Regulatory brief

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G-SIB capital: A look to 2015

Overview

This month, the Federal Reserve Board (FRB) issued a long-awaited proposal to impose additional capital requirements on the US's global systemically important banks (G-SIBs). The proposal implements the Basel Committee on Banking Supervision's (BCBS) G-SIB capital surcharge framework that was finalized in 2011, but also proposes changes to BCBS's calculation methodology resulting in significantly higher surcharges for US G-SIBs compared with their global peers.

The proposal, which we expect will be finalized in 2015, requires US G-SIBs to hold additional capital (Common Equity Tier 1 (CET1) as a percentage of Risk Weighted Assets (RWA)) equal to the greater of the amount calculated under two methods. The first method is consistent with BCBS's framework, and calculates the amount of extra capital to be held based on the G-SIB's size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity. The second method is introduced by the US proposal, and uses similar inputs but replaces the substitutability element with a measure based on a G-SIB's reliance on short-term wholesale funding (STWF).

The FRB estimates that this second methodology would result in a significantly higher capital surcharge, i.e., between 1% and 4.5%, compared with the first method under which G-SIBs are assigned surcharges of between 1% and 2.5%. Moreover, this surcharge would be combined and phased-in between 2016 and 2019 with the previously finalized capital conservation buffer (requiring another 2.5% CET1 when fully phased-in) and countercyclical capital buffer (requiring another up to 2.5% CET1 when fully phased-in),[1] creating a costly cumulative hurdle for US G-SIBs that could impact bank lending and economic growth.

The cumulative effect could mean that by January 2019, some US G-SIBs will be subject to a CET1 requirement of up to 14% (nearly three times today's required minimum), composed of the current minimum CET1 (4.5%), the proposed G-SIB surcharge (up to 4.5%), and the capital conservation and countercyclical buffers (together up to 5.0%). Please see the **Appendix** for a graphic depiction of these capital requirements.

The FRB's G-SIB buffer proposal is only the latest example of heightened regulatory expectations on US G-SIBs, related to capital, liquidity, or risk management requirements. The total impact of these requirements has not yet been publically addressed by the FRB, nor is it fully ascertainable by market participants given a number of upcoming US regulatory initiatives in 2015. These include the final single counterparty credit limits rule (which we expect early in 2015),[2] implementation of BCBS's

[1] See PwC's *Regulatory Brief, Basel III capital rules finalized by Federal Reserve* (July 2013).

[2] See PwC's *A closer look, SIFI standards: Single counterparty exposure limits* (April 2012).

recently finalized net stable funding ratio (NSFR),[3] and implementation of the Financial Stability Board's (FSB) Total Loss Absorbency Capacity (TLAC).[4]

This **Regulatory Brief** analyzes the FRB's G-SIB surcharge proposal, and assesses its impact in the context of other upcoming capital requirements.

Analysis of the G-SIB surcharge

Given that most US G-SIBs already meet the G-SIB surcharge proposal's heightened capital requirement as fully phased-in under both methodologies (based on the FRB's analysis), the surcharge is in reality an extra cost of doing business, rather than a measure critical to ending the Too-Big-To-Fail (TBTF) debate as it was once conceived.

However, the FRB has indicated that it may, by separate additional rulemaking, add all or a portion of the G-SIB surcharge to post-stress capital ratios under the severely adverse scenario of the FRB's Comprehensive Capital Analysis and Review (CCAR). As a consequence, the penalty on size would be very high and could impact capital distributions to shareholders and other discretionary payments (e.g., executive incentive compensation).

In our view, the FRB will likely choose to add at least a portion of the G-SIB surcharge to CCAR post-stress capital minimums before its full implementation in 2019, as a response to TBTF criticism. If the FRB ever chooses to add the full surcharge, the impact will be very significant since most G-SIBs did not meet their post-stress CCAR minimum 4.5% CET1 ratios by a wide enough margin in this year's released CCAR results[5] to accommodate an additional 1 - 4.5% requirement.

The only G-SIBs that would not be seriously impacted by this development are those that provide custody services; their stressed ratios far exceed the other G-SIBs' (at well over 10%). Custody banks are in fact limitedly impacted by the surcharge proposal's second methodology. Although replacement of the substitutability category with reliance on STWF greatly impacts G-SIBs that rely on investment banking activities, it potentially allows custody G-SIBs to avoid an increased surcharge (had the second methodology replaced any other factor besides substitutability, custody G-SIBs would have likely faced a higher capital surcharge like most other G-SIBs because of their relatively high score in the substitutability category).

[3] See PwC's *First take: Basel's final NSFR* (November 2014).

[4] See PwC's *First take: TLAC* (November 2014).

[5] See PwC's *A closer look, Stress testing: A look into the Fed's black box* (April 2014).

