervision and Regulation, stated that "on average" the surcharges calculated under Method 2 are 1.8 times higher than those calculated under the Method 1 international standard. The G-SIB surcharge will be phased in from January 1, 2016 through year-end 2018, becoming fully effective on January 1, 2019.[3]

Although the Final Surcharge Rule is generally consistent with the Federal Reserve's proposed rule issued in December 2014 (the "*NPR*" and the rules set forth therein, the "*Proposed Rule*"),[4] the Final Surcharge Rule contains several notable revisions, including:

- **Use of three-year average foreign exchange rate in place of a year-end spot rate to convert global indicator amounts:** In an effort to address the impact of the inherent volatility of spot foreign exchange rates as noted by commenters,[5] the Final Surcharge Rule uses a three-year average exchange rate to convert the global indicator amounts from euros to U.S. dollars in place of the daily spot rates envisioned in the Proposed Rule.
- **Use of fixed coefficients in the Method 2 surcharge calculation:** The Method 2 indicator scores are now calculated using fixed measures of systemic importance in place of the relative measures based on each G-SIB's indicator scores compared to the aggregate scores of the 75 other large U.S. and non-U.S. BHCs identified by the BCBS as potentially systemically important as set forth in the Proposed Rule and the Basel G-SIB Framework.[6] These fixed coefficients are calculated based on average global indicator amounts for 2012 and 2013. This change is meant to "increase the predictability of a G-SIB's surcharge and address the incentive concerns identified by commenters."[7] Nevertheless, relative measures are still used in the Method 1 surcharge calculation in the Final Surcharge Rule. As a result, a BHC will be identified as a G-SIB using the relative approach, but its Method 2 surcharge will be calculated using the fixed approach.
- **Revised components and weights in Method 2 STWF calculation:** The Final Surcharge Rule reduces the weight assigned to certain unsecured STWF sources as compared to the Proposed Rule, including wholesale deposits, brokered deposits from retail customers and brokered sweep deposits from retail customers. The Final Surcharge Rule also applies a lower weight for firm (but not client) short positions.
- **Calculation Required for Advanced Approaches BHCs Only:** The Final Surcharge Rule limits the requirement for a BHC to perform the annual calculation to determine whether it is a G-SIB to advanced approaches BHCs.

Significantly, although the Federal Reserve previously indicated that capital buffers (including the G-SIB surcharge) will not be incorporated into the Comprehensive Capital Assessment and Review ("*CCAR*") or Dodd-Frank Act Stress Testing ("*DFAST*") frameworks for the 2016 cycle,[8] the Federal Reserve notes in the preamble to the Final Surcharge Rule that it is analyzing whether these stress test rules, as well as the capital plan rule,[9] should also include a form of G-SIB surcharge. Moreover, Governor Tarullo noted in his opening remarks at the meeting adopting the Final Surcharge Rule that the Federal Reserve "will need to consider whether and, if so, how to incorporate the surcharges into the post-stress minimum capital levels required in [CCAR]." Governor Tarullo further stated that the Federal Reserve staff will develop a series of recommendations that would "make the supervisory stress test and CCAR better address systemic risks arising from correlations in the exposures and activities of large financial institutions," noting that incorporation is "only one among a number of possibilities" for accounting for those risks.[10] It is not yet clear which risks arising from exposure and activity correlations among banking organizations may be encompassed, or how they may be accounted for purposes of the capital plan rule, CCAR and DFAST.

In an effort to provide greater transparency regarding the Federal Reserve's analysis underlying the calibration of Method 1 and Method 2, the Final Surcharge Rule release includes a Federal Reserve white paper (the "*White Paper*") providing greater detail concerning the analytical and quantitative rationale behind the Federal Reserve's "expected impact" approach and the calibration of the ultimate G-SIB surcharge, discussed further below.[11]

DISCUSSION – HIGHLIGHTS

Like the Basel G-SIB Framework and the Proposed Rule, the Final Surcharge Rule establishes an indicator-based approach for determining which BHCs are U.S. G-SIBs and the amount of the risk-based capital surcharge that will be applied to each G-SIB,[12] but introduces several changes to the U.S.-specific Method 2 surcharge calculation.

