U.S. G-SIBs

Fed confirms methodology to set higher capital requirements for US global systemic banks (GSIB)

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The Board of the Federal Reserve has calibrated a more stringent capital surcharge for G-SIBs heavily reliant on short-term wholesale funding

On July 20 the Federal Reserve (Fed) released the final rule for identifying global systemically important bank holding companies (G-SIBs) that operate in the United States and the methodology for estimating the risk-based capital surcharge they will be subject to beginning January 2016. The framework identified eight bank holding companies that will be subject to an additional capital surcharge, which coincide with those identified by the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board.[1]

The Fed's G-SIB rule is only partially aligned with the framework adopted by BCBS in July 2013 and further explained in November 2014 (Method 1, with its five categories: size, interconnectedness, substitutability, complexity and cross-jurisdictional activity). However, it differs in that it includes a complementary methodology for estimating the capital surcharge (Method 2) which considers G-SIB's exposure to short-term wholesale funding instead of substitutability. A final systemic indicator is calculated and mapped into a capital surcharge under each of the two methods, the largest of which defines the G-SIB's required capital surcharge. The additional method for estimating the systemic indicator (Method 2) implies a larger capital surcharge range (1% to 4.5% of risk-weighted assets in common equity tier 1 capital) for U.S. based G-SIBs than what has been proposed by BCBS (Method 1) and accepted internationally (1% to 3.5%).

Assessment

The final Fed rule for U.S. G-SIBs follows the principle set in the Dodd-Frank Act in which it states that the stringency of prudential standards should vary with the systemic importance of regulated firms. The Fed's final rule imposes higher capital requirements for G-SIBs with higher systemic scores. The goal was to improve financial stability and limit moral hazard from G-SIBs without compromising significantly long term growth. In general terms, our assessment of the Fed's G-SIB rule is:

- The U.S. departs from the BCBS methodology by making it more stringent. It is not clear to what extent a national refinement was necessary, nor if it will be replicated in other jurisdictions (i.e. Europe).
- Method 2, which includes a short-term wholesale funding category instead of substitutability, stresses the funding vulnerability of entities. However, it is not clear that this category by itself is of systemic nature. Small institutions can be very reliant on short-term funding (e.g. Northern Rock).
- The proposal implies a significant increase in the capital surcharge for G-SIBs, which adds to the pressure of other on-going initiatives like total loss-absorbing capacity (TLAC).
- All this confirms the international regulatory trend towards an increasing burden associated with the G-SIB label.

[1] According to the BCBS and FSB the U.S. G-SIBs in descending systemic score order are: JP Morgan Chase, Citigroup, Bank of America, Goldman Sachs, Morgan Stanley, Wells Fargo, Bank of New York Mellon and State Street.

Figure 1
Components and weights of final U.S. G-SIB systemic indicator

Category	Measure	Method 1 weights (%)	Method 2 coeff value (%)
Size	Total exposure	20.0	4.423
Interconnectedness	Intra-financial system assets	6.67	12.007
	Intra-financial system liabilities	6.67	12.490
	Securities outstanding	6.67	9.056
Substituibility	Payments activities	6.67	[Weighted short-term wholesale funding / average RWA] *350
	Assets under custody	6.67	
	Underwritten transactions in debt and equity markets	6.67	
Complexity	Notional ammount of over-the-counter (OTC) derivatives	6.67	0.155
	Trading and available-for-sale (AFS) securities	6.67	30.169
	Level 3 assets	6.67	161.177
Corss-jursidictional activity	Corss-jursidictional claims	10.0	9.277
	Corss-jursidictional liabilities	10.0	9.926
		100.0	***

Source: Board of the Federal Reserve and BBVA Research *** Sum does not need to add to 100%.