The following three additional points are also important for analyzing the G-SIB surcharge proposal:

Trade-off between methods of calculating STWF

The proposal sets out an alternative to the second calculation methodology for quantifying reliance on STWF. This alternative allows the size of the capital surcharge to be based on the first methodology multiplied by the ratio of the amount of a G-SIB's STWF compared to its RWA.

This alternative methodology presents a trade-off between simplicity and precision. On one hand, it is easier to calculate and allows G-SIBs more room to influence results by altering the ratio's denominator (i.e., RWA), in addition to its numerator (i.e., amount of STWF). On the other hand, the primary method provides a more accurate measure of the bank's systemic risk, and is more consistent with other regulatory requirements, particularly the liquidity coverage ratio,[6] by not penalizing smaller RWA balances.[7]

A transparent measure?

Despite the continuing push for more regulatory transparency, the proposal's second methodology takes a step backwards. Under the first methodology, a G-SIB's systemic risk score is calculated using publically available data. In contrast, the second methodology reduces transparency by introducing reliance on STWF, which would be measured based on data that is not publically available. Therefore, unlike the BCBS framework, the FRB's calculation results may not be replicated or accurately predicted.

Symbolic change to the G-SIB definition

The proposal changes the commonly used definition of US G-SIBs (which has been those BHCs with $700 billion in total consolidated assets, or more than $10 trillion in assets under custody) with one based on the systemic risk score calculated under the proposed methodologies. A BHC with $50 billion or more in total consolidated assets that has a systemic risk score of 130 or more (based on the five factors of either methodology) would be considered a G-SIB. The proposal also changes the definition of G-SIB under the recently finalized

[6] See PwC's *First take: Liquidity coverage ratio* (September 2014).

[7] Under the alternative methodology, a smaller RWA balance would result in an increase in the ratio of STWF to RWA (all else equal), which may potentially increase a G-SIB's capital surcharge. This result is counterintuitive, as a smaller RWA balance generally indicates lower risk and more liquid assets, which, all else equal, would result in lower rather than higher systemic risk.

enhanced supplementary leverage ratio[8] to make it consistent with the proposal's definition.

While these changes at first glance reflect a shift in determining systemic risk from a purely size-based approach to a more holistic approach, in practice the ranks of US G-SIBs remain unchanged under the new definition. Furthermore, given the significant gap in systemic risk score between US G-SIBs and the highest ranking US non-G-SIB, it is highly unlikely that today's list of US G-SIBs will see any changes any time soon.

The G-SIB surcharge in context

Underlying the rising capital bar for G-SIBs is the regulators' view that even if these banks decrease lending under the weight of capital requirements, other banks (i.e., non-G-SIBs) will act as substitute providers of credit. However, the significant role of G-SIBs in providing credit suggests that this view is debatable.

Our analysis of the lending activities of the 18 firms originally subject to CCAR stress testing indicates that approximately 70% of these firms' lending was provided by the eight US G-SIBs as of September 2014. Furthermore, G-SIBs accounted for a similar proportion of the approximately 4% loan growth reported since September 2012.

The more likely outcome is that increased capital requirements for G-SIBs will impact lending, especially when the G-SIB surcharge is considered in combination with other yet-to-be fully understood capital requirements. Although the capital conservation buffer has long been expected to begin taking effect in 2016, it is not yet known under what exact circumstances the FRB would enact the countercylical buffer or how the FRB will implement the FSB's TLAC initiative.

Countercylical buffer

In a speech this month, FRB Governor Lael Brainard outlined potential approaches to implementation of the countercyclical buffer for US banks beyond those laid out in the US's 2013 final capital rule implementing Basel III. Under that rule, the FRB is allowed to require Advanced Approaches banks (i.e., those with over $250 billion in assets) to hold up to 2.5% more CET1 during periods of heightened systemic risk (phased-in from a maximum of 0.65% in 2016 to a maximum of 2.5% in 2019).

[8] See PwC's *First take: Supplementary leverage ratio* (April 2014).

Governor Brainard's speech reiterated the rule's condition that the countercyclical buffer be implemented during periods of excessive credit growth and increased market risk, and be "deactivated" once the excessive risk passes. She also reiterated that banks would have one year to comply once the FRB makes such a determination.

She provided some new perspective regarding how such periods of increased systemic risk would be identified, by suggesting that the FRB would consider indicators including debt growth, leverage, and other signs of growing financial imbalance to determine when to implement the buffer. Moreover, the fact she spoke of the countercyclical buffer at all, which no Governor has done since the capital rule was finalized, suggests that this buffer is more than words on a page – it may in fact be enacted during times of excessive market exuberance.

TLAC

The larger capital pain point for G-SIBs is the FSB's TLAC proposal that we believe will be implemented as a proposed rule by US regulators in 2015. As opposed to capital requirements that are meant to prevent a bank from failing, TLAC is more focused on ensuring that in the event of failure critical functions can continue, without requiring taxpayer support or threatening financial stability.

