BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: December 9, 2014

To: Board of Governors

From: Governor Tarullo DKT

Subject: Draft Notice of Proposed Rulemaking – Capital Surcharge for Systemically Important U.S. Bank Holding Companies

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Attached are a memorandum to the Board and draft *Federal Register* notice of proposed rulemaking that would establish a risk-based capital surcharge for the most systemically important U.S. bank holding companies pursuant to section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposal is based upon the international standard adopted by the Basel Committee on Banking Supervision, augmented to address risks to U.S. financial stability. The proposed surcharge methodology generally would result in significantly higher surcharges than those determined using the international standard and would reflect a bank holding company's use of short-term wholesale funding.

The proposed rule would require a U.S. top-tier bank holding company with $50 billion or more in total consolidated assets to calculate a measure of its systemic importance and would identify a subset of those companies as global systemically important bank holding companies (GSIBs) based on that measure. Each GSIB would calculate a GSIB surcharge that reflects its systemic risk profile. The proposal would increase a GSIB's capital conservation buffer by the amount of its GSIB surcharge, such that the firm would be required to hold additional common equity tier 1 capital in order to avoid limitations on capital distributions and certain discretionary bonus payments. The proposed surcharge framework would be phased in beginning on January 1, 2016, becoming fully effective on January 1, 2019. Full explanation of the proposal is included in the attached memorandum.

Staff seeks the Board's approval of the attached draft notice of proposed rulemaking, and requests authority to make technical and minor changes to the document prior to publication in the *Federal Register*.

The Committee on Bank Supervision has reviewed the proposed rule and I believe it is ready for the Board's consideration.

Attachments

Date: December 9, 2014

To: Board of Governors

From: Staff[1]

Subject: Notice of proposed rulemaking regarding risk-based capital surcharges for systemically important U.S. bank holding companies

ACTION REQUESTED

Approval to seek public comment on a proposed rule that would establish risk-based capital surcharges for U.S.-based global systemically important banking organizations (proposal). In addition, staff seeks approval to make minor technical changes (e.g., formatting) to the draft proposal in order to prepare it for publication in the Federal Register.

EXECUTIVE SUMMARY

- **Identification of a GSIB**: The proposal would implement in the United States a methodology for determining whether a U.S. top-tier bank holding company with total consolidated assets of $50 billion or more would be identified as a global systemically important banking organization (GSIB). The proposal would use five broad categories correlated with systemic importance—size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity—to calculate a numerical score that would be used to determine whether a U.S. bank holding company would be identified as a GSIB. Using year-end 2013 data, eight bank holding companies would be identified as GSIBs under the proposal.

- **GSIB surcharge amount**: A firm identified as a GSIB would calculate its GSIB surcharge under two methods. The first would consider the GSIB's size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity (method 1), consistent with the methodology developed by the Basel Committee on Banking Supervision (BCBS framework). The second would use similar inputs, but generally would result in significantly higher surcharges than the BCBS framework and would replace substitutability with use of short-term wholesale funding (method 2). A GSIB's surcharge would be the higher of the surcharges determined under the two methods. Staff estimates that GSIBs' surcharge

[1] Messrs. Gibson, Van Der Weide, Lindo, Climent, and Bleicher and Mmes. Hewko, Horsley, McKeehan, Kirkpatrick, and Milewski (Division of Banking Supervision and Regulation) and Messrs. Alvarez and Buresh and Mmes. Schaffer and Graham (Legal Division).

amounts under the proposal using 2013 data would range from 1.0 to 4.5 percent (measured as a percentage of the GSIB's risk-weighted assets).

- **Implementation and Timing**: The proposal would increase a GSIB's capital conservation buffer by the amount of the GSIB surcharge, such that the firm would be required to hold additional common equity tier 1 capital in order to avoid limitations on capital distributions and certain discretionary bonus payments. While the proposal would add the GSIB surcharge to the capital conservation buffer, at a later date, staff intends to seek the Board's views on potentially integrating some or all of the GSIB surcharge into the post-stress minimum capital requirements of the Board's capital plan and stress test rules. The GSIB surcharge would become effective on the same timeline as the capital conservation buffer, which will be phased in beginning in 2016 and become fully effective on January 1, 2019.
- **Impact analysis**: Staff estimates that almost all of the eight firms currently identified as GSIBs under the proposal would already meet their GSIB surcharges on a fully phased-in basis, and all firms are on their way to meeting their surcharges over the three-year phase-in period.