A. COMPUTING THE SURCHARGE

1. Foreign Exchange Rate Impacts

Under the Proposed Rule, the aggregate global indicators published by the BCBS would have been converted from euros to U.S. dollars using the conversion rate provided by the BCBS, that is, the daily spot foreign exchange rate at each year-end calculation period. In response to public comment regarding the potential volatility in G-SIB scores that would be introduced by the use of daily spot rates, the Final Surcharge Rule instead calculates the fixed coefficients for Method 2, discussed further below, by converting the average aggregate global denominators from euros to dollars using an exchange rate equal to the average daily foreign exchange spot rates from the period 2011-2013. Using a three-year average exchange rate reduces potential volatility from short-term fluctuations while "reflecting more sustained changes in exchange rates" that may be indicative of systemic importance.

2. Relative versus Absolute Measures

Under the Method 2 calculation introduced in the Proposed Rule, a G-SIB's systemic indicator score was measured in proportion to a corresponding aggregate global indicator amount—an annual dollar figure to be published by the Federal Reserve representing the sum of the systemic indicator scores of the 75 largest U.S. and foreign banking organizations as measured by the BCBS, and any other banking organization included in the BCBS sample for a given year. These annually updated aggregate global indicator amounts would have reflected yearly changes to the systemic indicators, and covered U.S. BHCs would have calculated their scores relative to the aggregate global denominator.

In response to public comments, however, the Final Surcharge Rule replaces this relative calculation based on aggregate global denominators with a fixed approach based on coefficients, or constants, established by the Federal Reserve for each systemic indicator for purposes of Method 2. The Federal Reserve developed these coefficients by (1) averaging the aggregate global denominator amounts for each indicator for year-end 2012-2013, (2) converting each from euros to dollars using a three-year average exchange rate (discussed above), (3) converting each to basis points, and (4) doubling the firm scores. The resulting coefficients for each systemic indicator are included in the text of the Final Surcharge Rule and thus any future changes will likely require a separate notice-and-comment rulemaking. The "doubling" of the systemic indicator scores calculated under Method 1 (using the STWF factor in place of substitutability) suggested under the Proposed Rule to produce higher Method 2 surcharges is accomplished in the Final Surcharge Rule by doubling the firm scores used to calculate the value of each of the fixed coefficients used to determine Method 2 scores. The outcome in terms of the applicable G-SIB surcharge remains the same—a significantly higher resulting surcharge under Method 2, on the one hand, than under Method 1 and the Basel G-SIB Framework, on the other, and, as a consequence, significantly higher G-SIB surcharges for U.S. banking organizations than for other banking organizations.

The Federal Reserve explains that this fixed approach is intended to improve score predictability and facilitate capital planning by reducing the steps that a G-SIB must take to determine its score and permitting each G-SIB to calculate its Method 2 score as soon as it has calculated its own systemic indicator values. Unlike the Proposed Rule, the Final Surcharge Rule's calculation no longer requires a G-SIB to await publication of the aggregate global figures to determine its score. Moreover, this will help ameliorate the issue inherent in using a relative calculation of G-SIBs not being able to effectively change their score by taking objectively risk-reducing steps if other G-SIBs in the sample take similar steps.

The Federal Reserve acknowledges, however, that over time, under the fixed approach, a G-SIB's Method 2 score may be affected by economic growth that does not represent an increase in systemic risk. As a result, the Federal Reserve intends periodically to review the coefficients and make appropriate adjustments.

3. Revisions to STWF Factor in Method 2

The STWF score calculation is largely retained in the Final Surcharge Rule as proposed, but with several adjustments made to components and weights.

First, the maximum weight for wholesale deposits of non-financial counterparties is reduced from 50 percent to 25 percent and the maximum weight for wholesale deposits of financial counterparties is reduced from 100 percent to 75 percent. These reductions are meant to reflect the fact that firms often use wholesale deposits and other unsecured STWF to fund high quality liquid assets ("*HQLA*") under the liquidity coverage ratio ("*LCR*"). Because unsecured deposits of financial clients are assigned a 100 percent outflow under the LCR, the LCR incentivizes firms to use those funds to support their holdings of HQLA. As a result, the Final Surcharge Rule reduces the relevant STWF factor weights to recognize that firms are incentivized to use these forms of STWF to fund relatively more liquid assets, which serves to reduce somewhat, but not—in the Federal Reserve's view—eliminate (or even sharply reduce), the associated fire sale risk which the STWF attempts to address.

