Transcript of Open Board Meeting

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CHAIR YELLEN. Good afternoon. I'd like to welcome our guest to the Federal Reserve today as we consider an important milestone in the Board's effort to mitigate the potential risks that systemically important financial companies could pose to financial stability in our economy. The proposed rules that the Board is considering today would impose risk-based capital surcharge upon the most systemically important U.S. bank holding companies. This framework would provide incentives to these banking organizations to hold substantially increased levels of high quality capital as a percentage of their risk weighted assets. This in turn would encourage such firms to reduce their systemic footprint and lessen the threat that their failure could pose to overall financial stability. The proposed rule is an important part of the board's efforts to establish enhanced prudential standards to the most systemic U.S. banking firms and would improve the resiliency of these firms. I look forward to today's discussion of these important issues and let me now turn to Governor Tarullo.

GOVERNOR TARULLO. Thank you, Madam Chair. The proposal before us today lies at the intersection of two important principles of post-crisis regulatory reform. One is that strong capital requirements are central to ensuring a safe and sound financial system. The other is the relatively new principle that the stringency of prudential standards should be proportional to the systemic importance of regulated firms. The proposed system of graduated capital surcharges would be another step toward implementation of section 165 of the Dodd-Frank Act. It builds on the framework for capital surcharges agreed upon in the Basel Committee on Banking Supervision for application to banks of global systemic importance. The Federal Reserve, along with a few like-minded central banks was an early advocate for the capital surcharges. And we should be pleased that we were eventually able to reach international agreement on this important innovation in international capital standards. The proposed regulation differs from the international framework in two significant respects. The calibration of surcharges would general be--generally be higher than those applicable to the eight covered U.S. banks under the international standard and the formula by which we calculate applicable surcharges would directly take into account the reliance of each firm on short-term wholesale funding. Let me briefly note the reasons for both these differences. First, with respect to calibration, surcharge levels for most of these eight banks would be higher under the proposal than those required by the Basel standard and likely meaningfully higher for some of the firms. The approach to calibration we developed in cooperation with other Basel Committee members was to determine 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 of a large but not systemically important bank holding company. However, the surcharge levels ultimately agreed to by the Basel Committee where toward the low end of the range suggested by this analysis. The levels included in the proposed rule are more in the middle of that range and has suggested in an economic impact analysis undertaken by Basel Committee members should provide substantial net economic benefits by reducing the risks of destabilizing failures of very large banking organizations. The applicable surcharge would be increased as the bank systemic importance grows and reduced as a bank reduces its size, interconnectedness, reliance on short-term funding or other characteristics that determine its systemic significance. Moreover, the surcharges apply only to systemically important banking organizations. Thus, other banks may have capacity to act as substitute providers of credit in response to any reduction in at least some forms of lending by larger banks. Finally, I note that several other countries have also decided to enhance financial stability by applying capital standards above Basel surcharge levels for their systemically important banks. With respect to the difference in the proposals formula from the Basel formula, inclusion of a short-term wholesale funding factor reflects the fact that reliance on short-term wholesale funding can leave a firm vulnerable to predator runs that force the firm to rapidly liquidate its own possessions or call in short-term loans to clients. Both of these responses can lead to fire sales that create a vicious cycle of mark-to-market losses, margin calls, forced deleveraging, and further losses. Thus, reliance on short-term wholesale funding is among the more important determinants of the potential impact of the distress or failure of a systemically important financial firm on the broader financial system. Unfortunately, the surcharge formula developed by the Basel Committee does not directly take into account reliance on short-term wholesale funding. Inclusion of reliance on short-term wholesale funding as one of the five factors in the systemic significance formula is intended principally as a means for assuring the resilience of large firms that are in fact dependent on such funding. It is not a substitute for liquidity regulation such as the liquidity coverage ratio or the next stable funding ratio that we will be considering next year. In conclusion, the proposed rule would strengthen the Basel standard as applied in the United States both by raising the surcharges to levels that would yield greater net economic benefits and by explicitly incorporating a factor for determining those surcharges that lay at the heart of the recent financial crisis. The proposed federal registry notice includes a number of questions designed to elicit view on these and other features of this important regulatory advance and I look forward to seeing public comments in the coming months. Let me now turn to Mike Gibson for a full presentation of the proposed rulemaking.

