Federal Reserve Requests Comment on a Risk-Based Capital Surcharge Proposal for GSIBs

Executive Summary

On December 9, 2014, the Federal Reserve Board ("Federal Reserve") issued a proposed rule to establish a capital surcharge for the largest, most interconnected U.S.-based bank holding companies ("BHCs") in accordance with its authority to establish enhanced risk-based capital standards under Section 165 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("*Dodd-Frank Act*"). The proposal would also revise the terminology used to identify firms subject to the enhanced supplementary leverage ratio requirement[1] to ensure consistency in the scope of application for both rulemakings. The proposed rule, which would amend the Federal Reserve's regulatory capital rule, is largely consistent with the international framework adopted by the Basel Committee on Banking Supervision ("BCBS") in July 2013, but contains certain modifications to the BCBS's calculation methodology to reflect systemic risk concerns specific to the funding structures of large U.S. BHCs.

As proposed, the rule would establish a methodology for determining whether a U.S. BHC with at least $50 billion in total consolidated assets that is not a subsidiary of a non-U.S. banking organization is a global systemically important bank holding company ("GSIB"). U.S. BHCs meeting the asset threshold would be required to calculate a measure of their systemic importance based on five broad categories that would include size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity.

Based on this measure, a subset of these U.S. BHCs would be identified as GSIBs and subject to a risk-based capital surcharge that would increase their capital conservation buffer under the Federal Reserve's regulatory capital rule. Under the proposed methodology, the Federal Reserve estimates that eight U.S. BHCs would currently be identified as GSIBs. These institutions would be required to calculate their GSIB capital surcharge using two methods and be subject to the higher of the two calculations, defined as:

- The sum of the GSIB's systemic indicator scores reflecting its size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity ("Method 1"); and
- The sum of the GSIB's systemic indicator scores reflecting its size, interconnectedness, complexity, and cross-jurisdictional activity, as well as a measure of the GSIB's use of short-term wholesale funding that replaces the substitutability systemic indicator scores ("Method 2"). The Federal Reserve states this method would usually result in a higher surcharge than Method 1.

The proposed rule states that the calibration of the measurements is designed to (1) induce a GSIB to reduce its risk of failure and internalize the negative externalities it poses, (2) correct for competitive distortions created by the perception that a GSIB may be too big to fail, (3) place additional private capital at risk before either the Federal Deposit Insurance Fund or the federal government's resolution mechanisms would be called upon, and (4) reduce the likelihood of economic disruptions owing to a GSIB's financial distress. Consistent with the punitive measures of the capital conservation buffer, failure to maintain the capital surcharge would subject the GSIB to restrictions on capital distributions and discretionary bonus payments.

The proposed rule would be phased in beginning January 1, 2016, through year-end 2018, and become fully effective on January 1, 2019. Comments on the proposal must be submitted to the Federal Reserve no later than March 2, 2015.

[1] See *KPMG Regulatory Practice Letter 14-08*.

Background

The Federal Reserve is proposing to impose risk-based capital surcharges upon U.S. BHCs that are identified as GSIBs pursuant to its authority to establish enhanced risk-based capital standards under Section 165 of the *Dodd-Frank Act*. Section 165 directs the Federal Reserve to establish enhanced prudential standards for certain BHCs and nonbank financial companies[2] in order to mitigate the risk to U.S. financial stability that could develop due to the distress or failure of large, leveraged, and interconnected financial institutions. The enhanced prudential standards include heightened risk-based capital requirements, leverage limits, liquidity standards, single-counterparty credit limits, stress testing requirements, and overall risk management standards for entities deemed to present risks to U.S. financial stability.

The proposed GSIB surcharge, which is based on the BCBS's July 2013 publication entitled *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirements* ("Basel GSIB Framework"), is one in a series of rulemakings developed by the Federal Reserve and other regulatory agencies in the wake of the financial crisis that encompasses an integrated set of prudential standards, including:

- **Annual resolution plans** for certain BHCs, foreign banking organizations ("FBOs"), and nonbank financial companies mandated by the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC") under a joint final rule issued in October 2011.[3]
- **Annual capital plans** for certain BHCs to submit to the Federal Reserve that demonstrates the BHCs' ability to meet certain minimum regulatory capital requirements over a range of stressed conditions under a final rule issued in November 2011.[4]
- **Stress testing requirements** for certain BHCs, state member banks, and savings and loan holding companies mandated by the Federal Reserve under two final rules issued in October 2012.
- Enhanced **risk-based capital, leverage, liquidity, and risk management requirements** for certain U.S. BHCs and FBOs mandated by the Federal Reserve under a final rule issued in February 2014.[5]
- A standardized minimum **liquidity coverage ratio** for the largest, most complex banking organizations adopted by the Federal Reserve, FDIC, and the Office of the Comptroller of the Currency in September 2014.[6]

