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Expert Analysis

'Capital' Update: Surcharge Proposed On Banks Posing Greatest Risk

By
Kathleen A. Scott

International banking executives are in the process of estimating how much additional capital their banks will have to maintain as a result of the initiatives adopted by the Basel Committee of the Bank for International Settlements to strengthen the stability of the international financial system and which are meant to be enacted in individual countries over the next few years. My January column discussed the December 2010 Basel Committee's new rules on capital and liquidity for banks and bank holding companies that could result in banks, large and small, generally having to maintain additional capital.[1]

Now, the Basel Committee is taking on the largest of the world's banks, those that potentially pose the most risk to the global financial system, some of which are often referred to as "too big to fail." This month's column discusses the Basel Committee's recent proposal regarding these banks aimed at "creat[ing] strong incentives for them to reduce their systemic importance over time."[2]

In addition, other countries, not waiting for the stricter Basel capital requirements to become effective, have enacted their own legislation touching on the same themes. The Dodd-Frank Wall Street Reform and Consumer Protection Act, the major regulatory reform legislation that was signed in July 2010, provides for enhanced regulatory supervision over "systemically important financial institutions" or SIFIs as they have come to be called.[3] Bank holding companies with $50 billion or more in assets and non-U.S. banks with more than $50 billion in global assets are automatically considered to be SIFIs.

A U.S. or non-U.S. nonbank financial company, also may be designated as a SIFI by the U.S. Financial Stability Council established by Dodd-Frank if it determines that "material financial distress" or "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of the nonbank financial company "could pose a threat to the financial stability of the United States."[4] This enhanced regulatory supervision of SIFIs can require the imposition of prudential requirements such as higher capital requirements for SIFIs. In addition, another provision of Dodd-Frank, the "Collins Amendment," requires the U.S. banking agencies to promulgate certain minimum risk-based capital requirements.[5]

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As noted in the January column, the Basel Committee's new rules require changes in the calculation of Tier 1 and Tier 2 capital and institute a leverage ratio for banks on a global basis (U.S. banks had been subject to such a requirement for years). Under the new rules, Total Tier 1 capital must be at least 6 percent of risk-weighted assets at all times. Total capital must be at least 8 percent of risk-weighted assets.

New Capital 'Surcharge'

On June 25, 2011, the oversight body of the Basel Committee (the Group of Governors and Heads of Supervision), agreed on a consultative document to be issued for public review and comment regarding "global systemically important banks" or G-SIBs, similar to SIFIs that are banks.[6] At the November 2010 G-20 summit in Seoul, the G20 Leaders had endorsed the concept of systemically important banks being required to maintain additional capital in order to address the greater risk these institutions pose to the international financial system.[7]

The consultative document will include both proposed standards for determining when a bank will be considered a G-SIB and additional capital requirements for G-SIBs.

The criteria for determining what would be considered a G-SIB will be based on five broad criteria—size, interconnectedness, lack of sustainability, global (cross-jurisdictional) activity and complexity. These criteria are similar to several of the criteria to be considered by the U.S. Financial Stability Oversight Council in imposing stricter prudential safeguards on SIFIs.[8]

The proposed capital surcharge, termed a "loss absorbency requirement," would be applied to Common Equity Tier 1 capital and would range from a minimum of 1 percent to a maximum of 2.5 percent, depending upon the bank's global systemic importance. In addition, in order to provide an even stronger disincentive to becoming more systemically risky, an additional 1 percent over and above the basic surcharge could be imposed in order to discourage a G-SIB already subject to the basic surcharge to materially increase its global risk. These requirements would be phased in at the same time as the other new capital requirements discussed in the January column: between Jan. 1, 2016, and Dec. 31, 2018, and becoming fully effective on Jan. 1, 2019.

What Is Tier 1 Capital?

As noted in previous columns, the new capital requirements adopted by the Basel Committee change the calculation of Tier 1 capital, including Common Equity Tier 1 capital, which is where the surcharge is to be placed on G-SIBs. Tier 1 capital should primarily be common

KATHLEEN A. SCOTT *is counsel in the financial institutions practice group at Arnold & Porter LLP.*

shares and retained earnings, both elements of Common Equity Tier 1 capital. In addition, Common Equity Tier 1 capital also includes stock surplus resulting from the issuance of instruments included as Common Equity Tier 1, accumulated other comprehensive income and other disclosed reserves, common shares issued by consolidated subsidiaries and held by third parties that meet the criteria for inclusion in Common Equity Tier 1, and certain regulatory adjustments.

Reason to Comment

These proposed rules could affect banks' financial condition significantly, so banks should plan to carefully review the text of the proposal once it is issued. The consultative document has been submitted to the Financial Stability Board (FSB), which is coordinating an overall set of measures to reduce the "moral hazard" that could be posed by global systemically important financial institutions. More detail on these measures is expected to be issued by the end of this month.

