SULLIVAN & CROMWELL LLP

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Bank Capital Requirements

Basel Committee Proposes Changes to the G-SIB Capital Surcharge Assessment Framework

On March 30, the Basel Committee on Banking Supervision published a consultative document proposing changes to the assessment framework used to identify global systemically important banks ("*G-SIBs*") and to impose higher capital requirements on G-SIBs that are intended to reduce the probability of their failure. The revised assessment framework would replace the framework issued in July 2013,[1] which the Committee previously committed to review every three years to ensure that "the framework remains consistent with its objectives in light of any structural change to the global banking system or to banks' business models."[2] The proposal includes several concrete changes to the assessment framework (including changes to scope, definitions, weights, indicators and disclosure requirements), as well as an "issue for discussion"—the introduction of a new indicator for short-term wholesale funding—which the Committee believes "would benefit from broader input on the usefulness and potential implications if included in the assessment methodology."[3]

Although the proposal includes the Committee's estimate of the potential quantitative impact of each proposed change based on year-end 2015 data, a comprehensive quantitative impact assessment to analyze the impact of the proposed changes will not be completed until after the end of the three-month consultation period. Following this comprehensive quantitative impact assessment, the Committee will publish the revised version of the G-SIB framework. The proposal's transition schedule indicates that the Committee seeks to publish the revised version in November 2017.

Comments on the consultative document are due by June 30, 2017.

Key Proposed Changes to the Assessment Methodology

Proposed changes to the G-SIB assessment methodology include the following:

- ***Removal of the cap currently applied to the substitutability category.*** The July 2013 G-SIB assessment framework included a cap on the maximum potential impact of the substitutability category on a bank's overall score. At that time, the Committee found that the substitutability category was having a greater than intended impact on the assessment of systemic importance for "banks that are dominant in the provision of payment, underwriting and asset custody services."[4] The Committee set the cap at 500 basis points (which, when weighted at 20%, would have a maximum impact of 100 points on the overall score). This could "move a bank up by one bucket, but not more."[5] In the July 2013 release, the Committee noted that it would reconsider the cap during the first three-year review of the framework. The U.S. G-SIB surcharge rule finalized by the Federal Reserve in 2015 also includes this cap on the substitutability category under its "Method 1" score.[6]
  - The Committee now believes that this cap "reduc[es] banks' incentives to become less systemically important" and should be removed to restore the "linear relationship between concentration and the G-SIB substitutability category score."[7] Removal of the cap would affect the scores of four banks according to the Committee's analysis, but would "provid[e] banks with an incentive to reduce concentration in the provision of [payments, custody and underwriting] services."[8]
- ***Introduction of a new indicator in the substitutability category.*** Within the substitutability category, the Committee further proposes to include a new indicator on trading volume that would "reflect banks' activities in the secondary market, in addition to the underwriting indicator, which captures activities in the primary market."[9] This new indicator is meant to capture banks' market-making (assuming the risk of holding securities in order to provide "liquidity immediacy" for clients) and agency-based trading, both of which the Committee believes "would be difficult to substitute in the event of default."[10] To accommodate this addition, the weight of the underwriting indicator would be reduced from 6.67% to 3.33% and the new trading volume indicator would be weighed at 3.33%.
  - In considering the potential impact of the new trading volume indicator on market-making, the Committee notes that given "the competitive nature of securities markets … smaller banks and securities firms could increase service provision in the medium term" and that this "relocation of trading would increase market resiliency through reduced concentration."[11] However, because central banking and central government securities are "key instruments for conducting monetary policy," the Committee would exclude central bank and central government instruments (the regulatory treatment of which is under review by the Committee) from this trading volume indicator.[12]
- ***Expansion of the regulatory scope of consolidation to include insurance subsidiaries.*** Some member jurisdictions do not require G-SIBs to include insurance subsidiaries in their regulatory scope of consolidation, which "creates inconsistencies in the systemic assessment of banking groups across jurisdictions."[13] In the United States, the same basis of consolidation is used for accounting and regulatory purposes, and the Federal Reserve's U.S. G-SIB surcharge rule accordingly does *not* exclude insurance subsidiaries from the regulatory scope of consolidation.
  - Because the International Association of Insurance Supervisors' methodology for identifying global systemically important insurers ("*G-SIIs*") also excludes bank-owned insurance subsidiaries from the G-SII framework, the Committee notes a "gap at the macroprudential level," as neither the G-SIB nor the G-SII framework captures these entities.[14]
  - To "better capture the loss-given-default of banking groups" and "reduce the potential for regulatory arbitrage by moving activities from banking groups into their insurance subsidiaries," the Committee proposes to include insurance activities in the regulatory scope of consolidation for the purpose of assessing G-SIBs.[15] The Committee proposes to include exposures from insurance subsidiaries in the size, interconnectedness, and complexity categories to "best reflect the systemic risks common to banks and insurers."[16]
- ***Amendment to the definition of cross-jurisdictional indicators.*** Previously, limitations in the collection of BIS consolidated banking statistics only captured derivatives liabilities at the "solo level" (the individual entity level, rather than the consolidated level) based on local accounting rules. In light of recent enhancements to the collection of consolidated banking statistics that allow the Committee

to capture derivatives liabilities on a consolidated basis, the Committee proposes to include these liabilities in the cross jurisdictional liabilities indicator (and the corresponding derivatives assets in the cross-jurisdictional claims indicator). The Committee does not expect this change to the definitions of the cross-jurisdictional indicators to materially impact the G-SIB scores of most banks. Consistent with the current Basel G-SIB framework, the form used to report data to the Federal Reserve under its U.S. G-SIB surcharge rule does not include assets or liabilities from positions in derivative contracts in the cross-jurisdictional indicators.[17]