Lastly, in July 2013, the Federal Reserve, FDIC, and OCC adopted a final rule revising the **regulatory capital rule** to increase the quality and quantity of regulatory capital that must be maintained by banking organizations.[7] The final rule established a new minimum ratio of common equity tier 1 ("CET1") capital to risk-weighted assets ("RWA") of 4.5 percent and a CET1 capital conservation buffer of 2.5 percent of RWA designed to encourage a banking organization to hold capital in excess of regulatory minimums by imposing certain restrictions on capital distributions and discretionary bonus payments if the entity's buffer falls below specified thresholds. The rule also raised the minimum ratio of tier 1 capital to RWA from 4 percent to 6 percent.

Banking organizations subject to the advanced approaches risk-based capital rule ("Advanced Approaches banks") are also subject to a potential countercyclical capital buffer of up to 2.5 percent of RWA, which could be implemented if the regulatory agencies determine excessive credit growth in the broader economy. Advanced Approaches banks generally include those with at least $250 billion in total consolidated assets or at least $10 billion in on-balance-sheet foreign exposure; other banking organizations that opt-in to the advanced approaches; and depository institution subsidiaries of banking organizations that trigger one of the asset or on-balance-sheet foreign exposure thresholds.

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[2] The enhanced prudential standards apply to BHCs with at least $50 billion in total consolidated assets and nonbank financial companies designated for Federal Reserve supervision by the Financial Stability Oversight Council.
[3] See *KPMG Regulatory Practice Letter 11-22*.
[4] See *KPMG Regulatory Practice Letter 12-03*.
[5] See *KPMG Regulatory Practice Letter 14-07*.
[6] See *KPMG Regulatory Practice Letter 14-13*.
[7] See *KPMG Regulatory Practice Letter 13-13*.

Description

GSIB Identification

The proposed rule would require a U.S. top-tier BHC with at least $50 billion in total consolidated assets to annually determine whether it is a GSIB by using five broad categories with twelve weighted indicators that measure multiple dimensions of global systemic importance based on values taken from the BHC's most recent Banking Organization Systemic Risk Report ("FR Y-15").[8] The Federal Reserve notes that these factors are consistent with the metrics it considers in reviewing financial stability implications of proposed mergers and acquisitions by banking organizations. A relative systemic risk indicator score for each BHC would then be derived based on a comparison with the corresponding aggregate global indicator amount, which is released by the BCBS under the Basel GSIB Framework. BHCs with aggregate systemic indicator scores below the proposed rule's 130 basis point threshold would not be subject to the GSIB surcharge.

The following table presents the five categories, twelve systemic indicators, and their corresponding weights:

Systemic indicators		
Category	Systemic Indicator	Indicator Weight
Size	Total exposures	20%
Interconnectedness	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Securities outstanding	6.67%
Substitutability	Payments activity	6.67%
	Assets under custody	6.67%
	Underwritten transactions in debt and equity markets	6.67%
Complexity	Notional amount of over-the-counter derivatives	6.67%
	Trading and available-for-sale securities	6.67%
	Level 3 assets	6.67%
Cross-jurisdictional activity	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Total		**100%**

GSIB Surcharge Calculation Methodologies

Under the proposal, a BHC with an aggregate systemic indicator score of at least 130 basis points would be identified as a GSIB, subject to the higher of two surcharges calculated under the Method 1 and Method 2 methodologies. Consistent with the Basel GSIB Framework methodology, Method 1 translates a BHC's aggregate systemic indicator score to a banded scale beginning with a 1 percent surcharge for a score of 130 basis points and requires a 0.5 percent surcharge increase per 100 basis point increase in score until 529 basis points and a 1 percent increase per 100 BPS increase in score from 530 to 629 basis points. If a GSIB's systemic indicator score is 630 basis points or higher, the surcharge would be 4.5 percent plus 1 percentage point for every 100 basis point increase in score.

Method 2 would factor in a measure for GSIB short-term wholesale funding reliance, which would replace the substitutability category used under Method 1. The inclusion of short-term wholesale funding is intended to address the systemic risks associated with its use, which the Federal Reserve asserts increases the probability of a BHC's default by making it vulnerable to short-term creditors runs,

[8] The FR Y-15 collects annual data on components of systemic risk from certain large BHCs and provides firm-specific information that enables an analysis of the BHCs' systemic risk profiles.

and potentially increases the associated social costs by heightening the risk that the BHC's significant stress or failure will lead to fire sale externalities for other firms.

