Global GSIB-Designation Criteria

Cite

Basel Committee, Final Standards, Revised Assessment Methodology and the Higher Loss Absorbency Requirement

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Impact Assessment

- Custody, PCS, and other specialized banks retain some protection from GSIB surcharges since the substitutability cap has been retained pending additional study.
- Custody and other infrastructure banks nonetheless face higher surcharges, as do banks with large trading positions and/or considerable global derivatives operations.
- Large U.S. insurers contemplating DIHC or similar status could face GSIB surcharges regardless of whether FSOC designates them as systemic non-banks.
- Host regulators now have a clearer path to applying domestic GSIB standards to foreign subsidiaries operating within their jurisdictions if the parent company is designated as a GSIB. Doing so for banks that are not so designated at the parent level is possible, but still difficult.

Overview

The Basel Committee has revised the designation criteria for global systemically-important banks (GSIBs) first adopted in 2013[1] with this new framework following a 2017 consultation.[2] Although there was little doubt that global regulators would retain the basic GSIB framework and its objective of higher capital for banks deemed the riskiest to reduce negative externalities, Basel has not only stood by the GSIB construct, but also strengthened it in several ways. The new approach will prove particularly costly to large banks with significant insurance activities, as insurance subsidiaries now count in various indicators that could lead to designation and, accordingly, capital surcharges. However, Basel drew back from the 2017 proposal simply to end the cap on counting indicators of "substitutability" – i.e.,

1 See **CAPITAL180**, *Financial Services Management*, November 16, 2011.

2 See **GSIB10**, *Financial Services Management*, April 5, 2017.

market dependence on core functions of the bank. Although the substitutability indicator has been beefed up, the cap is retained pending further study.

The U.S. GSIB-designation framework[3] is already tougher than the global approach, but it is now even more clear that – whatever their technical differences – global regulators stand by the U.S. effort not only to add more loss-absorption capacity at GSIBs, but also to reduce global spillover effects and "systemic footprints." Several sections in the new framework explicitly authorize national regulators to impose more stringent standards, thus endorsing the U.S. "gold-plated" approach. The global standards also authorize host-country regulators to designate subsidiaries of banks designated as GSIBs for their own systemic rules, which the U.S. has already done in its TLAC standards[4] but largely forborne in other GSIB regulations such as the enhanced supplementary leverage ratio.[5]

Impact

In the first substantive revision of the post-crisis GSIB-designation criteria, the Basel Committee has made only relatively minor modifications that somewhat toughen the capital surcharges now applied to designated GSIBs. Designated companies and those fearing a comparable fate have long argued that these added capital requirements are unnecessary in light of other post-crisis reforms that reduce the probability of bank default (PD) through an array of capital, liquidity, and resolution stress-test requirements. Many also argue that the loss given default (LGD) of big-bank failure is sharply reduced now due to capital and total loss-absorption capacity (TLAC) requirements. In its latest standards, Basel acknowledges the reduced-PD benefits of all of the post-crisis rules, but stands by GSIB-designation on LGD grounds.

That is, it believes that, despite TLAC and other buffers aimed at reducing failure cost, higher loss-absorption requirements mandated through capital surcharges are sure to give resolution authorities additional tools that reduce any remaining negative externalities. The difficulty with this line of argumentation is that regulatory capital, even if buttressed by surcharges, is usually totally depleted at the point of insolvency – indeed, that is what insolvency means. As a result, capital surcharges may give big banks an added buffer atop all the others now required of them to reduce PD, but LGD at the actual point of failure is likely to be little offset by GSIB surcharges unless resolution authorities step in well before insolvency. Given uncertainties here, the GSIB-designation rationale is likely to be more about shrinking GSIB size – also mentioned in the final standards – than reducing LGD.

As before, scores for banks subject to GSIB designation are set not in comparison to the market as a whole or even to all banks, but just to those banks in the sample being considered for potential designation. As a result, overall reductions in the riskiness of all GSIBs (i.e., through application of the GSIB-specific post-crisis rules other than the surcharge) are not captured. Theoretically, due to this methodology, GSIBs or those subject to possible designation in a nation or region with particularly stringent regulations could well see lower scores vis-à-vis its global competitors in more lenient regimes. It remains to be seen if such national shifts occur as the designation methodology advances in concert with implementation of stringent rules such as the U.S. TLAC standards. This methodology makes designation most unlikely only if large banks shrink below about $250 billion in assets – i.e., if they radically reduce their systemic footprint.

As discussed in more detail below, the "substitutability" indicator for GSIB designation has proven particularly problematic. This measures the extent to which the market could

[3] See **GSIB7**, *Financial Services Management*, July 23, 2015.

[4] See **TLAC6**, *Financial Services Management*, December 7, 2016.

[5] See **LEVERAGE13**, *Financial Services Management*, April 16, 2018.

function without the presence of a GSIB providing custody, infrastructure, or similar services. In the first methodology, it turned out to be the most important indicator, which Basel determined inappropriate given the importance of the others. It thus included a cap on the extent to which substitutability interacts with the four other indicators (see below). Retaining the cap for now prevents a sharp, sudden spike in GSIB surcharges for affected banking organizations. However, details in the new approach are likely to raise capital add-ons above current levels for at least some of these companies. Further, this may be only a reprieve given that Basel continues to look at ways to remove the cap altogether.