INTRODUCTION

Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directs the Board to establish enhanced prudential standards, including enhanced risk-based capital standards, for bank holding companies with total consolidated assets of $50 billion or more in order to prevent or mitigate risks to U.S. financial stability posed by these institutions. The standards must increase in stringency based on several factors, including the size and risk characteristics of a bank holding company, and the Board must take into account the differences among bank holding companies based on the same factors.[2]

Pursuant to its authority to establish enhanced risk-based capital standards under section 165, the Board has adopted capital plan and stress testing requirements for bank holding companies with total consolidated assets of $50 billion or more.[3] This proposal would further augment the risk-based capital requirements applicable to GSIBs—which are the largest, most systemic bank holding companies—in order to address the risks posed by these firms to U.S. financial stability. The proposal aims to reduce a GSIB's probability of default and help ensure

[2] See 12 U.S.C. 5365(a)(1)(B). Under section 165(a)(1)(B) of the Dodd-Frank Act, the enhanced prudential standards must increase in stringency based on the considerations listed in section 165(b)(3).

[3] 12 CFR 225.8. See 76 Federal Register 74631 (December 1, 2011); 79 FR 64026 (October 27, 2014); and 79 FR 13498 (March 11, 2014).

that each GSIB would have sufficient capital to continue its operations during times of stress, thereby requiring each GSIB to internalize the negative externalities it poses, protecting the financial system from the wider spillover risks of a GSIB's failure, and correcting for competitive distortions created by a GSIB's systemic nature. The proposed GSIB surcharge would incorporate a measure of short-term wholesale funding, given that reliance on short-term wholesale funding can leave a GSIB vulnerable to runs that threaten its solvency and impose externalities on the broader financial system. In doing so, the proposal complements the Board's other initiatives aimed at addressing risks arising from short-term wholesale funding, including the recently adopted liquidity coverage ratio standard.

The proposed GSIB surcharge is consistent with global efforts to address the financial stability risks posed by global systemically important financial institutions (GSIFIs). In November 2011, the Financial Stability Board (FSB) published an integrated set of policy measures to address the systemic and moral hazard risks associated with GSIFIs, intended to mitigate the impact of a failure of a GSIFI and to reduce the too-big-to-fail competitive funding advantage of GSIFIs.[4] The FSB identified global systemically important banks using the BCBS framework.[5] The BCBS calculates global firms' scores and releases a list of global systemically important banks on an annual basis.[6]

OVERVIEW OF THE PROPOSAL

A. Identification of a GSIB

The proposal would establish a methodology to identify whether a U.S. top-tier bank holding company with total consolidated assets of $50 billion or more is a GSIB. The proposal

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[4] See "Policy Measures to Address Systemically Important Financial Institutions" available at www.financialstabilityboard.org/publications/r_111104bb.pdf.

[5] In July 2013, the BCBS published revisions to this document entitled, "Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement," (BCBS Revised Document), which provides certain revisions and clarifications to the initial framework. The document is available at www.bis.org/publ/bcbs255.htm.

[6] See http://www.bis.org/bcbs/gsib/gsibs_as_of_2014.htm (as of November 2014).

would not apply to bank holding companies that are consolidated subsidiaries of non-U.S. banking organizations.

The proposed methodology would be based on five broad categories that are viewed as good proxies for, and correlated with, systemic importance – size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity. These factors are consistent with the factors that the Board considers in reviewing financial stability implications of proposed mergers and acquisitions by banking organizations.[7] Each of the categories would be given a 20 percent weighting in the calculation of a firm's score.

The proposal identifies 12 systemic indicators that measure a bank holding company's profile within those categories. Each systemic indicator score for a firm would be calculated by dividing the systemic indicator amount that the firm reported on its most recent FR Y-15 report by an aggregate global measure for that systemic indicator. This ratio would then be weighted and aggregated to determine a firm's aggregate systemic indicator score. All data needed to compute a firm's systemic indicator score—the firm-level data reported on the FR Y-15 report, the aggregate global measures for each systemic indicator, and the indicator weights—are publicly available.

If a bank holding company's aggregate systemic indicator score as calculated under the proposed methodology were 130 basis points or greater, then such a bank holding company would be identified as a GSIB. A bank holding company with an aggregate systemic indicator score below the 130 basis point threshold would not be identified as a GSIB and would not be subject to a GSIB surcharge. Using current data, there is a significant gap in aggregate systemic indicator scores between the eight bank holding companies that would be designated as GSIBs under the proposal and other large, but less systemically risky bank holding companies. The 130 basis point threshold was chosen to differentiate the bank holding companies in this higher systemic importance group. ***(See Attachment pp. 16-21).***

[7] See Dodd-Frank Act, § 604(d) and (e), codified at 12 U.S.C. § 1842(c)(7) and 1843(j)(2)(A).