MICHAEL GIBSON. Thank you, Governor Tarullo. The proposal before you today would complement other measures the Federal Reserve has taken to strengthen the resiliency of U.S. G-SIBs and to reduce the risks that these firms pose to U.S. financial stability. To put today's proposal in a broader context, I would like to mention three such measures, the LISSC, the stress test and resolution plans. First, in response to the lessons learned from the financial crisis, the Federal Reserve has changed the way we organize our supervision of the largest most systemically important banking organizations. We created a Federal Reserve system-wide committee called the Large Institution Supervision Coordinating Committee or LISSC that oversees the supervision of these firms. The LISCC is founded on several principles that large institution supervision should be more centralized, that it should focus on regular horizontal examinations across the entire group of firms and that it should be multidisciplinary. As a multidisciplinary committee, the LISSC include senior Federal Reserve staff from supervision at the Board and at the Reserve Banks from research, legal, markets and payments. Second, our stress testing which is part of our annual Comprehensive Capital Analysis and Review or CCAR is a valuable tool for ensuring the resiliency of the largest U.S. banking firms during periods of financial or economic stress. The CCAR exercise applies to the largest banking organizations and recognizes the greater risk that these firms pose to financial stability in times of stress. The most recent stress test conducted earlier this year with the fourth round led by the Federal Reserve since 2009. And the results demonstrated that the largest banking organizations in the United States are collectively much better positioned to continue to lend and to meet their financial commitments in a severe economic downturn than they were five years ago. Third, while these measures in the proposed G-SIB surcharge framework aim to improve the resiliency of G-SIBs, it is also critical to improve the resolvability of these firms in the event of their failure. We have been working with the FDIC to evaluate the resolution plans that are required by section 165 of the Dodd-Frank Act. We in the FDIC have jointly given feedback earlier this year to the largest firms on the shortcomings in the resolution plans and the changes that are needed to make these firms more resolvable. The Board staff have also been working with the FDIC to develop a proposal that would require U.S. G-SIBs to maintain a minimum amount if long-term debt at the parent holding company level. Together with the proposed G-SIB search arch framework that is being considered today, these efforts should better ensure that U.S. G-SIBs maintain a strong capital base that guards against adverse economic consequences that could contribute to systemic distress and reduces the likelihood of economic disruptions caused by problems at these firms. With that, I turn to Ann McKeehan and Jordan Bleicher who will provide a more detailed explanation of the rule making before us today.

ANN MCKEEHAN. Thank you, Mike. I will discuss key provisions of the proposed rule that would implement a methodology for determining whether a large U.S. bank holding company will be identified as a G-SIB and for computing a risk-based capital surcharge for each identified G-SIB. My colleague Jordan Bleicher will discuss the calibration and implementation timeline of the proposed surcharge. Then we, as well as my colleagues will help answer any questions you may have. As Governor Tarullo described, the proposed rule is based on an assessment methodology and surcharge framework developed by the Basel Committee on Banking Supervision but is modified to address systemic risk concerns specific to large U.S. bank holding companies. The proposal would require U.S. top tier bank holding companies with $50 billion or more in total consolidated assets to calculate a measure of their systemic importance on an annual basis and would identify a subset of those firms as G-SIBs based on that measure. Using yearend 2013 data, eight U.S. bank holding companies would currently qualify as G-SIBs and be subject to a capital surcharge as result. Specifically, the proposal would use five broad categories correlated with systemic importance, size, interconnectedness, cross border activity, substitutability and complexity to calculate a numerical score for each large bank holding company. The data needed to calculate a firm's score is already publicly reported. If a bank holding company's systemic footprint score is above a certain threshold, it would be identified as a G-SIB. The threshold is intended to capture bank holding companies whose failure or material financial distress would pose the greatest threat to financial stability. A bank holding company that is identified as a G-SIB would then determine its G-SIB surcharge under two methods and would be subject to the higher of the two resulting surcharges. Method one would use the five categories correlated with systemic importance that I just noted and is aligned with the Basel Committee surcharge framework. Method two would also use these categories but would replace substitutability with a measure of a G-SIB short-term wholesale funding. Method two would also generally produce higher surcharges than method one. My colleague Jordan will discuss calibration in more detail in a moment. The measure of a G-SIB short-term wholesale funding under method two would consider the firm's daily use of short-term wholesale funding average over calendar year. Short-term wholesale funding generally will be defined to include liabilities with the remaining maturity of less than one year and will focus on those liabilities to give rise to the greatest risk of creditor runs and associated systemic externalities. In line with this, our definition of short-term wholesale funding would not include retail or operational deposits. Under the proposal, each component of short-term wholesale funding would be weighted. In general, the proposed weights would progressively decrease as the remaining maturity of a funding source increases and as a quality of the collateral securing a funding source increases. The G-SIB surcharge would be integrated into the Board's regulatory capital rule by increasing the size of G-SIB's capital conservation buffer. Under the Board's regulatory capital framework, all banking organizations must maintain a minimum of four and a half percent of risk weighted assets in common equity tier one capital and hold an additional two and a half percent to avoid restrictions on capital distributions and discretionary bonus payments. I will now turn to Jordan who will describe in more detail how the proposed surcharge calibrations would differ under the two methods and how the higher surcharge may impact U.S. G-SIBs based on Board staff estimates.