The FSB monitors the implementation of internationally agreed policies to enhance financial stability and brings together national authorities responsible for financial stability in significant international financial centers. Interested readers may want to review the FSB's April 2011 report regarding the progress in implementing the various financial stability recommendations that have been proposed by the G20 Finance Ministers and Central Bank Governors.[9]

Areas for Comment to Consider. Even without having the text of the proposal available at this time, bank executives can begin to consider some of the practical effects of additional capital requirements over and above what was adopted in December 2010, such as:

- Assessing the financial impact generally of a surcharge on Common Equity Tier 1 of 1 percent, 2.5 percent or 3.5 percent, and for the world's largest banks often referred to as "too big to fail," what would be required to meet a 3.5 percent capital surcharge;
- Analyzing whether the surcharge should be placed solely on the bank's Common Equity Tier 1 and if not, what is the recommended alternative;
- Commenting on whether the proposed criteria for determining what is a G-SIB are so broad as to include a bank usually not perceived by the market as a systemic risk;
- Commenting on whether the stated aim of the surcharge, to act as a disincentive for banks to grow too large, will be adequately addressed by the proposal;
- Opining whether, regardless of how high the capital surcharge is set, there will continue to be a presumption that certain globally active banks always will be considered "too big to fail."

Governor Weighs In

Earlier in June and prior to the issuance of the statement by the Basel Committee governing body, Daniel Tarullo, a member of the Board of Governors of the Federal Reserve System in a speech and testimony before a U.S. congressional committee spoke about the need for enhanced capital and liquidity requirements for SIFIs.[10] In his recent speech, Mr. Tarullo set out five proposed characteristics of an enhanced capital requirement for SIFIs:

- An enhanced capital requirement should be based upon the impact of a firm's failure on the financial system as a whole, which includes an analysis of not only the size of the institution, but the interconnectedness of the institution to the entire financial system. Such an analysis also could include intra-financial firm assets and liabilities, cross-border activity, and the use of various complex financial instruments.
- Any criteria for determining an additional capital requirement should be transparent and replicable, and clear to financial firms, markets, and the public.
- The enhanced capital standard should be progressive in nature, becoming more stringent the more systemically important the financial company.
- The enhanced capital requirement must be satisfied by using "high quality" capital, primarily common equity, and the use of hybrid capital instruments such as contingent capital instruments should be discouraged.
- The U.S. enhanced capital requirements should, to the extent possible, track international standards.

At least in the concept des-cribed in the June 25 press release, the reader can see similar ideas included in the Basel Committee's new proposal. According to various press reports, certain U.S. regulators, such as the Board of Governors, had argued for higher surcharges, while certain other European regulators (and the U.S. supervisor of national banks, the Comptroller of the Currency) argued for lower capital requirements and a broader definition of what capital instruments could be used to satisfy the requirements.[11]

Update on Requirements

As additional guidance in parsing through the Basel III requirements issued in December 2010, the Basel Committee has posted on its webpage its answers to frequently asked questions about both the capital and the liquidity requirements.[12]

Conclusion

No matter how much capital could be required of the world's largest banks, a presumption still could persist that there are some banks that always will be considered too big to fail. The Basel Committee's proposal can be seen as one way to deal with the problem—just make it financially unpleasant for a bank to become too big, and as a result, the bank, on its own initiative (as opposed to in response to a regulatory enforcement order), will seek to reduce its "systemic importance over time."

It will be interesting to see if the U.S. Financial Stability Oversight Council and the board adopt some form of that proposed surcharge in the enhanced capital standards for all SIFIs. While the prudential standards for SIFIs are to be formulated on a case-by-case basis, this proposed surcharge could appear to be a good place to start. In any event, banks most likely to be subject to the surcharge, whether 1 percent, 2.5 percent or 3.5 percent, should plan to comment on these proposals and provide a clear idea to the regulators of the practical effect that these requirements could have on their operations.

1. "New International Capital and Liquidity Requirements," New York Law Journal, Jan. 12, 2011.
2. "Measures for global systemically important banks agreed by the Group of Governors and Heads of Supervision," June 25, 2011, which can be accessed at http://www.bis.org/press/p110625.htm.
3. Pub. Law No. 111-203 ("Dodd-Frank"), July 21, 2010.
4. Dodd-Frank, section 113.
5. Dodd-Frank, section 171.
6. See Note 1 supra.
7. "Reducing the moral hazard posed by systemically important financial institutions: FSB Recommendations and Time Lines," Oct. 20, 2010, available on the website of the Financial Stability Board at www.financialstabilityboard.org.
8. For example, see §§113 and 115 of Dodd-Frank.
9. "Progress in the Implementation of the G20 Recommendations For Strengthening Financial Stability," April 10, 2011, which can be accessed at the FSB's website at http://www.financialstabilityboard.org.
10. See "Regulating Systemically Important Financial Firms," Remarks by Daniel K. Tarullo at the Peter G. Peterson Institute for International Economics, June 3, 2010; Statement by Daniel K. Tarullo before the Committee on Financial Services of the U.S. House of Representatives, June 16, 2011. Both documents can be accessed through the board's website at www.federalreserve.gov.
11. See, for example, Eric Dash, "Higher Reserves Proposed for 'Too Big to Fail' Banks," The New York Times, June 26, 2011; Rob Blackwell, "Regulators Give Big Banks a (Little) Break on Capital Surcharge," American Banker, June 25, 2011; Donna Borak, "OCC's Walsh Signals U.S. Split Over SIFI Charge," American Banker, June 21, 2011.
12. See http://www.bis.org/press/p110705.htm.