B. Computing the Applicable GSIB Surcharge and Impact

A bank holding company that is identified as a GSIB under the proposed methodology would calculate its GSIB surcharge under two methods, each of which is described below. A GSIB's surcharge would be the higher of the two amounts determined under the two methods.

1. Method 1 Surcharge

A GSIB's method 1 surcharge would use its aggregate systemic indicator score, calculated as described above, and identify the method 1 surcharge, as set forth in Table 1 below, that corresponds to that score. For instance, if a GSIB's aggregate systemic indicator score is 251, the GSIB's method 1 surcharge would be 1.5 percent.

Table 1 — Method 1 Surcharge

Method 1 Score (basis points)	Method 1 Surcharge
Less than 130	0.0 percent (no surcharge)
130 – 229	1.0 percent
230 – 329	1.5 percent
330 – 429	2.0 percent
430 – 529	2.5 percent
530 – 629	3.5 percent
630 or greater	3.5 percent plus 1.0 percentage point for every 100 basis point increase in score

The proposal would generally measure a GSIB's surcharge in 0.5 percentage point increments because this method is simple, transparent, and enables a GSIB and the public to better anticipate the size of a firm's method 1 surcharge for future periods. The bands set forth in Table 1 are intended to be sufficiently large so that modest changes in a firm's systemic indicators generally would not cause a firm to move between surcharge bands. ***(See Attachment pp. 22-24).***

2. Method 2 Surcharge

A GSIB's method 2 surcharge would be based on the sum of the firm's systemic indicator scores reflecting its size, interconnectedness, cross-jurisdictional activity, and complexity, as well as a measure of its use of short-term wholesale funding (short-term wholesale funding score). Method 2 includes short-term wholesale funding because, as noted above, reliance on short-term wholesale funding can leave a GSIB vulnerable to runs that threaten the firm's solvency and can impose externalities on the broader financial system. In particular, excessive reliance on this type of funding can result in large fire sale externalities and undermine financial stability.

To arrive at its method 2 score, a GSIB would add its short-term wholesale funding score (described below) to its systemic indicator scores for size, interconnectedness, complexity, and cross-jurisdictional activity and multiply this figure by two. To determine its method 2 surcharge, a GSIB would identify the method 2 surcharge that corresponds to its method 2 score, as set forth in Table 2 below.

For instance, if a GSIB's short-term wholesale funding score were 100 and the sum of its systemic indicator scores for the size, interconnectedness, complexity, and cross-jurisdictional activity indicators were 230, the GSIB's method 2 score would equal 660 (330 * 2), and its method 2 surcharge would be 3.5 percent.

Table 2 — Method 2 Surcharge

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

A GSIB's short-term wholesale funding score would be based on the GSIB's daily use of short-term wholesale funding sources with a remaining maturing of less than one year averaged over a calendar year. Under the proposal, the components of short-term wholesale funding would focus on those funding sources that give rise to the greatest risk of creditor runs and associated systemic externalities. These components would be defined using terminology from the Board's liquidity coverage ratio rule and would be aligned with items that are reported on the

Board's Complex Institution Liquidity Monitoring Report, Form 2052a.[8] The GSIB would apply a weight to each short-term wholesale funding source based on remaining maturity, counterparty, and collateral type to take account of the varying degrees of risk associated with different short-term wholesale funding sources. The measure of short-term wholesale funding would be equally weighted relative to the other systemic indicators.

The proposed methodology for the method 2 surcharge would not incorporate a measure of substitutability, even though the proposal would use substitutability to determine whether a bank holding company is identified as a GSIB. Staff believes a bank holding company's substitutability is relevant in determining whether a firm is a GSIB, as the failure of a bank holding company that performs a critical function where other firms lack the expertise or capacity to do so can pose significant risks to U.S. financial stability. However, the capital surcharge imposed on a GSIB should be tailored to reduce the GSIB's risk of failure, and increasing a GSIB's surcharge based on short-term wholesale funding rather than substitutability is a more effective means of requiring a GSIB to internalize the externalities it imposes on the broader financial system and to reduce its probability of failure. ***(See Attachment pp. 24-27).***

3. Calibration and Impact

Under the proposal, a GSIB would be subject to the greater GSIB surcharge resulting from the two methods described above. Based upon the proposed formulation of method 2, a GSIB would be subject to the method 2 surcharge in most instances.

