New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 256—NO. 8
WEDNESDAY, JULY 13, 2016

INTERNATIONAL BANKING

Expert Analysis

Measuring Up to International Capital Standards

By
Kathleen A. Scott

The Basel Committee of the Bank for International Settlements (Basel Committee) sets international capital standards but those standards must be adopted by individual countries to have any legal effect. As a result, the standards are only as good as enacted in each individual country. Actions taken after the recent economic crisis to strengthen the global financial system included adoption of an enhanced capital surcharge, called the higher loss absorbency (HLA) requirement, imposed on the banking organizations designated as the world's global systemically important banks (G-SIBs).[1]

A Basel Committee assessment team recently evaluated the HLA requirement in the jurisdictions in which the current G-SIBs are headquartered[2]: United States, China, European Union, Japan and Switzerland.[3] In some cases, these countries have gone beyond the standards to be even more protective of their financial stability. This month's column will discuss how each of these countries, and in particular the United States, measures up to the international standards.

Recap

The Basel Committee's G-SIB standards were published originally in 2011 and updated in 2013. The standards include indicators to determine which banks would be considered G-SIBs. The 12 indicators for determining a G-SIB include total exposures, intra-financial system assets and liabilities, securities outstanding and securities trading and available for sale, and cross-jurisdictional claims and liabilities. Each G-SIB is given a score, and ranking, based on its score of systemic importance. If a G-SIB violates the HLA requirement, consequences include restrictions on paying distributions that escalate in severity as the G-SIB's systemic score increases.

A Basel Committee assessment team recently evaluated the HLA requirement in the jurisdictions in which the current G-SIBs are headquartered.

The capital surcharge can be satisfied only with so-called core capital, common equity. The surcharge increases the higher the systemic importance score, and currently is divided into five bands (buffer bands) ranging from one percent to 3.5 percent of the bank's risk-weighted assets, with the top band currently empty. For G-SIBS with leverage ratio exposure measures exceeding EUR 200 billion, the 12 indicators used in the assessment methodology must be made publicly available.

The recent assessment focused on the extent to which the countries reviewed had implemented the G-SIB HLA requirement and the G-SIB reporting and public disclosure requirements.

What They Have in Common

Each of the countries was assessed overall as compliant, the highest grade possible, while in a few of the countries, one or other subcomponent was assessed as largely compliant. The assessment team discussed each of the deviations from the standards, whether falling short or exceeding them.

United States

Eight of the current G-SIBs are headquartered in the United States, and comprise almost 50 percent of the total exposure of the U.S. banking system. The United States was assessed compliant overall and each of the subcomponents was assessed compliant. The assessment team identified two deviations falling short of the standards and two deviations exceeding the standards.

Under the Basel standards, if a G-SIB violates the HLA requirement, it is required to produce a capital remediation plan to be implemented within a fixed time frame. Under the U.S. regulations, there is no specific requirement to that effect, but U.S. banks with $50 billion in consolidated assets or more (a group that includes all of the

KATHLEEN A. SCOTT *is senior counsel in the New York office of Norton Rose Fulbright.*

US G-SIBs) are required to comply with strict capital requirements, including submission of a capital plan reviewed by the Federal Reserve Board.

A revised plan would have to be submitted if there is a material change, and violation of the HLA requirement is such a material change. So while the Federal Reserve Board regulations do not have a specific capital remediation plan if there is a violation of the HLA requirement, the effect of the U.S. regulations is the same because the regulations otherwise require submission and revisions of a bank's capital plans. As a result, the assessment team did not see this negative deviation from the Basel standards as negative.

Under the Basel standards, the G-SIB HLA requirement was to be phased in starting Jan. 1, 2016. Under the Federal Reserve Board regulations, U.S. G-SIBs having less than $700 billion in total assets or USD $10 trillion under custody have until Dec. 31, 2016, to put the requirement into effect. However, all U.S. G-SIBs were above that criteria and thus were required to comply starting Jan. 1, 2016, and thus the assessment team did not see this negative deviation as material.

With respect to the G-SIB disclosure requirement, the Basel standards require that the G-SIBs publish their own G-SIB indicators in their financial statements, but the U.S. G-SIB regulations do not. However, the Federal Reserve Board publishes the information. The fact that the information is published by the Federal Reserve Board instead of the banks themselves was not deemed to be a material negative deviation.

The assessment team also found that the United States was more conservative than the Basel standards in a few areas. The U.S. reporting threshold for G-SIB reporting and disclosures is USD $50 billion in total consolidated assets which the assessment team found was a lower (and therefore more conservative) threshold than the Basel standards' leverage ratio exposure exceeding EUR 200 billion.

The Federal Reserve Board has two methods of calculating the G-SIB surcharge, one equal to the Basel standards and one that generally results in a higher surcharge; the higher of the two calculations is what G-SIBs must follow; so the Basel standard is the floor. In addition, the disclosure of G-SIB indicators is set at a lower level than the Basel standard (USD $50 billion v. EUR 200 billion). Moreover, starting with the second quarter of 2016, these banks began reporting quarterly rather than annually per the Basel standards.

The other countries also passed the test; some of the more substantive deviations are discussed below.

China

Four of the current G-SIBs are headquartered in China and account for about 45 percent of the total exposure of the Chinese banking system. China was assessed compliant overall, with one subcomponent assessed as largely compliant and the other subcomponent assessed as compliant.

The assessment team noted a potential material deviation in that the Chinese incorporation of the G-SIB standard lacked specific language regarding available supervisory measures should the HLA requirement be breached, in particular the restrictions on a G-SIB's payment of distributions, despite the China Banking Regulatory Commission (CBRC) having the authority to impose supervisory measures such as restricting distributions should the HLA requirement be breached.