Second, the Final Surcharge Rule differentiates between firm and customer short transactions and adjusts the assigned weights. The Proposed Rule treated all short positions as STWF and loans of collateral to a BHC's customer to effect short positions as secured funding transactions, and weighted them accordingly. The Final Surcharge Rule, however, excludes firm short positions—that is, those held for the G-SIB's own account—involving Level 1 and Level 2A securities under the LCR from the STWF definition entirely, and assigns a weight of 25 percent to firm short positions involving Level 2B securities or securities that do not qualify as HQLA. These revised weights recognize that the risk of runs from a firm's own short positions is mitigated by the firm's ability to control the closeout of the short position. However, with respect to client short positions, the Federal Reserve takes the position that, because the closeout of such positions is ultimately controlled by a firm's clients and is therefore more unpredictable for the G-SIB, the weights assigned to client shorts should not be reduced. As a result, the Final Surcharge Rule adopts the same treatment of client short positions as the Proposed Rule without change.

Finally, the STWF weights assigned to brokered deposits and brokered sweep deposits of retail customers are reduced from 50 percent under the Proposed Rule to 25 percent under the Final Surcharge Rule, in line with the reduced weights assigned to unsecured wholesale deposits of a non-financial sector counterparty. Furthermore, the STWF weights for other brokered deposits and brokered sweep deposits are decreased from 100 percent under the Proposed Rule to 75 percent under the Final Surcharge Rule to align with the weights assigned to other similar forms of unsecured STWF.

B. IDENTIFICATION OF A G-SIB

To identify U.S. G-SIBs, the Proposed Rule would have required each U.S. top-tier BHC with total consolidated assets of $50 billion or more to annually compute its Method 1 score. In the Final Surcharge Rule, this annual calculation requirement is limited to U.S. top-tier BHCs that are required to utilize the advanced approaches under the U.S. regulatory capital rules[13] (that is, those with $250 billion or more in consolidated total assets or $10 billion or more in consolidated total on-balance sheet foreign exposures), on the theory that firms that do not meet the definition of an advanced approaches BHC are unlikely to pose systemic risk to the U.S. financial system.

C. ANALYTICAL SUPPORT FOR G-SIB SURCHARGE AND ITS CALIBRATION

As set forth in the White Paper included as part of the Final Surcharge Rule release, the expected impact framework is fundamentally based on an attempt to measure each G-SIB's expected impact on the financial system in terms of the potential harm it would cause to the financial system were it to fail (that is, systemic loss given default or "*LGD*") multiplied by the probability that it will fail (that is, probability of default or "*PD*"). The purpose of the Federal Reserve's G-SIB surcharge and resulting calibration is to reduce overall systemic risk by attempting to "equalize" the expected impact of a G-SIB failure as compared to a smaller, benchmark institution by decreasing the probability of default. Under the Federal Reserve's analytical framework, because the failure of a G-SIB would cause more harm than the failure of a non-G-SIB, a G-SIB would need to hold enough capital to lower its probability of failure so that its expected impact is approximately equal to that of a non-G-SIB.

To implement this approach, the Federal Reserve sought to calibrate the G-SIB surcharge to require a G-SIB to maintain a level of capital sufficient to reduce its overall expected impact to equal that of a large BHC that is not a G-SIB, or a "reference BHC."

Several assumptions, many of which may be debatable, are used to support this calibration, including selection of (1) a metric for quantifying a BHC's LGD, (2) a reference BHC with an LGD score that can be compared to the scores of the G-SIBs, and (3) a function for evaluating the amount of additional capital necessary to reduce a G-SIB's PD by the appropriate fraction. First, the White Paper uses Methods 1 and 2 of the Final Surcharge Rule to measure LGD, using these as proxies for the systemic importance of a banking organization. The White Paper, however, does not appear to otherwise explicitly quantify the actual LGD of G-SIBs or, importantly, appear to take into account the upcoming Total Loss Absorbing Capital, or "*TLAC*", requirement which is designed to make G-SIBs more readily resolvable and reduce LGD by requiring greater amounts of bail-in gone concern capital.[14]

Second, the White Paper discusses the alternatives considered by the Federal Reserve in choosing the reference BHC and the surcharges resulting from each option considered. The alternatives included: (1) a BHC with $50 billion in total assets (the threshold used in the Dodd-Frank Act to determine which BHCs should be subject to enhanced prudential standards), (2) a BHC with $250 billion in total assets, (3) the actual U.S. non-G-SIB with the highest score under each of Methods 1 and 2 (that is, the most systemically important non-G-SIB BHC), or (4) a hypothetical BHC with a score somewhere between most systemic U.S. non-G-SIB and the least systemic G-SIB. For each option, the Federal Reserve considered where the range between the lowest-scoring G-SIB and highest-scoring non-G-SIB would lie, and considered several options for the cutoff line within the target range. To calibrate the surcharge, the Federal Reserve ultimately set the Method 1 reference BHC score near the top of the target range, to recognize international standards applied globally to G-SIBs, and set the Method 2 reference BHC score near the bottom of the target range, an approach that results in higher surcharges for most G-SIBs "consistent with the statutory mandate to protect financial stability in the United States."[15]