JORDAN BLEICHER. Under the proposal, if G-SIB would be subject to the greater G-SIB surcharge resulting from the two methods described by Ann, based upon the proposed formulation of the two methods, the G-SIB would be subject to the surcharge resulting from method two in most instances. Under the proposal, the eight G-SIBs would be subject to estimated surcharges ranging from 1.0 to 4.5 percent. On average, the estimated U.S. surcharges are approximately 1.8 times the Basel Committee surcharges. While the method two surcharge generally would be the binding surcharge, the G-SIB could potentially be bound by the method one surcharge. Staff believes the method one surcharge which is based on the BCBS global framework should serve as a floor for a G-SIB surcharge. This approach would facilitate comparability among jurisdictions implementing the Basel Committee's surcharge framework. As Governor Tarullo indicated, the proposed surcharge calibration is based on Board staff's analysis of the capital necessary to equalize the probable systemic impact from a failure for G-SIB with that from the failure of a large but not systemically important bank holding company. The proposal also builds an analysis conducted by the Basel Committee and its members of the long-term economic impact stronger capital and liquidity requirements for global banks. The study found that tightening risk-based capital requirements from global banks would provide substantial net economic benefits by reducing the probability of the financial crisis. Indeed, the study found that such benefits would continue to improve at even higher levels of risk-based capital than reflected in the Basel free standards. The calibration of the proposed surcharges is intended to maximize its net economic benefits. Since 2009, the aggregate tier one common equity ratio of the eight firms currently identified as U.S. G-SIBs under the proposal has more than doubled. This substantial improvement in firm capital positions reflects in significant part the Board's revised regulatory framework and stress testing regime. As a result, staff estimates that almost all of the eight G-SIBs already have sufficient tier one common equity capital to meet their estimated G-SIB surcharge in a fully phased in basis and that all firms are on their way to meeting their surcharges over at the three-year phase in period given both continued phase in of the capital deductions and phase in of the buffer. The proposed G-SIB surcharge would help ensure that firms maintain strong capital positions as we move further away from the financial crisis. Now turning to timing, the proposal with phase in G-SIB surcharge on a straight line basis from January 1, 2016 through January 1, 2019, this implementation period was chosen to align with the phase in of the regulatory capital framework's capital conservation buffer. That concludes our formal remarks. With that, my colleagues and I are happy to address your questions.

CHAIR YELLEN. Thank you very much. Let me start off and I want to first thank the staff and Governor Tarullo and the Banking Supervision Committee for all of your excellent work on this proposal. I think the first question I wanted to ask pertains to the likely impact of these surcharges on the decisions of the affected G-SIBs to rely on short-term wholesale funding. And I guess my question is do you see these surcharges as actually creating any incentive for a G-SIB to rely instead on more stable forms of funding and I--because I'm asking this question in part because as I understand it, the SIFI surcharge while it takes dependence of the G-SIB on short-term wholesale funding into account in computing its magnitude. In fact that a firm's capital charge would only really change if the funding pattern that it engages in changes enough to move it from one surcharge bucket into another. But if the margin for a smaller change, it doesn't strike me that it creates such an incentive to shift funding patterns and I understand I guess that the purpose of this surcharge is to reduce the odds of failure for a firm that is systemic but it seems to me there is also merit in trying to force internalization by market participants of fire sale externalities that are associated with reliance on this kind of financing. So, that's my question.

