FedFin Client Report

Monday, July 20, 2015

FRB Sets Surcharge to Force U.S. G-SIB Structural Revolution

Client Report: **GSIB5**

Executive Summary

The Federal Reserve today finalized a very stringent capital surcharge for U.S. G-SIBs, adopting the proposed capital and short-term standards (see FSM Report **GSIB2**) with relatively minor changes. The FRB did not add to the surcharge an immediate, express requirement that it be factored into CCAR, but this will be considered later this year. We understand the Board decided not to do so today to give markets a bit of time to adjust to a surcharge framework some had expected would be significantly modified in final form – which it emphatically was not. Chair Yellen and other Governors made it clear that the Board intends the new surcharge framework to force the biggest banks to break themselves up unless the market permits them to raise massive amounts of additional capital, a message underscored by the accompanying final rule for GE Capital. In contrast to the proposal (see FSM Report **SIFI**), the FRB stayed its hand on systemic surcharges because GE Capital is in fact breaking itself up. Smaller BHCs got a break – the final surcharge rule now requires systemic calculation only from BHCs with assets above $200 billion (not the $50 billion threshold), likely laying out a number the FRB and Administration would take for a change in the overall statutory systemic threshold.

The Board also proposed changes to the revisions to the FR Y-15 reporting forms (see FSM Report **GSIB4**) to conform the collection of information with the requirements of the final G-SIB surcharge, extending the comment deadline to 60 days after the publication of the G-SIB surcharge in the *Federal Register*.

Analysis

Opening Statements

Chair Yellen argued that the surcharge is an important step to ensuring G-SIBs internalized the costs that their failure poses to the broader economy, providing them

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with a choice either to hold more capital or to shrink their systemic footprint. Gov. Tarullo noted that the calibration of the Basel G-SIB rules are at the lower end of what economic analyses would support. The Board will consider a Net Stable Funding Ratio later in the year, with work underway to incorporate systemic risks into stress testing.

Staff presentation

Key changes from the proposed rule include:

- Increasing the threshold at which banks have to calculate their systemic footprint. Before, all banks under $50 billion in assets needed to calculate their threshold; now, BHCs under $200 billion in assets "generally" would not be subject to this requirement.
- Method 2 of calculating the surcharge, which replaces the substitutability measure with one based upon short-term wholesale, which would not be calculated on a relative basis to other banks, but instead use fixed global totals.
- Method 2 also requires a conversion of Euros to dollars for measuring short-term wholesale funding, and the proposed rule would utilize a spot rate. The final rule uses a one-time conversion based upon the year's average, and then a three-year average moving forward.
- Changes to the weights of certain sources of unsecured short-term wholesale funding under method 2. In response to comments that suggested the risk weights were overstated, the Fed reduced the maximum risk weight of funding from nonfinancial clients to 25 percent from 50 percent, and reduced the maximum risk weight of funding from financial clients to 75 percent from 100 percent.

The staff noted that surcharges under method 2 were approximately 1.8 times higher than method 1, and that seven of the eight G-SIBs already meet the surcharge.

Commenters argued that the short-term wholesale funding measure was unnecessary given the LCR – the categories of weighting in both are largely similar – but staff and Gov. Brainard argued the LCR and other liquidity measures are aimed at addressing a single firm's risk of failure. The G-SIB surcharge goes further to limit the risk to the entire system.

Comments had also requested analysis justifying the calibration of the surcharge, and the Fed staff discussed the white paper that was released concurrently with the final rule. The white paper estimates the amount of capital necessary to make the impact of the failure of a G-SIB equivalent to the failure of a large non-G-SIB (i.e. if a G-SIB's failure would cause five times as much financial damage, then the probability of failure must be one-fifth that of a non-G-SIB). The white paper uses the

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two methods of calculating systemic risk in the final rule to measure the impact of a failure, estimates probability of failure at different levels of capital, and then compares both to large non-G-SIB reference banks.

Q&A

Chair Yellen asked about the assumptions behind calculating loss given default used in the white paper, and the staff said the analysis assumed the systemic risk scores used in the final rule were proportional to loss given default. They noted that some components may not have a linear relationship – loss given default may increase at an increasing rate – and that those issues were taken into account on a qualitative basis.

Vice Chair Fischer pointed out that the relative measures of method 2 in the NPR would still have given firms benefits for decreasing their relative reliance on wholesale funding even if the industry as a whole decreases its reliance. He also asked why the U.S. has higher requirements than other countries. Staff stated that it is necessary to internalize the costs of their failure. Further, Switzerland and Sweden exceeded the minimums required by Basel, and the U.K. was working towards a higher leverage surcharge. The U.S. also had decades of more stringent bank regulation and competed successfully on a global scale. Vice Chair Fischer also expressed some concern about the changes to the exchange rate calculation, but staff defended it on the basis that short-term fluctuations (e.g. de-pegging of the Swiss Franc to the Euro) may not reflect long-term changes in currency rates.

Gov. Tarullo asked why the changes to the relative measures were not used for method 1, and staff stated that it was done so to ensure consistency with Basel's rules. Gov. Powell asked if there is sufficient transparency in surcharge calculation. Gov. Brainard made it clear that she strongly supports the rule and the rationale behind it.

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