Finally, the White Paper explains in greater detail the framework used to evaluate the additional capital necessary to reduce a G-SIB's PD to the desired level. The chosen framework uses 30 years of historical data on the return on risk-weighted assets to relate capital ratio increases to reductions in PD, or the probability that a BHC will incur losses within a given time period that exceed the difference between its capital ratio at the beginning of the time period and a "failure point" beyond which the firm is unable to recover and ultimately defaults. The White Paper maintains that this approach actually moderates PD because the frequency of extremely large losses would likely have been higher in the absence of government intervention to protect financial stability—a "survivorship bias" leading to an underestimation of the probability of such large losses. The White Paper explains, however, that this underestimate is likely offset by the overestimation of the required surcharge that results from the calibration's failure to take into account the impacts on PD of existing and forthcoming regulatory reforms such as the LCR, the net stable funding ratio, and the enhanced supplementary leverage ratio. None of these, or other recent regulatory reforms designed to strengthen banking institutions, were in place during the historical period analyzed.

D. MODIFICATIONS TO FR Y-15

On July 9, based on the December 2014 G-SIB surcharge NPR, the Federal Reserve published for comment a proposal to modify the FR Y-15 reporting form to collect the data necessary to compute the G-SIB surcharge. The FR Y-15 is the form on which BHCs report to the Federal Reserve information necessary to determine whether the BHC is a G-SIB and to calculate its G-SIB surcharge. The Final Surcharge Rule proposes to incorporate updates to the FR Y-15 to align it with the definitions and changes to the STWF factor as implemented in the Final Surcharge Rule. The comment period for the FR Y-15 proposal will be extended to 60 days after the publication of the Final Surcharge Rule in the Federal Register to allow commenters the opportunity to comment on the full proposal.

E. OTHER OBSERVATIONS

The preamble to the Final Surcharge Rule also addresses several other related topics, including:

First, consistent with the Proposed Rule, the Final Surcharge Rule does not automatically apply the G-SIB surcharge to nonbank financial institutions designated as systemically important by the Financial Stability Oversight Council under the Dodd-Frank Act. Rather, the Federal Reserve intends to assess each such nonbank financial institution on a case-by-case basis by considering the business model, capital structure and risk profile of each designated company to determine whether and how to apply the G-SIB surcharge to such firms.

Second, the Federal Reserve indicates that, given the implementation time frame, it does not anticipate any significant adverse impacts on any specific financial markets, but will nevertheless monitor the impacts of the enhanced prudential standards on financial institutions and markets more broadly to evaluate whether they strike an appropriate balance between the costs imposed on institutions and financial markets and the benefits to U.S. financial stability. The Federal Reserve further notes that it will also continue to monitor the effects of its regulation on the competitiveness of U.S. G-SIBs as compared to foreign banking organizations and unregulated entities.

Finally, the Federal Reserve chose not to differentiate between centrally cleared and non-centrally cleared securities financing transactions included in the STWF factor in the Final Surcharge Rule, noting that some residual risk remains for these transactions and any financial stability benefits associated with central clearing cannot be measured with enough precision to warrant specific STWF weight reductions at this time.

IMPLEMENTATION AND TIMING

The phase-in period remains unchanged from the Proposed Rule, which was chosen to align with the phase-in of the capital conservation buffer, the countercyclical capital buffer and the phase-in schedule of the Basel G-SIB Framework. The G-SIB surcharge for January 1, 2016 must be calculated by December 31, 2015 based on the systemic indicator scores reported by a G-SIB on the FR Y-15 as of December 31, 2014, with the exception of the STWF score, which will be based on the average of the G-SIB's STWF amounts calculated for July 31, 2015, August 24, 2015, and September 20, 2015 in data reported to the Federal Reserve. G-SIBs will be required to compute their STWF in this manner for 2016 as well, but the surcharge calculation for 2017 and thereafter will compute the STWF score using average daily STWF amounts as then collected on the FR Y-15.

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ENDNOTES

[1] Federal Reserve System, Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, 12 C.F.R. Part 217.