MICHAEL GIBSON. So, you're right that the inclusion of short-term wholesale funding in the systemic importance measure would give an incentive to a bank to reduce its reliance on short-term wholesale funding or to shift to longer maturities or higher quality collateral to reduce its systemic footprint measure which would tend to reduce its surcharge. Now the proposal does include buckets of 50 basis points. So, you have to reduce your systemic impact measure enough to get into the next lower bucket. The decision to propose buckets, basically it's a tradeoff between how predictable will the surcharge be and how strong is the incentive. So, having buckets gives it some predictability because there will be fluctuations from year-to-year and banks need to plan in advance, so it should be relatively easy to plan. If you're in the middle of a bucket, you'll know that it will take a big change to move you to the next bucket. But, you know, there is still some incentive especially when you get lower in the bucket to reduce your systemic impact sufficiently to get into the next lowest bucket. So, that was a tradeoff but certainly we're asking for comment from the public on whether we got the tradeoff right and obviously you can make smaller buckets or there's different ways to go about it.

MARK VAN DER WEIDE. I'm going to add it's this particular element of our SIFI capital surcharge framework is just one of the different ways that we're attempting to force these firms to internalize the externalities of their usage of short-term wholesale funding, so we will have this surcharge on the capital side. We also adopted the LCR and we've been working internationally on the NSFR and larger requirements on securities financing transaction. So there are other elements of our current regulatory regime and other future coming elements of the regulatory regime that will as a package produce the right structure that we want.

CHAIR YELLEN. Thank you. Let me just ask one other question and it concerns the stress test. Isn't it necessary in order to make sure that many of these firms I guess already have capital levels that are in excess of what would be required under this proposal in order to meaningfully increase capital levels, isn't it necessary for these firms to also change the threshold that has to be passed in the stress tests?

MICHAEL GIBSON. So, the question about whether the G-SIB surcharge should be incorporated into the post-stress minimum for the purpose of the stress test is something that is not addressed in this rule making. This is a rule making for--relative to the regulatory capital rules. We have a separate rule, the capital plan rule, that governs the stress test but we did note in the proposal and would welcome public comment on the question of whether some or all of the surcharge should be incorporated into the post-stress minimum. And the reason is that if you believe that the motivations for the surcharge around systemic risk impact are the same in times of stress as they are in normal times and that would be a reason to include it the way you suggest but that's not something that's being proposed here. That's something that we plan to come back and talk about in the future.

CHAIR YELLEN. OK. Thank you very much, Vice Chair Fischer.

VICE CHAIRMAN FISCHER. Thank you, Madam Chair. The two methods for calculating the surcharge, basically the second replaces reliance, replaces substitutability by the reliance on the short-term wholesale funding. Presumably this discussion must have taken place in Basel as well when it was decided by Basel to do it the other way. What were the arguments one way or the other?

MICHAEL GIBSON. So we definitely had a lot of discussion at the Basel Committee around the composition of the Basel formula. Say one thing that's different is that those discussions happened several years ago when we were still evaluating what our regulatory program, we in the U.S. were still evaluating our program around short-term wholesale funding so we had identified it as one of the risks coming out of the financial crisis but we weren't able to convince people in Basel to retain it as part of the actual formula but when we came back and in the few years since Basel crystallized its formula, we've been focusing more on that and are really--have focused on ways to address the risks from a short-term wholesale funding which is why you see the difference here. Now, there is a review underway in Basel that will be coming in a couple years on their formula and we have certainly taken the position with them and shared our analysis with them around the reasons why it's a good idea to include short-term wholesale funding in the measure of systemic importance and we hope that they take that onboard when they review their measure as they've already committed to do.

VICE CHAIRMAN FISCHER. Has any other country adopted the approach we've taken, and--they are all free to do this?

MICHAEL GIBSON. So, different countries have done different sorts of surcharges. No one--I'm not sure what other countries have gone ahead and adopted the Basel formula yet.

