

I. The Impact of the Federal Reserve's New Risk-Based Capital Surcharges

A. Introduction

On July 20, 2015 the Board of Governors of the Federal Reserve System (Fed) approved a final rule (Final Rule) imposing risk-based capital surcharges on “the largest, most systemically important U.S. bank holding companies.”¹ The Final Rule was adopted pursuant to the requirements of Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).² In response to the 2008 financial crisis, Congress passed Dodd-Frank, which requires, among other things, the establishment of improved “prudential standards” for certain bank holding companies, including standards regarding risk-based capital requirements applicable to bank holding companies and other financial institutions that pose significant risks to global financial stability.³ Institutions that are determined to be global systemically important banks (GSIB) will be subject to risk-based capital surcharges, likely to “range from 1.0 to 4.5 percent.”⁴ The Final Rule is intended to mitigate the potential risk that financial distress or failure of a GSIB could pose to the financial system.⁵ By increasing the stringency of capital standards for GSIBs, the Fed hopes to

¹ Press Release, Fed. Reserve, Federal Reserve Board Approves Final Rule Requiring the Largest, Most Systematically Important U.S. Bank Holding Companies to Further Strengthen Their Capital Positions (July 20, 2015), *available at* <http://www.federalreserve.gov/newsevents/press/bcreg/20150720a.htm> [<http://perma.cc/J7BD-P9B2>].

² See Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, 12 C.F.R. § 217 (2014).

³ *Id.* (“Section 165 of . . . Dodd-Frank . . . directs the Board to establish enhanced prudential standards for bank holding companies with \$50 billion or more in total consolidated assets and for nonbank financial companies that the Financial Stability Oversight Council . . . has designated for supervision by the [Fed] These standards must include risk-based capital requirements [and] . . . [t]hey must be more stringent than the standards applicable to other . . . financial companies that do not present similar risks to U.S. financial stability.”).

⁴ Press Release, Fed. Reserve, *supra* note 1.

⁵ See *id.*

increase the financial stability of large, interconnected financial institutions, thereby further safeguarding the global economy against another financial crisis.⁶

This article examines the Final Rule and its potential implications for GSIBs and the global economy. Part B provides a description of the Final Rule and its function. Part C assesses the Final Rule's relevance and potential implications, including criticism and support from banking industry insiders.

B. Overview of the Final Rule

The Fed is requiring higher bank capital levels because banks are better suited to withstand losses—such as decreases in asset value—when they have sufficient capital on hand.⁷ Risk-based capital “is a method of measuring the minimum amount of capital appropriate for a reporting entity to support its overall business operations in consideration of its size and risk profile.”⁸ In December 2014, the Fed made available for public comment a proposed version of the Final Rule.⁹ The Final Rule differs significantly from the proposed rule in the identification of bank holding companies that qualify as GSIBs.¹⁰ The proposed rule would have labeled all bank holding companies with “total consolidated assets of \$50 billion or

⁶ *See id.*

⁷ See William Alden, *What Is Bank Capital, Anyway?*, N.Y. TIMES DEALBOOK (July 10, 2013, 3:52 PM), http://dealbook.nytimes.com/2013/07/10/what-is-bank-capital-anyway/?_r=0 [<http://perma.cc/28YQ-8VNE>].

⁸ *Risk-Based Capital*, NAT'L ASS'N OF INS. COMM'RS, http://www.naic.org/cipr_topics/topic_risk_based_capital.htm [<http://perma.cc/LN4R-KG9D>].

⁹ 12 C.F.R. § 217.

¹⁰ See *Federal Reserve Board Approves Final Common Equity Surcharge For U.S. Global Systemically Important Banks*, SULLIVAN & CROMWELL LLP 3 (July 29, 2015), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_7_29_2015.pdf [<http://perma.cc/8MPG-RBSG>] [hereinafter *Federal Reserve Board Approves Final Surcharge Rule*] (“Like the Basel G-SIB Framework and the Proposed Rule, the Final Surcharge Rule establishes an indicator-based approach for determining which BHCs are U.S. G-SIBs and the amount of the risk-based capital surcharge that will be applied to each G-SIB.”).

more” as GSIBs; the Final Rule limits the designation to those institutions “with \$250 billion or more in consolidated total assets or \$10 billion or more in consolidated total on-balance sheet foreign exposures.”¹¹