Method 2 is based on the GSIB's average annual use of short-term wholesale funding and derived from values reported on the Complex Institution Liquidity Monitoring Report ("FR 2052a"),[9] weighted for funding type and maturity and divided by the GSIB's average total RWA. A fixed conversion factor and multiplier would be applied to the short-term wholesale funding measure to normalize the value relative to the other systemic indicators. This amount would constitute the GSIB's short-term wholesale funding score, which would be added to the systemic indicator scores for the size, interconnectedness, complexity, and cross-jurisdictional activity indicators and multiplied twice to arrive at the GSIB's Method 2 score. The banded scale under this methodology would begin with a 1 percent surcharge for a Method 2 score of 130 and would require a 0.5 percent surcharge increase for every 100 basis point increase in score until 1129. If a GSIB's Method 2 score is 1130 or higher, the surcharge would be 5.5 percent plus 0.5 percentage point for every 100 basis point increase in score.

The following table compares the range of applicable surcharges under the two proposed methodologies:

<table>
<tr><th colspan="3">GSIB surcharge calculation comparison</th></tr>
<tr><th>Score (basis points)</th><th>Method 1 surcharge</th><th>Method 2 surcharge</th></tr>
<tr><td>Less than 130</td><td>No surcharge</td><td>No surcharge</td></tr>
<tr><td>130-229</td><td>1%</td><td>1%</td></tr>
<tr><td>230-329</td><td>1.5%</td><td>1.5%</td></tr>
<tr><td>330-429</td><td>2%</td><td>2%</td></tr>
<tr><td>430-529</td><td>2.5%</td><td>2.5%</td></tr>
<tr><td>530-629</td><td>3.5%</td><td>3%</td></tr>
<tr><td>630-729</td><td rowspan="6">4.5%
plus 1 percentage point per 100 basis point increase in score exceeding 630[10]</td><td>3.5%</td></tr>
<tr><td>730-829</td><td>4%</td></tr>
<tr><td>830-929</td><td>4.5%</td></tr>
<tr><td>930-1029</td><td>5%</td></tr>
<tr><td>1030-1129</td><td>5.5%</td></tr>
<tr><td>≥ 1130</td><td>5.5%
plus 0.5 percentage point per 100 basis point increase in score exceeding 1130[11]</td></tr>
</table>

[9] See *KPMG Regulatory Practice Letter 15-01.*
[10] The Basel GSIB Framework uses 4.5 percent for the 630 basis point or greater band, while the Federal Reserve proposal indicates both 4.5 percent in the proposed rule and 3.5 percent in the preamble, presumed to be a typographical error.
[11] The Federal Reserve proposal indicates "5.5% and an additional 0.5% for each 100 basis points that the BHC's score exceeds *630* basis points" in the proposed rule, presumed to be a typographical error, and "5.5% plus 0.5% point for every 100 basis point increase in score" in the preamble.

Capital Ratios and the GSIB Surcharge: Transition Schedule Overview

As proposed, the GSIB surcharge would be phased in from January 1, 2016, to January 1, 2019. This schedule is intended to align the surcharge with the capital conservation buffer and countercyclical capital buffer transition period. The following table summarizes the total regulatory capital levels for GSIBs that would be required with the proposed surcharge:

Capital ratios and the GSIB surcharge: transition schedule overview				
Regulatory capital levels for GSIBs	January 1, 2016	January 1, 2017	January 1, 2018	January 1, 2019
Minimum CET1 capital ratio	4.5%	4.5%	4.5%	4.5%
Minimum tier 1 capital ratio	6%	6%	6%	6%
Minimum total capital ratio	8%	8%	8%	8%
Capital conservation buffer	+ 0.625%	+ 1.25%	+ 1.875%	+ 2.5%
Maximum countercyclical capital buffer (for Advanced Approaches banks only)	+ 0.625%	+ 1.25%	+ 1.875%	+ 2.5%
Minimum CET1 capital ratio + capital conservation buffer + applicable GSIB surcharge	5.125% + 25% of applicable GSIB surcharge	5.75% + 50% of applicable GSIB surcharge	6.375% + 75% of applicable GSIB surcharge	7% + 100% of applicable GSIB surcharge
Minimum tier 1 capital ratio + capital conservation buffer + applicable GSIB surcharge	6.625% + 25% of applicable GSIB surcharge	7.25% + 50% of applicable GSIB surcharge	7.875% + 75% of applicable GSIB surcharge	8.5% + 100% of applicable GSIB surcharge
Minimum total capital ratio + capital conservation buffer + applicable GSIB surcharge	8.625% + 25% of applicable GSIB surcharge	9.25% + 50% of applicable GSIB surcharge	9.875% + 75% of applicable GSIB surcharge	10.5% + 100% of applicable GSIB surcharge
Minimum CET1 capital ratio + capital conservation buffer + maximum countercyclical capital buffer + applicable GSIB surcharge	5.75% + 25% of applicable GSIB surcharge	7% + 50% of applicable GSIB surcharge	8.25% + 75% of applicable GSIB surcharge	9.5% + 100% of applicable GSIB surcharge
Minimum tier 1 capital ratio + capital conservation buffer + maximum countercyclical capital buffer + applicable GSIB surcharge	7.25% + 25% of applicable GSIB surcharge	8.5% + 50% of applicable GSIB surcharge	9.75% + 75% of applicable GSIB surcharge	11% + 100% of applicable GSIB surcharge
Minimum total capital ratio + capital conservation buffer + maximum countercyclical capital buffer + applicable GSIB surcharge	9.25% + 25% of applicable GSIB surcharge	10.5% + 50% of applicable GSIB surcharge	11.75% + 75% of applicable GSIB surcharge	13% + 100% of applicable GSIB surcharge

Maximum Payout Ratio: Transition Schedule Overview

Beginning January 1, 2016, the capital conservation buffer, including the applicable proposed GSIB surcharge and any applicable countercyclical capital buffer amount, will be used to determine a BHC's maximum payout ratio, expressed as a percentage of eligible retained income. The following table summarizes the maximum payout ratio for GSIBs that would be required with the proposed surcharge:

Maximum payout ratio: transition schedule overview				
Maximum payout ratio	Calendar year 2016	Calendar year 2017	Calendar year 2018	Calendar year 2019
No payout limitation	> 0.625% plus (A) 25% of countercyclical capital buffer amount and (B) 25% of GSIB surcharge	> 1.25% plus (A) 50% of countercyclical capital buffer amount and (B) 50% of GSIB surcharge	> 1.875% plus (A) 75% of countercyclical capital buffer amount and (B) 75% of GSIB surcharge	> 2.5% plus (A) 100% of countercyclical capital buffer amount and (B) 100% of the GSIB surcharge
60%	≤ 0.625% plus (A) 25 % of countercyclical capital buffer amount and (B) 25 % of GSIB surcharge, and > 0.469 % plus (A) 17.25% of countercyclical capital buffer amount and (B) 17.25% of GSIB surcharge	≤ 1.25% plus (A) 50% of countercyclical capital buffer amount and (B) 50% of GSIB surcharge, and > 0.938% plus (A) 37.5% of countercyclical capital buffer amount and (B) 37.5% of GSIB surcharge	≤ 1.875% plus (A) 75% of countercyclical capital buffer amount and (B) 75% of GSIB surcharge, and > 1.406% plus (A) 56.25% of countercyclical capital buffer amount and (B) 56.25% of GSIB surcharge	≤ 2.5% plus (A) 100% of countercyclical capital buffer amount and (B) 100% of GSIB surcharge and > 1.875% plus (A) 75% of countercyclical capital buffer amount and (B) 75% of GSIB surcharge
40%	≤ 0.469% plus (A) 17.25% of countercyclical capital buffer amount and (B) 17.25% of GSIB surcharge, and > 0.313% plus (A) 12.5% of countercyclical capital buffer amount and (B) 12.5% of GSIB surcharge	≤ 0.938% plus (A) 37.5% of countercyclical capital buffer amount and (B) 37.5% of GSIB surcharge, and > 0.625% plus (A) 25% of countercyclical capital buffer amount and (B) 25% of GSIB surcharge	≤ 1.406% plus (A) 56.25% of countercyclical capital buffer amount and (B) 56.25% of GSIB surcharge, and > 0.938% plus (A) 37.5% of countercyclical capital buffer amount and (B) 37.5% of GSIB surcharge	≤ 1.875% plus (A) 75% of countercyclical capital buffer amount and (B) 75% of GSIB surcharge, and >1.25% plus (A) 50% of countercyclical capital buffer amount and (B) 50% applicable GSIB surcharge
20%	≤ 0.313% plus (A) 12.5% of countercyclical capital buffer amount and (B) 12.5% of GSIB surcharge, and > 0.156% plus (A) 6.25% of countercyclical capital buffer amount and (B) 6.25% of any applicable GSIB surcharge	≤ 0.625% plus (A) 25% of any applicable countercyclical capital buffer amount and (B) 25% of any applicable GSIB surcharge), and > 0.313% plus (A) 12.5% of countercyclical capital buffer amount and (B) 12.5% of GSIB surcharge	≤ 0.938% plus (A) 37.5% of countercyclical capital buffer amount and (B) 37.5% of GSIB surcharge, and > 0.469% plus (A) 18.75% of countercyclical capital buffer amount and (B) 18.75% of GSIB surcharge	≤ 1.25% plus (A) 50% of countercyclical capital buffer amount and (B) 50% of GSIB surcharge, and > 0.625% plus (A) 25% of countercyclical capital buffer amount and (B) 25% of GSIB surcharge
0%	≤ 0.156% plus (A) 6.25% of countercyclical capital buffer amount and (B) 6.25% of GSIB surcharge	≤ 0.313% plus (A) 12.5% of countercyclical capital buffer amount and (B) 12.5% of GSIB surcharge	≤ 0.469% plus (A) 18.75% of countercyclical capital buffer amount and (B) 18.75% of GSIB surcharge	≤ 0.625% plus (A) 25% of countercyclical capital buffer amount and (B) 25% of GSIB surcharge