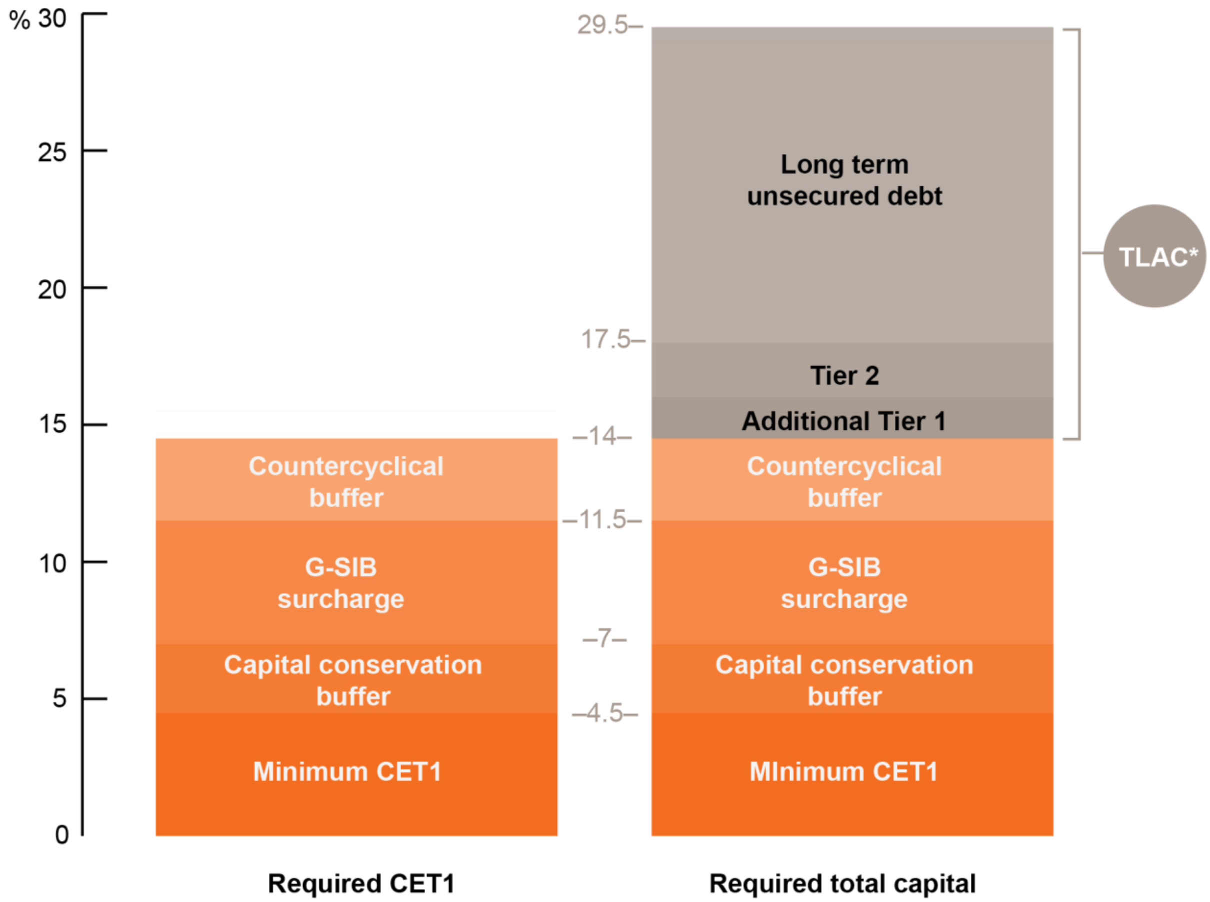
The FSB's TLAC proposal essentially adds a requirement, on top of the current minimum CET1 of 4.5%, that an additional 11.5% to 15.5% of capital be held in the form of Tier 1 and Tier 2 capital and, more importantly, in the form of long term unsecured debt (as a percentage of RWA). Banks are already required to hold a minimum 3.5% of RWA in the form of Tier 1 and Tier 2 capital on top of CET1, so the remaining 8% to 12% will be a new mandate which will largely be met by holding debt (because of debt's generally cheaper cost and because the TLAC proposal requires that at least 33% of TLAC be composed of long term unsecured debt). Notably, minimum CET1 is considered to be a part of TLAC, but additional CET1 cannot count towards TLAC (additional CET1 must instead be counted toward the G-SIB surcharge and capital buffers).

Although US G-SIBs' TLAC shortfall is manageable at the expected low range of the upcoming requirement, the high end of the range will impose significantly greater cost, and will require changes in balance sheet management for firms that use relatively lower levels of long term unsecured debt as part of their strategy. These G-SIBs may need to consider significant changes to their funding models if US regulators ultimately choose to implement TLAC at the high end of the range.

Please see the **Appendix** for a graphic depiction of the interplay of TLAC with CET1 capital requirements.

Appendix

G-SIB capital requirements as of 2019
(top of regulators' proposed ranges)



* The depicted TLAC is the amount required on top of CET1.

Additional information

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