ANNA LEE HEWKO. So, most of the Basel Committee members who are home country supervisors for G-SIBs have adopted the Basel G-SIB framework, Japan is the only other jurisdiction that hasn't adopted it yet. So, most of them have adopted the Basel framework. A few have chosen to put their own super equivalents on it. Switzerland has done something. Sweden, the Netherlands have also done things. They're different from what's being proposed here and they don't incorporate short-term wholesale funding but different jurisdictions based on their local conditions have been adding their own bells and whistles on top of the basic Basel framework.

VICE CHAIRMAN FISCHER. Just one other question, the--if you compare the method one surcharge with method two surcharge, two looks really a lot stronger. And so it's kind of surprising, and I got to the point that it said well that you said--well, actually it's on the--there's no bank that is going to have to increase its current capital. Did I get that right? No?

MICHAEL GIBSON. Roughly. I'm going to repeat what the--I think what we said was that almost all the banks with their current capital today would meet the fully phased in surcharges being proposed, so almost--we said almost all.

VICE CHAIRMAN FISCHER. Yeah, you have one bank that while having said that you also have one bank that didn't.

MICHAEL GIBSON. Right.

VICE CHAIRMAN FISCHER. Would be quite a powerful impact in--its a big bank and it was $22 billion short, that's pretty impressive shortfall, which means--which seems to me that, you, I know that Governor Tarullo and you, the banking supervisors and regulators have been very concerned about short-term wholesale funding and there are other places where it enters as well, doesn't it, in the calculation. So, there was something in the capital structure of JPMorgan, which is a firm which is going to actually have to come up with more capital which made it different than the others. What was that and why doesn’t it meet the requirements already?

MICHAEL GIBSON. So, the Basel Committee has published its list which shows the different buckets that the U.S. G-SIBs are in and that's publicly available and they've been--we've been collecting the data for them on the components that go into the Basel Committee's systemic importance measure which is method one. We're proposing a method two which includes short-term wholesale funding as 20 percent weight of systemic importance but we haven't been collecting on a regulatory report the measure of short-term wholesale funding and exactly the way we've--that the way that's being proposed in the regulation. And since the regulation is out for comment, we expect to get comment on the ways that we've defined the different buckets that's a two-dimensional matrix of weights on different types of short-term wholesale funding depending on maturity and underlying collateral type. So, we know what the Basel Committee surcharge formula produces. We have estimates of what the method two surcharge would produce and we can't be as precise about the method two surcharge as we can about the method one surcharge because it's based on confidential supervisory information that's only estimated. So, I think we're pretty confident that with our projection that almost all of the companies would meet the--would have capital today to meet the proposed surcharge but we didn't go into more precision about that because of the fact that the method two short-term wholesale funding measure is something that's just being proposed now for the first time. We don't have as good data on that measure.

VICE CHAIRMAN FISCHER. Thanks very much. This is not only important, it's also interesting. Thank you.

GOVERNOR TARULLO. Thank you, Madam Chair and thank you, Mr. Vice Chair. Just to clarify a little bit of what the issue that the vice chair was asking about, I think, Mike, isn't it, my perception on the question of the factors for the systemic formula is that even over the last couple of years, internationally about the Basel Committee and the FSB, there actually has been more attention paid to the short-term wholesale funding, you know? Three and four years ago when we are talking about this in Basel, it--some of the countries I think were already of the view that short-term wholesale funding created big vulnerabilities, but others who are much more focused I think on size and some of these substitutability issues. In the intervening years, as you see in the net stable funding ratio with the minimum margining requirement, there's been a good deal more concern I think. So--and some hope although to qualify it that over time we might get a change in the international formula which would more accurately reflect what we think is the systemic risk associated with some of these institutions. One question and I think the vice chair's question may have clarified this, Jordan, but I just want to make sure it is clear to everybody. On that question of the firms likely being able already to meet the surcharges that are proposed under your method two, as Mike said, the data is not precise enough to let you make a real judgment about that. But when you said that you were not referring only to the Basel committee formula, right, you were also referring to the method two which includes the higher surcharges?

JORDAN BLEICHER. Yeah, that's right.