Institutions that garner the GSIB designation are the only firms subject to the surcharge required by the Final Rule, which partially implements the Basel Committee on Banking Supervision’s framework (Basel Framework)¹² “for assessing a common equity surcharge on [GSIBs].”¹³ The Final Rule requires a GSIB to perform its own calculation of the surcharge via two provided methods, with the greater rate being applicable.¹⁴ The first method, adopted from the Basel Framework, is based on an “aggregation of a [GSIB’s] ‘systemic indicator scores’ reflecting size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity relative to the other 75 largest U.S. and foreign banking organizations identified by the Basel Committee.”¹⁵ The second method, another divergence from the initial proposed rule, drops the substitutability indicator (an evaluation of a GSIB’s “dominance in certain customer services”)¹⁶ from the first method, replacing it with a measurement of a GSIB’s

¹¹ *Id.* at 5.

¹² The Basel Committee on Banking Supervision (BCBS) is a committee comprised of global banking authorities that releases standards and guidelines aimed at strengthening the financial stability of the banking sector. The Basel Committee Framework is a series of reforms designed by the Basel Committee to “determin[e] a bank’s relative global systemic performance” and impose capital surcharges on GSIBs in order to help mitigate the “negative externalities created by systemically important banks which current regulatory policies do not address.” *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement*, BASEL COMM. ON BANKING SUPERVISION (2011), available at <http://www.bis.org/publ/bcbs201.pdf> [<http://perma.cc/AKB7-6LPY>].

¹³ *Federal Reserve Board Approves Final Surcharge Rule*, *supra* note 10, at 1.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Meraj Allahrakha, Paul Glasserman, & H. Peyton Young, *Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data*, OFFICE OF FIN. RESEARCH (2015), available at <http://financialresearch.gov/briefs/files/2015-02-12-systemic-importance-indicators-for-us-bank-holding-companies.pdf> [<http://perma.cc/W6RA-22CM>].

“reliance on short-term wholesale funding,”¹⁷ and is intended to produce a surcharge greater than that of the first method.¹⁸ The Fed’s intention for the second method to provide the higher, and thus applicable, rate stems from its desire to strengthen capital requirements as much as possible.¹⁹ The second method also notably replaces the first method’s systemic indicator scores relative to other large banks with “fixed measures of systemic importance.”²⁰ Although GSIBs are likely disappointed with the Fed’s imposition of further regulations, industry participants have noted that the Final Rule’s second method is preferable to the first method—and the proposed rule’s second method—because the second method’s surcharge is not dependent on a measure of each bank’s systemic importance relative to other global banks.²¹ This should provide more predictability with regard to an individual firm’s surcharge.²² Had GSIBs been left only with the first surcharge calculation method, a firm’s surcharge would partially depend on the actions of other GSIBs.²³ Thus, a GSIB “seeking to reduce its surcharge by shrinking could be stymied if other [GSIBs] took the same tack.”²⁴

C. Relevance and Implications

It is unclear at this time what the ultimate effect will be of the Final Rule on current institutions identified as GSIBs, as the Final Rule does not begin to phase in until “January 1, 2016,

¹⁷ See Phalguni Soni, *What Are the Risks Associated with Short-Term Wholesale Funding?*, MKT. REALIST (Sept. 15, 2014, 4:27 PM), <http://marketrealist.com/2014/09/risks-associated-short-term-wholesale-funding/> [<http://perma.cc/T6YW-4R4W>].

¹⁸ *Federal Reserve Board Approves Final Surcharge Rule*, *supra* note 10, at 5.

¹⁹ See *id.* at 1-2 (“[A] further example of the Federal Reserve implementing more stringent, or ‘super equivalent,’ requirements than under certain internationally-agreed BCBS frameworks.”)

²⁰ *Id.* at 2.

²¹ John Carney, *Big Banks’ Stress Level is Rising*, WALL ST. J. (July 20, 2015, 5:31 PM), <http://www.wsj.com/articles/big-banks-stress-level-is-rising-1437426262> [<http://perma.cc/8LNN-99F8>].