Methodology

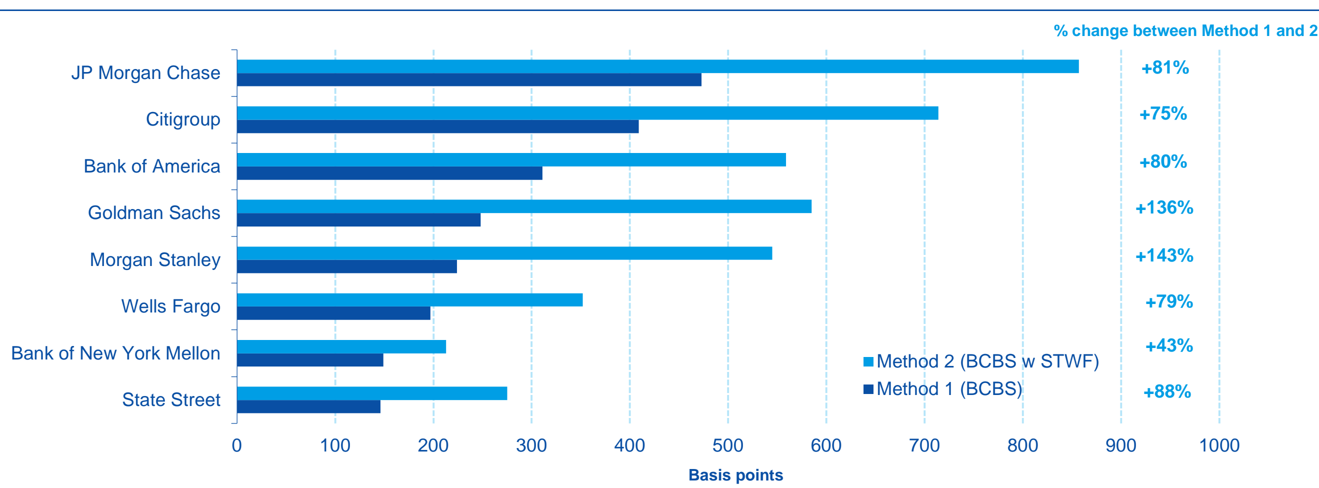
Method 1 (BCBS) mirrors BCBS internationally agreed framework for identifying G-SIBs. The framework is based on five equally weighted broad categories: size, interconnectedness, substitutability, complexity and cross-jurisdictional activity, and applies to bank holding companies at the consolidated level (Figure 1). Each category is composed of measurable indicators, for a total of twelve, that make up the final systemic indicator. The exposure of each bank holding company to each measure is estimated as a percentage of the global aggregate exposure of systemic banks published by the BCBS.[2] Bank holding companies are considered G-SIB if their final systemic indicator under Method 1 has a score greater than 130, and therefore are subject to a capital surcharge.[3] Five capital surcharge buckets are defined, the lowest of which starts with a value equivalent to 1% of risk-weighted assets (RWA) and rises by 0.5% increments for each 100pb score range difference. The highest bucket is 3.5% of RWA and is intentionally left in blank in order to dissuade G-SIBs from increasing systemic exposures. In any case, if the final systemic indicator of a G-SIB rises within the range of the highest bucket, a new bucket with an additional 1 percentage point in capital surcharge for the following 100bp score range would be added and left empty as the highest bucket (Figure 4).

Method 2 (BCBS with STWF) is based on the mentioned BCBS framework, but replaces the substitutability category with a measure of short–term wholesale funding exposure collected through the Fed's supervisory process. The final systemic indicator is calculated through a fixed approach, instead of relative to the global aggregate exposure, using coefficient values which the Fed has calibrated such that each of the five categories remain with an equal 20 per cent weighting (as in Method 1). This simplifies the final estimation and provides

[2] The BCBS publishes annually the global aggregate exposure of G-SIBs to each of the measures based on 75 of the largest banking organizations. These values are referenced as the denominators used to calculate the scores of sample banks.
[3] The Fed developed a calibration exercise for U.S. based bank holding companies, both under Method 1 and Method 2, and agreed that the 130 bp G-SIB threshold adopted by BCBS and FSB is adequate for the U.S. financial system.

greater certainty for bank holding companies to predict the score of their systemic indicators. The short-term wholesale funding measure is calculated by dividing the weighted short-term wholesale funding amount by the bank's average risk weighted assets and multiplied by a fixed factor of 350.[4] On the other hand, each of the other measures are calculated by multiplying the bank holding company's exposure to the specific measure by the corresponding coefficient value (Figure 1).[5] Consequently, banks more heavily reliant on short-term wholesale funding achieve a higher final systemic indicator and thus require a larger risk-based capital surcharge. Method 2 clearly seeks to reduce G-SIBs incentives to rely on short-term wholesale funding as it proved to be a significant source of financial instability during the crisis and left entities vulnerable to runs and fire sales. Furthermore, the additional common equity tier 1 capital has proven to allow financial institutions to be more resilient under economic stress and therefore strengthens the financial stability of the system. The inclusion of short-term wholesale funding has a significant impact on the score of the final systemic indicator for all G-SIBs. This is particularly true for Goldman Sachs and Morgan Stanley, which reflect their strong investment bank heritage and continued reliance on short-term funding (Figure 2).

Figure 2
U.S. G-SIB final systemic indicator (Method 1 vs. Method 2)



