BANK POLICY INSTITUTE

GSIB Surcharge Issue Summary

The Global Systemically Important Bank (GSIB) surcharge is a capital buffer held by the largest banks, over and above their risk-based capital requirements and other buffers. The amount of additional capital required depends on several factors, including size, risk, complexity and reliance on short-term wholesale funding. The GSIB surcharge is intended to reduce the probability of failure of a U.S. GSIB relative to that of a non-GSIB to offset the relatively greater systemic costs of a GSIB's failure. Because U.S. GSIBs make 45 percent of all bank loans to businesses and households in the Unites States, this surcharge has real economic impact on lending.

BPI's Position

The GSIB surcharge framework has numerous weaknesses that should be addressed. Fundamentally, the methodology used to determine its calculation is not appropriately tied to empirical data, and ignores significant progress made by banks and regulators to reduce the impact of failure on the broader financial system. Together, improvements to the regulatory framework applicable to GSIBs, as well as the increased resilience of these institutions, have already served to reduce the potential impact of a GSIB's failure. These regulatory improvements decrease the probability of a failure and mitigate the impact of a failure were it nevertheless to occur. The current U.S. GSIB framework inhibits economic growth and efficient capital markets and also reduces the global competitiveness of U.S. banks.

Recommendations: 1. The GSIB surcharge should be adjusted to account for the improvements in GSIB resiliency and resolvability, including significant post-crisis policies that have been taken by regulators and banks to reduce systemic risk. 2. The methodology for calculating a firm's GSIB surcharge should be replaced with one that is empirically calibrated against appropriate data and takes into account true measures of systemic risk.

Flawed Methodology

The GSIB surcharge is based upon a deeply flawed methodology that is not tied to any hard, empirical data and ignores significant indicators for a bank's actual systemic risk. The methodology does not estimate the systemic losses that would occur if each GSIB were to fail. Conversely, the losses are assumed to be proportional to selected bank characteristics such as size. A recent Federal Reserve staff paper states that the "G-SIB score framework is best interpreted as a judgment by bank supervisors about which balance sheet measures are correlated with systemic importance." In other words, the reason to include certain characteristics was not subject to rigorous judgement. Also, while the methodology does estimate the relationship between capital levels and the odds of failure, the estimate is based on historical experience, is very sensitive to the number of banks over time, and not representative of today's GSIBs. Any GSIB capital surcharge should be based on methodologies that reflect a bank's actual systemic risk profile. The Fed has suggested expanding both the scope and significance of the surcharge, combining it with the current stress tests, so the need to revisit the U.S. GSIB surcharge methodology is more urgent than ever.

Significant Progress Ignored

The surcharge methodology omits the significant post-crisis steps that have been taken by regulators and banks to reduce the systemic impact of a GSIB default. Specifically, the surcharge ignores the robust new liquidity and capital rules, single point of entry resolution plans, living wills required by the Dodd Frank Act, the Federal Reserve's total loss absorbing capacity (TLAC), and international protocol for derivatives dealers that prevents the type of close-outs seen with Lehman. These changes are significant in considering systemic risk and should not be ignored in calculating the impact of a GSIB default. In fact, arguably, these factors may be more relevant than those considered as materially reducing systemic risk, and yet, none has any impact on the GSIB surcharge calculation. Federal Reserve Vice Chairman for Supervision Randal Quarles has stated that now is "an eminently natural and expected time to step back and assess" what changes should be made to the post-crisis regulatory framework. This is particularly important given that the surcharge goes beyond the international minimum requirements. The substantial over-calculation of systemic risk in the surcharge has real economic consequences and creates powerful incentives for institutions to reduce the activities that drive the score, including reducing an institution's market-making and other activities that support economic growth.