²² *Id.*

²³ *Id.*

²⁴ *Id.*

becoming fully effective on January 1, 2019.”²⁵ Currently eight financial institutions—seven bank holding companies and one nonbank—have been identified as GSIBs subject to the Final Rule.²⁶ The seven bank holding company GSIBs and their current “estimated surcharges are: JP Morgan Chase, 4.5%; Citigroup, 3.5%; Goldman Sachs, 3%; Morgan Stanley, 3%; Wells Fargo, 2%; State Street Corp., 1.5%; and the Bank of New York Mellon Corp., 1%.”²⁷ The percentages will likely fluctuate during the Final Rule’s phase-in.²⁸ The nonbank institution identified as a GSIB is General Electric Capital Corp., which in response to the Final Rule has announced that it will reduce its capital by selling parts of its portfolio deemed high-risk in order to shed its label as a systemically important firm.²⁹ As a result of the banking industry’s efforts to increase capital in the wake of the 2008 financial crisis, at the time of the Final Rule’s adoption, all but one of the eight identified GSIBs was already in compliance with the capital requirement.³⁰ The lone firm to fall short of the capital requirement was JP Morgan Chase with a deficit of \$12.5 billion.³¹ As incentive to comply with the Final Rule, GSIBs that fail to meet the “surcharge requirements will face restrictions on dividends and certain executive compensation payments.”³²

i. Support for the Final Rule

²⁵ Press Release, Fed. Reserve, *supra* note 1.

²⁶ Paul Davidson, *Fed Approves Surcharges on Biggest Banks*, USA TODAY (July 20, 2015, 5:18 PM), <http://www.usatoday.com/story/money/2015/07/20/fed-capital-surcharges/30413471/> [<http://perma.cc/B2J3-QJJM>].

²⁷ *Id.*

²⁸ Denny Gulino, *Fed Imposing Expected Capital Surcharges on Largest Banks*, MNI (July 20, 2015, 1:27 PM), <https://www.marketnews.com/content/fed-imposing-expected-capital-surcharges-largest-banks> [<http://perma.cc/AG2Z-BUBK>].

²⁹ *Id.*

³⁰ John Heltman, *Fed Finalizes Contentious Capital Surcharge, Nonbank Rules*, AM. BANKER (July 20, 2015), <http://www.americanbanker.com/news/law-regulation/fed-finalizes-contentious-capital-surcharge-nonbank-rules-1075480-1.html> [<http://perma.cc/Y2W9-DJ2C>].

³¹ Gulino, *supra* note 28.

³² *Federal Reserve Board Approves Final Surcharge Rule*, *supra* note 10, at 1.

Janet Yellen, Chair of the Fed, believes the Final Rule to be a positive step toward further reducing the potential risk that a GSIB's failure poses to U.S. and global financial markets, stating, "In practice, this final rule will confront [GSIBs] with a choice: they must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system."³³ Yellen and the Fed believe that financial stability of the firm and the system will be enhanced regardless of the choice the GSIBs make.³⁴

The Systemic Risk Council (SRC), a "private sector, non-partisan body of former government officials and financial and legal experts,"³⁵ responded to the Fed's unanimous approval of the Final Rule with cautioned support. Sheila Blair, chair of the SRC, stated that while the SRC has "serious concerns about the complexity of" the rules and their reliance on the GSIBs' internal models, the SRC "applaud[s] the Governors [of the Fed] for imposing a surcharge up to 4.5 percent higher than the current 7 percent requirement and congratulate[s] the Federal Reserve for holding firm against industry efforts to significantly weaken its original, proposed rule."³⁶

Camden R. Fine, President and CEO of Independent Community Bankers of America (ICBA), released a statement the day of the Final Rule's approval indicating support for the Fed.³⁷

³³ Janet L. Yellen, Chair, Fed. Reserve, Opening Statement on Federal Reserve's Risk-Based Capital Surcharge Final Rule (July 20, 2015), available at <http://www.federalreserve.gov/newsevents/press/bcreg/yellen-statement-20150720a1.htm> [<http://perma.cc/7J8Y-D7V7>].

³⁴ Davidson, *supra* note 26.

³⁵ SYSTEMIC RISK COUNCIL, <http://www.systemicriskcouncil.org/> [<http://perma.cc/GC5M-FECF>].