Relatively small banking organizations with very large trading activities have also enjoyed lower GSIB surcharges than diversified banking organizations. The new methodology may well change that due to redesigned indicators intended to capture cross-border derivatives activities as well as large underwriting and trading activities. This would reduce the relative capital disadvantage in which like-kind activities housed in diversified GSIBs are subject to the higher surcharges applied across like-kind risk-weighted assets.

What's Next

These standards were issued on July 5. This new assessment methodology will take effect in 2021 and surcharges are to come into force in 2023.

Even as this framework comes into effect, Basel will also review its standards in 2020 and complete the review in 2021. In this review, the substitutability methodology will be a main focus, looking to remove the current cap on this designation criterion. The role of branches will also come under scrutiny, although Basel does not say how.

The U.S. has already adopted its own substitutability approach to the extent that its rules have two methods for calculating the GSIB surcharge, laying out "method 1" (the Basel substitutability standard) and "method 2" (a short-term, wholesale funding indicator) and using the higher of the two methods for designation. It is unclear if the U.S. will now revise these methods to reflect Basel's final standards or await the 2021 round, but the Fed's focus on short-term funding risks suggests that the two methods will be maintained.

Consistent with FSB instructions,[6] Basel is also looking at GSIB surcharges that go beyond capital to include large exposures and liquidity. No timeline for doing so is set. The U.S. standards for single-counterparty credit limits do, however, include additional limits for GSIB exposures to other GSIBs.[7]

Analysis

A. Designation Methodology

As before, this methodology depends on "indicators." Supervisory qualitative judgments may override these indicators, but only in rare, "egregious" circumstances and even then subject to international peer review and other obstacles.

6 See **SYSTEMIC32**, *Financial Services Management*, August 3, 2010.

7 See **CONCENTRATION11**, *Financial Services Management*, June 5, 2018.

1. Scope

GSIB surcharges apply at the consolidated parent-company level to capture global effects. However, host supervisors may impose them on consolidated GSIB operations in their jurisdictions.

The standards are revised now to capture not only banking operations but also insurance ones in the global group. Basel determined that the International Association of Insurance Supervisors designation standards do not capture these groups,[8] although some national regulators have done so. Insurance subsidiaries now count towards individual factors in the size, interconnectedness, complexity, and certain other indicators.

2. Indicators

These equally-weighted indicators remain as before with some differences in how each is measured as follows:

- Size: This is judged by total exposures as measured in the Basel leverage ratio.[9]
- Cross-Jurisdictional Activities: These are measured by cross-jurisdictional claims and cross-jurisdictional liabilities. This toughens up this indicator by now including in it derivatives assets and liabilities in conformity with pending BIS data-collection metrics.
- Interconnectedness: Three indicators here are intra-financial system assets, intra-financial system liabilities, and securities outstanding.
- Substitutability/Financial-Institution Infrastructure: This is judged by four indicators: assets under custody, payment activities, debt-and-equity market underwriting, and (a new indicator) trading volume. Sovereign-debt instruments appear to be excluded from the trading volume calculation.
- Complexity: The three indicators here are notional amounts of OTC derivatives, level 3 assets, and trading and available-for-sale securities. Insurance subsidiaries are now covered by the first two indicators.

3. Sample

As noted, these indicators are assessed across banks selected for GSIB review. Sample-inclusion criteria are:

- the 75 largest banks based on leverage-denominator assets and insurance subsidiaries;
- GSIBs designated in the prior year, absent a compelling reason to exclude them; and
- banks added to the sample by national supervisors.

8 See **INSURANCE33**, *Financial Services Management*, July 25, 2013.
9 See **LEVERAGE11**, *Financial Services Management*, December 13, 2017.

4. Bucketing

As before, Basel sets a floor above which GSIBs are designated and "buckets" in which capital surcharges are increased. This process remains largely unchanged, as does Basel's plan to add a still-higher fourth bucket if needed due to increased GSIB risk.

The FSB continues to make the final designation and bucketing decision, considering quantitative results and handling supervisory challenges or additions. Further, where one supervisor differs from another, views of the home and major-host supervisors are also considered. Notably, home or host supervisors, subject to certain limitations, bucket a bank differently based on concerns not necessarily included in the designation process (e.g., the quality of a relevant resolution regime).

B. Disclosure Requirements

National supervisors are to require all banking organizations with leverage-denominator exposures over €200 billion (counting insurance subsidiaries and under applicable year-end exchange rates) to disclose the figures they calculate under the thirteen indicators described above. Banks below this threshold considered subject to designation under supervisory discretion would also need to make these disclosures. When revisions are required, this must be disclosed along with accurate data. National regulators may also require disclosure of the full breakdown of systemic indicators.

C. Higher Loss-Absorbency Requirements

As before, the buckets range from 1.0 percent to an unpopulated top bucket of 3.5 percent of risk-weighted assets, with these add-ons to be met with additional common equity Tier 1 capital. National jurisdictions may elect higher requirements.

The new standards reiterate prior policy about remediation through dividend and other restrictions when GSIBs fail to hold their required surcharges and about the transition periods when requirements increase.

When the indicators here are similar to those for which a national supervisor imposes a Pillar 2 charge, the Pillar 2 charge should be revised to prevent double-charging. However, most Pillar 2 charges are for concentration, interest rate, or other risks not captured by the surcharge; regulators are told to ensure that the surcharge does not substitute for these capital requirements.

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