There were areas where the Chinese requirements were found to be stricter than the Basel standards. The G-SIB minimum 1 percent HLA requirement was phased in three years earlier than the Basel standards required. Chinese banks also set up one HLA requirement (instead of five buffer bands) and the CBRC can take pre-emptive measures including prohibition on distributions if a G-SIB breaches the requirement, rather than incorporating the Basel standards under which the distribution restrictions correspond to the five buffer bands. The Chinese regulations also do not allow a 12-month grace period for a G-SIB migrating to a higher buffer band, as permitted by the Basel standards.

Switzerland

Two of the current G-SIBs are headquartered in Switzerland and account for about 45 percent of the total exposure of the Swiss banking system. Switzerland was assessed compliant overall, with one subcomponent assessed as largely compliant and the other subcomponent assessed as compliant.

Under the Basel standards, the HLA requirement increases by buffer band the higher the G-SIB's systemic score, maxing out at 3.5 percent of risk-weighted assets. Swiss G-SIBs are subjected to a minimum common equity capital requirement of 10 percent. However, would one of the Swiss G-SIBs be classified in buffer band 5 (currently there are none), it would not be compliant with the total minimum 10.5 percent common equity capital required under the Basel framework. However, the Swiss Financial Market Supervisory Authority (FNMA) can require an increase in a G-SIB's capital if necessary, and the assessment team did not see this negative deviation as material.

As noted above, should a G-SIB violate the HLA requirement, the Basel standards require restrictions on distributions by the G-SIB, and the G-SIB must take steps to return to compliance within a time frame set by its regulator. There is no Swiss regulation mandating restrictions on dividend payouts in that situation, but FNMA informed the assessment team that it would take the necessary steps to ensure that the G-SIB would come into compliance, including a prohibition on paying dividends.

In addition, FNMA meets with its G-SIBs at least quarterly on their capital plans and plans that do not provide for maintenance of the minimum 10 percent common equity floor are not accepted and actions would be taken to avoid the G-SIB falling below that threshold. Nonetheless, the assessment team found that this negative deviation could be considered material because even though Swiss G-SIBs would have to suffer large capital losses before there was a practical difference between the Swiss regulations and the Basel standards, there are no explicit restrictions on G-SIB distributions under the Swiss regulations.

The assessment team did note that Swiss G-SIB regulations are more conservative than the Basel standards because Swiss G-SIBs must hold common equity capital of at least 10 percent, a requirement which under the Basel standards is reached only in (currently) empty band 5, and FNMA has a broad variety of measures available to make sure that the G-SIBs maintain or restore these capital levels to at least 10 percent.

Japan

Three G-SIBs are headquartered in Japan, and account for about 44 percent of the total exposure of the Japanese banking system. Japan was assessed as compliant overall, as was each subcomponent.

The Japanese regulations do not explicitly state that the HLA requirements are to be compliant with the Basel standards, nor do they specifically incorporate the five buffer band approach, but regulations require that the Financial Services Agency (FSA) take the Basel standards into account and Japanese Supervisory Guidance indicates that the FSA would follow the Basel standard in designating G-SIBs and imposing the HLA surcharge. This was deemed a nonmaterial negative deviation from the Basel standards.

The FSA regulations also do not incorporate all the specific consequences of a violation of the HLA requirement included in the Basel standards, such as a requirement that any restrictions on distributions must stay in place until the G-SIB returns to compliance, or allowing a 12-month transition period for a G-SIB moving to a higher buffer band. However, the FSA told the assessment team in case of a violation of the HLA requirement, the FSA would impose a specific remediation plan with a timeline on a case-by-case basis. The assessment team did not see this negative deviation as material because the same effect as the Basel standards would be met from supervisory guidance rather than explicitly in the regulations.

> The United States was assessed compliant overall and each of the subcomponents was assessed compliant. The assessment team identified two deviations falling short of the standards and two deviations exceeding the standards.

European Union

Thirteen current G-SIBs are headquartered in the current European Union (EU) member states and account for about 50 percent of the total assets across the EU. The EU G-SIB framework was assessed compliant overall, as was each of the subcomponents. EU legislation implementing the standards must be complied with by the Member States, and Member States were required to enact conforming legislation.

A few deviations were observed. As noted above, the Basel standards provide for five buffer bands, with the fifth band, currently empty, and for the ability to add additional bands and higher SLA requirements if necessary. The EU standards include the equivalent of the five buffer bands but does not provide for an expansion of the bands nor an equivalent increase in the HLA surcharge. The assessment team noted this deviation but found that it was not material because an additional band buffer was not likely in the short to medium term.

While the Basel standards require that a G-SIB be restricted in distributions if it violates the HLA requirement, the EU regulations imply that in that situation, some distributions could be made from the current year's profits so long as it does not reduce retained earnings or common equity capital. Nevertheless, the assessment team still viewed the EU as compliant given that the totality of EU distribution restrictions make it consistent with the Basel standards.

Conclusion

Once the extent of the economic crisis beginning in 2007 became apparent, international banking regulators knew that they needed to take firm action to address the systemic risk of the global financial system. This led to a strengthening of the basic capital standards and the establishment of the G-SIB system and additional G-SIB capital surcharges. The countries with the current G-SIBs have adopted the Basel standards, with some nonmaterial deviations and in some cases more stringent requirements. All countries have seen the chaos on a country's financial system when a major economic crisis hits, and taking preemptive action now could help mitigate the adverse effects of a possible future economic crisis.

1. See http://www.bis.org/publ/bcbs255.pdf.
2. The Financial Stability Board issued its latest G-SIB list in November 2015. www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-banks-G-SIBs.pdf.
3. All of the assessments may be found at www.fsb.org.