³⁶ *Systemic Risk Council Congratulates Federal Reserve Board on Finalizing the G-SIB Capital Surcharge*, SYSTEMIC RISK COUNCIL (July 20, 2015), <http://www.systemicriskcouncil.org/2015/07/systemic-risk-council-congratulates-federal-reserve-board-on-finalizing-the-g-sib-capital-surcharge/> [<http://perma.cc/KQE9-V4H5>].

³⁷ Press Release, Camden R. Fine, President & CEO, Indep. Cmty. Bankers of Am., ICBA Supports Fed Rule Requiring Stronger Capital Levels at Megabanks (July 20, 2015), available at <http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=377934> [<http://perma.cc/DSM8-LD9V>] ("ICBA supports the Federal Reserve Board's final rule requiring stronger capital reserves for the nation's largest and riskiest financial institutions.").

Fine stated, “Today’s final rule will prevent the megabanks—which in recent years caused the worst financial crisis since the Great Depression—from distributing capital when it is most urgently needed.”³⁸ He went on to claim that the Final Rule will help discourage GSIBs “from becoming even larger and more interconnected,” thereby increasing the stability of our financial system.³⁹

ii. Criticism of the Final Rule

The Final Rule has been met with criticism from the banking industry, specifically from The Clearing House, which represents many of the GSIBs subject to the surcharges.⁴⁰ The Clearing House’s CEO, Jim Aramanda, stated that there will be “meaningful and negative consequences” while expressing his disappointment with the Fed’s adoption of the Final Rule.⁴¹ Aramanda, intimating that the issue the Final Rule is intended to resolve no longer exists, said that the Fed failed to acknowledge the “dramatic reduction in systemic risk that has come from enhanced liquidity, increased use of clearing, stricter margining, resolution and recovery rules, and other post-crisis changes.”⁴² Aramanda believes previously imposed regulations have sufficiently reduced the potential systemic impact, and likelihood, of a GSIB’s failure.⁴³

Karen Shaw Petrou, “managing principal of Federal Financial Analytics,” went a step further than Aramanda by suggesting the Fed essentially intends to dismantle GSIBs and encourage other systemically important financial institutions to downsize.⁴⁴ Petrou stated that the Fed “clearly intends the very largest U.S. banks to buckle under this new capital regime, restructuring quickly and dramatically.”⁴⁵ Jason Goldberg, an analyst

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ See Heltman, *supra* note 30 (“The Clearing House, a trade group that represents many of the largest banks subject to the G-SIB surcharge, said it was disappointed with the Fed’s passage of the final rule, though it appreciated some of the changes that made the methodology more transparent.”).

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

at Barclays Plc, ominously noted that “Historically, when these rules get proposed they tend to be really, really, really bad for banks, . . . [A]nd the final results tend to be just really, really bad.”⁴⁶

The Final Rule will also potentially result in lower returns for shareholders of the GSIBs because the surcharge, “in addition to the 7% capital buffer already required for large banks,” may hinder the GSIBs’ “ability to buy back stock or pay higher dividends,” thus negatively affecting a GSIB’s attractiveness to future investors.⁴⁷

D. Conclusion

The Fed adopted the Final Rule imposing risk-based capital surcharges on the U.S.’s largest, most systemically important bank holding companies in an effort to “reduce [the] overall systemic risk” those institutions pose to the domestic and global financial markets.⁴⁸ The Fed has essentially attempted to “‘equalize’ the expected impact” of the failure of a GSIB with that of the impact of the failure of “a smaller, benchmark institution by decreasing the probability of default.”⁴⁹ The Final Rule has elicited support and criticism from various corners of the banking industry, but the ultimate impact of the surcharges will not be immediately realized.

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⁴⁶ Jesse Hamilton & Ian Katz, *JPMorgan No Longer \$20 Billion in Hole for Fed Capital Demand*, BLOOMBERG BUS. (July 17, 2015, 12:13 PM), <http://www.bloomberg.com/news/articles/2015-07-17/jpmorgan-no-longer-20-billion-in-hole-for-fed-capital-demand> [<http://perma.cc/U7NC-NKY7>].

⁴⁷ Davidson, *supra* note 26.

⁴⁸ *Federal Reserve Board Approves Final Surcharge Rule*, *supra* note 10, at 6.

⁴⁹ *Id.*

⁵⁰ Student, Boston University School of Law (J.D. 2017).