- ***Addition of a requirement that banks disclose the indicators used in their "final" G-SIB calculations, which may require restatement in some cases.*** The Basel G-SIB framework currently requires banks to disclose their 12 indicator scores no later than four months after the financial year-end, and in any case, no later than the end of July. However, the G-SIB assessment and data quality review of this information is performed by the Committee from June to August, which potentially requires banks to report two or more rounds of data before the indicator scores are considered final. The Committee proposes also requiring banks to disclose the indicators used in the "final" G-SIB calculations used by the Committee to compute the annual G-SIB scores in August of each year.
  - Banks would be required to note in their initial disclosures of the 12 indicator scores that those figures are subject to revision and restatement. If the "final" data used to calculate the G-SIB scores differs from these previously disclosed figures, the banks would be required to further disclose the final indicator scores, "in the financial quarter immediately following the finali[z]ation of the Committee's G-SIB score calculation."[18]
- ***Potential introduction of a new indicator for short-term wholesale funding.*** The Committee proposes, as an "issue for discussion", the introduction of a new indicator for short-term wholesale funding as a new, fourth indicator in the interconnectedness category. By contrast, the Federal Reserve's U.S. G-SIB surcharge rule includes two "Methods" for calculating the G-SIB surcharge score, one of which, "Method 2", replaces the substitutability category of the Basel framework with a short-term wholesale funding category. Under the U.S. framework, the Method 1 score is used to identify U.S. G-SIBs from among large bank holding companies, and the higher of a G-SIB's Method 1 and Method 2 scores is used to determine the applicable capital surcharge.[19] The Committee estimates that the addition of its proposed short-term wholesale funding factor to the interconnectedness category would impose higher capital requirements on only two banks—each moving up one bucket.[20]
- ***Clarification that a bank may immediately apply the lower capital surcharge when its G-SIB score declines such that the bank is in a lower capital surcharge bucket.*** The Basel G-SIB assessment framework is currently silent on the timing of the release of capital in the event of a "downward bucket migration," *i.e.*, when a bank's G-SIB score declines to a level such that the bank becomes subject to a lower capital surcharge. To provide "strong incentives for banks to reduce their systemic importance," the Committee proposes to allow banks to immediately release the capital and apply the lower capital surcharge in "circumstances where the G-SIB score falls," subject to national discretion.[21]

Proposed Transition Period

The annual G-SIB scores determined by the Committee will continue to be based on the July 2013 assessment framework until the Committee finalizes and approves any proposed revisions. As set forth in the table below, the Committee will rely on the July 2013 methodology until the 2018 G-SIB assessment based on end-2017 data. Any revisions announced in November 2017 would take effect in 2019 based on end-2018 data, and the resulting capital requirement would apply as of January 2021.

Year of Assessment	Methodology of Reference	Data Used in Assessment	Applicability of Capital Requirement
2017	Current (published July 2013)	End-2016	January 1, 2019
2018	Current (published July 2013)	End-2017	January 1, 2020
2019	Revised (to be published in 2017)	End-2018	January 1, 2021

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ENDNOTES

[1] Basel Committee on Banking Supervision, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (July 2013), *available at* www.bis.org/publ/bcbs255.pdf (the "July 2013 framework"). For additional information regarding prior iterations of the Basel G-SIB framework see our client memoranda *Bank Capital Requirements: Basel Committee Updates Framework for Assessing a Common Equity Surcharge for Global Systemically Important Banks* (July 26, 2013), *available at* https://sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements.pdf and *Bank Capital Requirements: Basel Committee Issues Final Rule Regarding Common Equity Surcharge for Global Systemically Important Banks* (November 10, 2011), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_11-10-11.pdf.

For information on the U.S. implementation of the Basel-based G-SIB capital surcharge see our client memoranda *Bank Capital Requirements: Federal Reserve Proposes Rule Establishing Common Equity Surcharge on U.S. Global Systemically Important Banks* (December 14, 2014), *available at* https://sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_12_14_14.pdf, and *Bank Capital Requirements: Federal Reserve Approves Final Common Equity Surcharge for U.S. Global Systemically Important Banks* (July 29, 2015), *available at* https://sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_7_29_2015.pdf.

[2] Basel Committee on Banking Supervision, *Global Systemically Important Banks – Revised Assessment Framework* (March 2017), *available at* http://www.bis.org/bcbs/publ/d402.htm (the "Proposal").

[3] The Proposal, at 2.

[4] July 2013 framework, at 6.

[5] The Proposal, at 4.

[6] *See* 12 C.F.R. § 217.404(b)(2).

[7] The Proposal, at 5.

[8] The Proposal, at 5.

[9] The Proposal, at 6.

[10] The Proposal, at 6.

[11] The Proposal, at 7.

[12] The Proposal, at 7.

[13] The Proposal, at 5.

[14] The Proposal, at 5.

[15] The Proposal, at 5.

[16] The Proposal, at 5.

[17] Board of Governors of the Federal Reserve System, *Instructions for Preparation of the Banking Organizations Systemic Risk Report*, Reporting Form FR Y-15 (December 2016), Schedule E – Line Item Instructions for Cross-Jurisdictional Activity Indicators, available at https://www.federalreserve.gov/reportforms/forms/FR_Y-1520170331_i.pdf.

[18] The Proposal, at 8.

[19] *See* 12 C.F.R. § 217.404 (the Method 1 score) and 12 C.F.R. § 217.405 (the Method 2 score).

[20] The Proposal, at 14.

ENDNOTES (CONTINUED)

[21] The Proposal, at 9.

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