GOVERNOR TARULLO. OK. I just want to make sure people are aware of that because in the stress test every year, we have been incorporating the anticipated Basel surcharges but not these. OK. Good. Second question, I had was on the issue of the rest of the world and the fact that many countries at least haven't yet chosen to apply surcharges higher than the Basel framework, which is really set of minimum surcharges. You--I referred in my remarks to the fact that the Basel economic impact analysis suggested that there was more gain to be had from greater resiliency staving off financial instability, and that on net, it was still a gain for the economy. But what about the issues of direct competitiveness between U.S. banks that would, under this proposal, have higher than Basel surcharges and banks from other countries not, I guess, Sweden or the Netherlands or Switzerland but from other countries, which might have a very similar risk profile--systemic risk profile but would at least as of the moment have probably a somewhat lower surcharge. What kind of competitive effects are you projecting on the U.S. banks and I guess just a little discussion on that would be helpful.

MARK VAN DER WEIDE. Sure. So, we try to design the framework, the structure of it and its calibration primarily to achieve the financial stability goals that we had. But we did give some consideration to competitive effects. I think the principle competitive effect that we anticipate is a leveling of the competitive playing field between the most systemic U.S. banking firms and the less systemic U.S. banking firms, the small, medium and large but not quite systemic class. So, we think those competitive advantages are pretty significant. We also think the whole international framework as surcharges for G-SIBs, foreign and domestic, is one that will work to the competitive advantage of these small, medium, and large but not systemic U.S. banking firms. But to your specific question about the competitive playing field between the U.S. G-SIBs and the foreign G-SIBs, as you noted, there are few countries that are going to go super equivalent like us. But--and others may follow and we expect others will follow but probably not all. So, from our perspective, equity capital is slightly more expensive than debt capital. But at the same time, well capitalized banking firms tend to have a lower cost of debt financing as well. So, there something of a natural offset there. I think there are also times in the economic cycle, particularly in the stressful economic times where strong capital can be a competitive strength, and I think as we've watched our large American banking firms compete with foreign large banking firms over the past few decades, they've been subject to higher capital requirements all along the way and they've competed reasonably well against their foreign competitors. To the extent that certain of the U.S. G-SIBs find our proposals, if finalized in their current form, to be a competitive impediment, they'll always have the option to reduce their systemic footprint under our formula and therefore reduce that competitive disadvantage. But fundamentally, we're mostly focused on trying to achieve our financial stability goals at the least cost to economic growth and credit availability and credit cost. And, that was our primary motivation behind the proposal.

GOVERNOR TARULLO. Sorry, just one other question. Mike, when does the Basel committee have scheduled a reconsideration of the formula for determining systemic importance?

MICHAEL GIBSON. Yeah, and I'm looking at Wayne [assumed spelling] because I'm not sure of the time table for that.

WAYNE PASSMORE. The time table, the Basel committee has a three-year review of the process and the process has just started. So, it will be roughly two to three years before the proposals are really in hand. There's going to be period of data collection on possible measures, assuming that it makes--is the initial data collection is approved by the Basel committee.

GOVERNOR TARULLO. Thank you, Madam Chair.

CHAIR YELLEN. Thank you, Governor Powell.

GOVERNOR POWELL. Thank you Madam Chair. So, the vulnerabilities of short-term wholesale funding were critical to the evolution of the crisis and the damage that was done and we've responded appropriately with a broad array of measures including as Governor Tarullo mentioned, LCR and the NSFR could also Tri-Party Repo reform and money market reform today's measure soon enough minimum margins on securities financing transaction. So, and yet we know that there is still a role for short-term wholesale funding. I mean, it is appropriate if you safely and so, I wanted to give you a chance to discuss, you know, whether we've left enough room and how we think about that and how we feel about the possibility of affecting important financing markets like for example treasury repo?

JORDAN BLEICHER. OK. Let me take a shot at that, the basic reason I think for including short-term wholesale funding in surcharge formula as been said, is that we think that the surcharge should scale the standard firm's systemic footprint and we think that short-term wholesale funding this a key factor in determining the impact that a firm's failure would have. As you say, inclusion of the short-term wholesale funding component in the surcharge is part of a broader package of reforms that also includes LCR, NSFR, and potentially other things like margin requirements. With respect to sort of impact of including short-term wholesale funding on things like the Treasury market and other markets, we think there are several factors that reduce the risk of adverse impact. One is the weighting system that the surcharge would use to assign weights to different types of short-term wholesale funding liabilities to the extent that short-term wholesale funding liabilities are backed by U.S. treasuries or other highly liquid collateral, those liabilities would receive a relatively low-weight to the extent that short-term wholesale funding liabilities are backed by less liquid collateral, they would receive a higher weight. That differentiation, I think, would help to protect against some of the potential adverse impacts that you suggested. It's also important to note that short-term wholesale funding is just one of five factors in the surcharge formula. So, although the proposed surcharge levels are roughly doubled those of the Basel standard, short-term wholesale funding is only going to be about 20 percent of the total, so that should also reduce the impacts that the inclusion of that component could have. And then finally, I'd point out, it's probably relatively clear already, that the surcharge would only apply to a handful of firms that are systemically important. So to the extent that those firms would decide to reduce their activity in certain areas, other firms not subject to the surcharge could potentially substitute.