[2] The Final Surcharge Rule implements the BCBS's July 2013 revised G-SIB framework (the "*Revised G-SIB Framework*") for assessing a common equity surcharge on certain designated G-SIBs, which updated and replaced the framework issued by the BCBS in November 2011 (the "*Initial G-SIB Framework,*" and, together with the Revised G-SIB Framework, the "*Basel G-SIB Framework*"). Discussion of the Initial G-SIB Framework and the Revised G-SIB Framework can be found in our previous client memoranda, including: Bank Capital Requirements—Regulatory Capital Surcharge for Global Systemically Important Banks (Jul. 26, 2011); Bank Capital Requirements—Basel Committee Issues Final Rule Regarding Common Equity Surcharge for Global Systemically Important Banks (Nov. 10, 2011) and Bank Capital Requirements—Basel Committee Updates Framework for Assessing a Common Equity Surcharge on Global Systemically Important Banks (Jul. 26, 2013).

[3] The phase-in of the G-SIB surcharge will align with the phase-in of the capital conservation buffer. On January 1 for each of 2016, 2017, 2018 and 2019, the eight BHCs expected to qualify as G-SIBs must hold an additional one-fourth of the applicable G-SIB surcharge (in addition to one-fourth of the capital conservation buffer, or 0.625 percent) in addition to the minimum CET1 capital ratio to avoid limitations on capital distributions and certain discretionary bonus payments. For example, on January 1, 2017, a G-SIB will be required, in addition to its 4.5% CET1 minimum capital ratio, to hold 50 percent of the 2.5 percent capital conservation buffer and 50 percent of the applicable G-SIB surcharge; on January 1, 2018, a G-SIB will be required to hold 75 percent of the 2.5 percent capital conservation buffer and 75 percent of the applicable G-SIB surcharge. The capital conservation buffer and the applicable G-SIB surcharge will be fully phased-in on January 1, 2019.

[4] Federal Reserve System, Notice of Proposed Rulemaking, Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, 79 Fed. Reg. 75,473.

[5] *See*, *e.g.*, The Clearing House Association L.L.C., The Securities Industry and Financial Markets Association, and The Financial Services Roundtable, Comment Letter Regarding Proposed Capital Surcharge for U.S. G-SIBs (Apr. 2, 2015).

[6] Discussion of the systemic indicators and score calculations under the Method 1 calculation, which have been adopted as proposed, can be found in our previous client memo, Bank Capital Requirements—Federal Reserve Board Proposes Rule Establishing Common Equity Surcharge on U.S. Global Systemically Important Banks (Dec. 14, 2014).

[7] Memorandum from Governor Tarullo to the Board of Governors of the Federal Reserve System, Draft Final Rule—Risk-based Capital Surcharges for Systemically Important U.S. Bank Holding Companies (Jul. 15, 2015) at 5.

[8] Board of Governors of the Federal Reserve System, Notice of Proposed Rulemaking, Amendments to the Capital Plan and Stress Test Rules (Jul. 17, 2015). Discussion of this NPR can be found in our client memorandum Bank Capital Plans and Stress Tests—Federal Reserve Board Proposes Rule Amending Certain Aspects of Existing Capital Plan and Stress Test Rules (Jul. 22, 2015).

[9] 12 C.F.R. Section 225.8.

[10] Additionally, in a July 9, 2015 speech, Federal Reserve Governor Brainard stated that "[f]or the systemic banking institutions, it will be important to assess incorporating the risk-based capital surcharge in some form into the CCAR post-stress minimum in order to ensure these institutions remain sufficiently resilient to reduce the expected losses to the system through periods of financial and economic stress." Brainard, Lael, Dodd-Frank at Five: Assessing Progress on Too Big to Fail, Bipartisan Policy and Managed Funds Association (Jul. 9, 2015), available at http://www.federalreserve.gov/newsevents/speech/brainard20150709a.htm.

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ENDNOTES (CONTINUED)

[11] Board of Governors of the Federal Reserve System, Calibrating the G-SIB Surcharge (July 20, 2015), available at http://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf.

[12] For U.S. BHCs, the values for each systemic indicator are taken from each BHC's most recent Banking Organization Systemic Risk Report (FR Y-15) and converted into scores. Discussion of the systemic indicators and score calculations under the Method 1 calculation, which have been adopted as proposed, can be found in our previous client memo, Bank Capital Requirements—Federal Reserve Board Proposes Rule Establishing Common Equity Surcharge on U.S. Global Systemically Important Banks (Dec. 14, 2014).

[13] *See* 12 C.F.R. Part 217.

[14] *See* Financial Stability Board, Consultative Document—Adequacy of loss-absorbing capacity of global systemically important banks in resolution (Nov. 10, 2014), available at http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.

[15] Board of Governors of the Federal Reserve System, Calibrating the G-SIB Surcharge (July 20, 2015) at 7, available at http://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf.

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