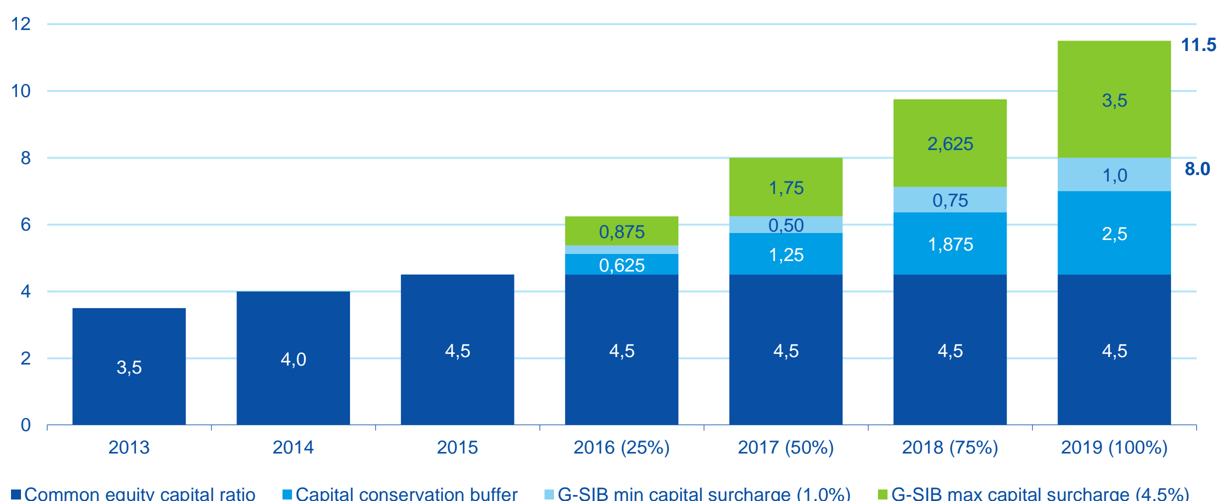
Source: Board of the Federal Reserve of the United States and BBVA Research

An important difference between the adopted rule and the one proposed in December 2014 is that it now applies only to bank-holding companies with more than USD 250 billion in consolidated assets or USD 10 billion in total on-balance sheet foreign exposure, also referred to as advanced approaches Board-regulated institutions. Initially the scope included all bank-holding companies with more than USD 50 billion in assets, but the threshold has been revised upwards under the final rule as the additional regulatory burden is deemed unnecessary for entities with lower exposures as it is considered unlikely they would be of systemic importance for the U.S. financial system.

[4] The weights of short-term wholesale funding are assigned depending on a combination of type of funding (four categories) and their time remaining to maturity (four buckets). Details of the weightings are found in Table 1 of page 103 of the final rule.
[5] The coefficient values have been calibrated by the Fed such that when multiplying the bank holding company's exposure to the specific measures, the weights remain the same as under Method 1.

Finally the required surcharges will be phased in beginning January 2016 and become fully effective on 1st January 2019, following the same timeline as that of the capital conservation buffer (Figure 3).[6] Firms that do not comply with the surcharges will be subject to restrictions on capital distributions and discretionary bonus payments. Currently all U.S. G-SIBs, with the exception of JP Morgan Chase, have sufficient capital to comply with the fully-loaded capital surcharge. JP Morgan Chase will have to raise additional capital or reduce its systemic exposure during the upcoming years in order for restrictions on capital distribution and bonus payments no to be applied.

Figure 3
Phase-in schedule for U.S. G-SIB common equity tier 1 capital surcharge as % of risk weighted assets



Source: Basel Committee on Banking Supervision, Federal Reserve and BBVA Research

[6] Phase-in of capital conservation buffer and G-SIB capital surcharge is 25% in 2016, 50% in 2017, 75% in 2018 and 100% in 2019. All capital ratios must be achieved by January 1st of the mentioned year.

Figure 4

Capital surcharge for U.S. G-SIBs July 2015

Method 1 (following BCBS)

Capital Surcharge as %RWA	Range (bp)	Points (bp)	U.S. GSIB
7.5%	930 - 1029		
6.5%	830 - 929		
5.5%	730 - 829		
4.5%	630 - 729		
3.5%	530 - 629		Left empty
2.5%	430 - 529	473	JP Morgan Chase
2.0%	330 - 429	409	Citigroup
1.5%	230 - 329	311	Bank of America
		248	Goldman Sachs
1.0%	130 - 229	224	Morgan Stanley
		197	Wells Fargo
		149	Bank of New York Mellon
		146	State Street

Method 2 (BCBS adjusted for short-term wholesale funding)

Capital Surcharge as %RWA	Range (bp)	Points (bp)	U.S. GSIB
7.5%	1330 - 1429		
7.0%	1230 - 1329		
6.5%	1130 - 1229		
5.5%	1030 - 1129		
5.0%	930 - 1029		
4.5%	830 - 929	857	JP Morgan Chase
4.0%	730 - 829		
3.5%	630 - 729	714	Citigroup
3.0%	530 - 629	585	Goldman Sachs
		559	Bank of America
		545	Morgan Stanley
2.5%	430 - 529		
2.0%	330 - 429	352	Wells Fargo
1.5%	230 - 329	275	State Street
1.0%	130 - 229	213	Bank of New York Mellon

No capital surcharge for scores below 130 points.

Source: Board of the Federal Reserve of the United States and BBVA Research.
Note: Each G-SIB is subject to the maximum capital surcharge obtained from estimating systemic risk indicators under Method 1 and Method 2.

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