Commentary

Consistent with other jurisdictions that have established more stringent capital requirements for GSIBs, the proposed U.S. rule is similar in concept to the Basel GSIB Framework, but would likely result in higher surcharges than the international standard. Under the proposal, the Basel GSIB Framework's higher loss absorbency requirement would serve as a floor for the GSIB surcharge, although the proposed rule introduces a higher surcharge requirement for scores equaling or exceeding 630 basis points. In connection with the proposed rule, the Federal Reserve intends to propose modifications to the FR Y-15 to include disclosure of the BHCs' systemic indicator scores and information on the BHCs-that-would-be-GSIBs' short-term wholesale funding scores. Once these reporting changes are finalized, GSIBs will likely need to reconcile the revised FR Y-15 requirements with the data collected through their FR 2052a reporting that would determine their short-term wholesale funding scores.

As the short-term wholesale funding indicator proposed under Method 2 is intended to require GSIBs to hold additional capital if they rely more heavily on this funding type, covered entities will need to consider modifying their funding profiles to reduce short-term wholesale funding use or prepare to hold additional capital against the same degree of funding used. The inclusion of short-term wholesale funding use deviates from the Basel GSIB Framework calculation, however, the Federal Reserve has stated that it is encouraging the BCBS to consider modifying the international standard to incorporate this funding type. Regulatory pressure to reduce GSIB reliance on this type of funding will likely continue through the Federal Reserve's anticipated net stable funding ratio ("NSFR") rulemaking (see *KPMG Regulatory Practice Letter 14-20*).

Based on the 2013 BCBS aggregate global indicator amounts, FR Y-15 data, and aggregated short-term wholesale funding data from the FR 2052a, the Federal Reserve estimates that the GSIB surcharges applicable to the eight U.S. BHCs that would be identified as GSIBs would range from 1.0 percent to 4.5 percent. Using these estimates as floors, the minimum capital requirements for GSIBs, when fully phased in, would range from (1) 8 percent to 11.5 percent for the minimum CET1 capital ratio, capital conservation buffer, and GSIB surcharge, (2) 9.5 percent to 13 percent for the minimum tier 1 capital ratio, capital conservation buffer, and GSIB surcharge, and (3) 11.5 percent to 15 percent for the minimum total capital ratio, capital conservation buffer, and GSIB surcharge.

Although the Federal Reserve notes that nearly all of the eight BHCs are already positioned to meet their GSIB surcharges on a fully phased-in basis and all eight would be ready to meet their surcharges over the proposed three year phase-in period, the proposed rule would still likely have a substantial impact when taking other proposed regulatory capital requirements into consideration. Specifically, the GSIB surcharge will likely be added to the Total Loss Absorbing Capacity ("TLAC") standard for GSIBs proposed by the Financial Stability Board in November 2014 and also anticipated to be the subject of future Federal Reserve rulemaking. Additionally, while the proposed surcharge would currently only augment the capital conservation buffer, the Federal Reserve has stated that it intends to analyze whether its capital plan and stress test rules should include a form of GSIB surcharge in the post-stress minimum capital requirements. Taken cumulatively, these measures could significantly impact GSIBs' strategic flexibility and funding costs, and their capital and liquidity risk management and profile will likely need to be adjusted accordingly.

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