GOVERNOR POWELL. That's very helpful Jordan. Thanks.

CHAIR YELLEN. Thank you Governor Brainard.

GOVERNOR BRAINARD. Thank you Madam Chair. So I think this proposal is designed, you're trying to calibrate the surcharge, I think appropriately, to get institutions to take into account the specific kinds of risks that they're opposing to the system in terms of things like interconnectedness and reliance in short-term wholesale funding, and it's nicely tiered, it really presents important advancement on the turning of regulation. How did you though trade off the desire to carefully target those sources of potential risk to the system against the desire which I know we also have to maintain a fairly simple, not excessively complex system of requirements for financial institutions?

MICHAEL GIBSON. So I guess that way the surcharge, the systemic impact measure is designed, it does trade off the complexity versus the effectiveness and the decision was made to go with a relatively small number of indicators, I think there's 12 indicators, that we collect data on already under the method one surcharge. And then, there will be the additional short-term wholesale funding data under the method two surcharge. And you know, it's a relatively small number of data points for each firm and it is publicly available in the case of the method one surcharges or would be in the future publicly available under the method of surcharge. So, it's possible for either the banks or the public to calculate their own surcharge and to do what if scenarios to say, well if we reduce our size or our interconnected by so much, how much would it change our systemic impact measure and what effect would it have on our surcharge. So, it is a tradeoff between the simplicity of the system and giving the right incentives, but you know, we've tried to strike a balance and we certainly welcome the comments on whether the balance is appropriate or not.

GOVERNOR BRAINARD. So, second question about the design is as in the international framework, there's kind of a first level you're in or you're out at a certain level of complexity and size, and then a sort of calibration above that. What's that thinking about institutions that may be large and complex but don't quite hit that threshold and what kinds of additional incentives might you think about building in in the future there or is this going to remain a sort of pretty high threshold above which there's a surcharge and below which there is not.

MICHAEL GIBSON. So we always have to draw a line and some banks are going to be in and some banks are going to be out. I think in the U.S. we're relatively fortunate that there's a big gap between the least systemically important G-SIB among the eight that are included in the current proposal and the next bank on the list that would be systemically important. So, there's no issue around if the line were a little bit higher or a lower, a U.S. Bank would be in or out. No, that's not true in other countries and that is more of an issue for other countries. One way the Basel Committee manages that is that countries are allowed to add banks to the G-SIB list so they might have one bank that's right above the boundary and one bank that's right below the boundary that they see is very comparable. And, so they might put that second bank in through supervisory judgment even if their score was a little bit on the low side but we don't face that. We're lucky that we don't face that issue in the U.S.

ANNA LEE HEWKO. We do have enhanced prudential capital standards for bank holding companies greater than $50 billion dollars. So, we do have something targeted to those firms and then the purpose of the G-SIB surcharge is different. It's really focusing on systemic risk above and beyond the adequate capitalization and with the enhanced supervisory and regulatory focus we put on all of the large bank holding companies.

GOVERNOR BRAINARD. Thank you, Madame Chair.

CHAIR YELLEN. Yes, of course. Vice Chair.

VICE CHAIRMAN FISCHER. A simple question regarding to what Governor Tarullo--sorry--Governor Brainard has said. What is the minimum definition of globally active or internationally active? Is that some X percent of its revenue business or something?

MICHAEL GIBSON. So, the Basel Committee collects data from the 75 largest banks in the world to do their systemic impact score and then they compute the scores and they rank them and they have a methodology that has a cut off which currently includes 30 global banks is that right? Thirty, so, 30 out of 75 are judged to be in the systemically important group. And the line was drawn originally just based on the judgment of looking at, you know, where the measures came out.

