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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 357

Statement of the Shadow Financial Regulatory Committee on

The Fed's SIFI Surcharge: An Alternative Proposal

February 9, 2015

On December 18, 2014, the Federal Reserve Board (Fed) issued a notice of proposed rulemaking (NPR) to impose a surcharge on U.S.-based Global Systemically Important Banks (G-SIBs). The proposed framework would require a top-tier U.S. bank holding company (BHC) with $50 billion or more in total consolidated assets to calculate a measure of its systemic importance. The Fed would then identify a subset of BHCs that would be labeled as G-SIBs and subjected to a risk-based capital surcharge. The Shadow Committee has reviewed this proposal. Two basic principles underlie this proposal: (1) certain U.S. financial companies have grown so large, leveraged and interconnected that their failure could pose a threat to financial stability in the U.S. and globally; and (2) higher capital requirements would mitigate the threat posed by those institutions.

Although this emphasis is a welcome change from the pre-crisis policy, which reduced capital requirements for G-SIBs, the Shadow Committee believes that a less costly alternative should be available. Specifically, we suggest that the Fed consider a new "opt-in" capital ratio policy as follows: in exchange for substantial regulatory relief including the proposed surcharge, BHCs should be granted the option to maintain a minimum capital ratio of at least double the current level (e.g. 10-15% leverage ratio). The numerator of the ratio would be Tier 1 Common Equity and the denominator would be the total leverage exposure as defined by the Fed. The total leverage exposure measure takes into account both on-balance sheet assets and off-balance sheet exposures such as OTC derivatives, cleared derivatives, repo-style transactions and other off-balance sheet exposures. Although the Shadow Committee does not favor reliance on Risk Weighted Assets for numerous reasons described in previous statements, the requirement could be stated as maintaining a ratio of at least double the current level of Tier 1 Common Equity relative to Risk Weighted Assets.

The NPR describes in detail the indicators the Board would use to identify and measure the systemic profile of an institution and explains how these indicators would be weighted. These include five dimensions of systemic risk, which are proxied by 12 different indicators that receive various weights in the calculation of a BHC's systemic score. The novel feature of the Fed's approach, which distinguishes it from the approach adopted by the Basel Committee and the Financial Stability Board, is the introduction of an additional measure of systemic risk reflecting a BHC's reliance on short-term wholesale funding. A BHC's systemic score would be the greater of its score under the Basel methodology or under the alternative Fed proposal. The upshot is that the G-SIB surcharge for U.S. BHCs would be about 1.8 times higher than that suggested by the Basel Committee. This reflects not only the inclusion of an indicator of funding risk, but also the calibration that converts systemic scores into capital surcharges. We commend the effort to identify and measure systemic risk indicators, setting capital standards for U.S. banks above the Basel minimums and building greater capital strength for the BHCs deemed to be systemically important.

We are concerned not only about the specifics of this proposal, but more importantly about the growing complexity and opacity of prudential regulation generally. The NPR states "The proposed calibration of the G-SIB surcharges is based on the Board's analysis of the additional capital necessary to equalize the probable systemic impact from the failure of a systemically important bank as compared to the probable systemic impact from the failure or a large, but not systemically important bank holding company." Governor Tarullo explained the objective in terms of an example: "For example, if the probable systemic impact from the failure of a Global Systemically Important Bank (GSIB) would be five times that resulting from the failure of a nearly-systemic bank holding company, the GSIB should hold capital sufficient to make the probability of its failure one-fifth that of the nearly-systemic firm." We question whether the systemic surcharge can be calibrated with this degree of precision. Moreover, the calibration described in the proposal does not appear to be based on reproducible "analysis." The five categories are weighted equally and, within categories with multiple indicators, each of the indicators is weighted equally. There is no justification for weighting size, interconnectedness, substitutability, complexity and cross-jurisdictional activity equally at precisely 20% each. Nor, for example, should the notional amount of over-the-counter derivatives, trading and available for sale securities and Level 3 Assets each be weighted precisely at 6.67% (which does not sum to the 20% weight for the category). These weights do not appear to be the result of the kind of rigorous empirical analysis implied in the language of the regulation.

As proposed the average G-SIB surcharge for U.S. banks would be 1.8 times that of banks headquartered outside the U.S. Without the surcharge, projected total capital requirements would be 10%. With the surcharge, the total capital requirement for the US BHCs deemed most systemic would go to 14.5%.

The G-SIB surcharge adds to the complexity and opacity of a system of prudential regulation that is based on numerous existing risk-based capital requirements, leverage limits, liquidity requirements, single-counterparty credit limits, stress testing requirements and risk-management requirements. Collectively these measures impose substantial compliance costs on banks and regulators and produce a system so complex and opaque that it is difficult for anyone to judge the extent to which they have mitigated the risk to financial stability.

The Committee's "opt-in" proposal is free of many of the problems in the Fed's NPR and can be calibrated to provide at least as much safety as the G-SIB proposal. The advantages of our approach are simplicity, greater transparency, more resilience to a greater variety of shocks, and lower compliance costs for both regulators and G-SIBs. Exploring this proposal would give us greater insight into compliance costs. Furthermore, it provides an avenue for reducing regulatory compliance costs without exceeding the Board's authority under the Dodd-Frank Act. One might hope that Congress and other regulators would be willing to consider proposals for further reductions in compliance costs.