The proposed calibration of the GSIB surcharges is based on staff's analysis of the additional capital necessary to equalize the probable systemic impact from the failure of a GSIB as compared to the probable systemic impact from the failure of a large, but not systemically important, bank holding company. Increased capital at a GSIB increases the firm's resiliency to failure, thereby reducing the probability of it having a systemic effect. The proposed approach also builds on analysis of the return on risk-weighted assets that was developed to inform the calibration of the minima and capital conservation buffers of the Board's regulatory capital framework. Staff also considered that other jurisdictions have established capital requirements for global systemically important banking organizations that exceed those required by the BCBS framework. GSIB surcharges under the proposal would range from 1.0 percent to 4.5 percent based upon 2013 data. Under both method 1 and method 2, the surcharge applicable to a GSIB

[8] 79 FR 61440 (October 10, 2014).

would increase proportionately as its systemic risk, measured in accordance with each method, increases.

While the method 2 surcharge generally would be the binding surcharge, a GSIB with a high substitutability score but low scores in all other categories may be bound by the method 1 surcharge. Staff believes the method 1 surcharge (which is based on the BCBS framework) should serve as a floor for a GSIB's surcharge, as a firm that is designated as a GSIB should be subject to an enhanced risk-based capital standard in order to correct for competitive distortions created by the perception that it may be too big to fail. This approach would also facilitate comparability among jurisdictions implementing the BCBS framework.

Using data as of year-end 2013, staff estimates that the GSIB surcharges that would apply to the eight U.S. top-tier bank holding companies that would be identified as GSIBs under the proposal would range from 1.0 to 4.5 percent.[9] Based upon these estimates, nearly all of the eight firms currently identified as GSIBs under the proposal would already meet their GSIB surcharges on a fully phased-in basis, and all firms are on their way to meeting their surcharges over the three-year phase-in period. ***(See Attachment pp. 27-31).***

C. Implementation and Timing

1. Implementation

The GSIB surcharge would be integrated into the Board's regulatory capital rule by extending the GSIB's thresholds for the capital conservation buffer.[10] For example, if a GSIB's surcharge were 3.0 percent, in order to avoid a limitation on capital distributions and discretionary bonus payments, the GSIB would need to maintain a common equity tier 1 capital ratio in excess of 10.0 percent (determined as the sum of the minimum common equity tier 1

[9] These estimates were generated using BCBS aggregate global indicator amounts from year-end 2013, 2013 Y-15 data, and 2013 short-term wholesale funding data from the FR 2052a.

[10] Under the Board's regulatory capital rule, all banking organizations must hold a minimum of 4.5 percent of risk-weighted assets in common equity tier 1 capital, and must hold an additional 2.5 percent capital conservation buffer in order to avoid restrictions on capital distributions and certain discretionary bonus payments. A firm's capital conservation buffer is divided into quartiles, each associated with increasingly stringent limitations on capital distributions and bonus payments as the capital conservation buffer approaches zero.

capital ratio of 4.5 percent plus the 2.5 percent capital conservation buffer plus the 3 percent GSIB surcharge).

While the proposal adopts the GSIB surcharge as an augmentation of the capital conservation buffer, at a later date, staff intends to seek the Board's views on potentially integrating some or all of the GSIB surcharge into the post-stress minimum capital requirements of the Board's capital plan and stress test rules. ***(See Attachment pp. 32-34).***

2. Timing

The proposal would phase-in the GSIB surcharge over a three-year period, beginning on January 1, 2016. In 2016, a GSIB would be required to hold capital in excess of 25 percent of its capital conservation buffer plus 25 percent of its applicable GSIB surcharge in order to avoid limitations on capital distributions and discretionary bonus payments. The capital conservation buffer and the GSIB surcharge would be phased in at a rate of 25 percent per year in 2017 and 2018 until fully effective on January 1, 2019. This phase-in period was chosen to align with the phase-in of the capital conservation buffer and countercyclical capital buffer. ***(See Attachment pp. 34-40).***

D. Other Modifications

The proposed rule would also revise the terminology used to identify the firms subject to the enhanced supplementary leverage ratio standards to ensure consistency of the scopes of application of both rulemakings.

CONCLUSION

Based on the foregoing, staff recommends that the Board approve the attached draft proposed rule and related Federal Register notice. Staff also seeks approval to make minor technical changes to the proposal (e.g., formatting) in order to prepare it for publication in the Federal Register.

Attachment