VICE CHAIRMAN FISCHER. So, there's no number if you do X percent of your business abroad your—

MICHAEL GIBSON. Well, it's a complicated formula with many variables and they're all weighted so it's not quite as simple as that.

CHAIR YELLEN. Further questions? OK. Hearing none what I'd like to next do is have a go around and I'd like to ask each person to state their position on this proposal whether you supported or not. Maybe we'll start with Vice Chair Fischer.

VICE CHAIRMAN FISCHER. I support the proposal Madam Chair.

CHAIR YELLEN. Thank you. Governor Tarullo.

GOVERNOR TARULLO. And, I do as well but it is a proposal and as always I think we'll be interested in hearing the comments upon it.

CHAIR YELLEN. Governor Powell.

GOVERNOR POWELL. Thank you, Madam Chair. I too support the proposal. I think it make sense to include short-term wholesale funding since it was such a crucial vulnerability in the crisis. I think that these higher levels of risk based capital will both reduce the probability of default and also in some sense encourage these firms to reduce their systemic footprint. As always I look forward to hearing and reading, understanding the comments and considering them but I'm happy to support the proposal.

CHAIR YELLEN. Thank you. Governor Brainard.

GOVERNOR BRAINARD. Yeah. I believe the proposal represents a significant step in tiering regulation to reflect the risks that an institution poses to the system and it gets--important to note that the enhanced capital requirements will be material only for institutions well above the $50 billion dollar Dodd-Frank floor with the focus on those institutions that are complex and highly interconnected. I think it also builds on the new capital framework in a clear and direct way. It very much embodies the one, I think resounding lesson from the crisis which is that excessed risk taking and distress at the largest and most interconnected firms pose risks not only to the safety and soundness of those institutions but also to the system, and so our new surcharge builds an incentives for senior managers in the Board to take into account the risk that they're posing to the system overall. I think it is important that the proposal requires greater capital, the greater--the institution's reliance on the short-term wholesale funding which does reflect the lessons we learned on asset fire sales when we see distress in these institutions. And I think it's also important as was stated earlier that the calibration is on specific metrics that institutions themselves can take into account. And because the risk or the capital surcharge is indirect proportion to this set of metrics, it provides clear benefits to actions that a firm might take to reduce its size and its complexity which I think are all desirable features. So, I support the proposal and I'm interested in seeing the comments that we received on it. Thank you.

CHAIR YELLEN. Thank you and I also support approval of this notice of proposed rulemaking and I'm also looking forward to seeing the comments. I certainly agree that financial institutions whose failure could result in systemic consequences for the broader financial system and for the economy as a whole should hold more high quality capital than organizations that have a less systemic footprint. And I think this does impose meaningful additional capital requirements. I'm pleased to see that the staff is going beyond what was required by the Basel proposal and I think that that's appropriate. With respect to the decision that you've made to include reliance on short term wholesale financing in deciding on the systemic footprint, I think that definitely make sense because the failure of a firm with high reliance on this kind of financing I think would impose greater costs on the financial system in the economy. But I would simply add that in terms of forcing firms to internalize the externalities, the fire sale externalities associated with their decisions to rely on short-term wholesale funding, I don't think that this proposal completely addresses these risks. And you mentioned the LCR in the net stable funding ratio and I hope staff will continue to consider a set of minimum margin requirements that would address this issue and would do so broadly through at the financial sector not only for these firms. OK. So, we're going to have two separate motions. I first need a motion to approve the proposed rulemaking that would establish risk based capital surcharge for U.S. based global systemically important bank-holding companies.

VICE CHAIRMAN FISCHER. So, I moved, Madam Chair.

CHAIR YELLEN. Thank you. Second.

GOVERNOR TARULLO. Second. All in favor.

ALL. Aye. Aye.

CHAIR YELLEN. And now I need a second motion to authorize staff to make minor technical changes to prepare the proposal for publication in the federal register.

VICE CHAIRMAN FISCHER. So moved.

GOVERNOR TARULLO. Second.

CHAIR YELLEN. Thank you sir. All in favor.

ALL. Aye. Aye. Aye.

CHAIR YELLEN. We'll thank you, both motions is passed and we'll look forward to the comments and I appreciate all your hard work. Thank you.