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Opening Statement on Global Systemically Important Banking Organization Capital Surcharge Final Rule by Governor Daniel K. Tarullo

A set of graduated capital surcharges for the nation's most systemically important financial institutions will be an especially important part of the strengthened regulatory framework we have constructed since the financial crisis. Like the higher leverage ratio requirements we will apply to these firms, they reflect the relatively new, but very significant, principle that the stringency of prudential standards should vary with the systemic importance of regulated firms. They will be added onto the increased capital requirements of Basel III, and they will take their place alongside another post-crisis regulatory innovation--the supervisory stress tests, to which I will return at the end of my remarks.

The final rule incorporates the framework for capital surcharges agreed upon in the Basel Committee on Banking Supervision for application to banks of global systemic importance, but adds an alternative method for calculating the surcharges. The higher of the surcharges determined by these two methods will be applied to each firm. Let me briefly mention the differences between the two methods.

One difference is that the second method calibrates surcharge levels so that they will generally be higher than those required by the Basel method, and meaningfully higher for some of the firms. As we noted in considering the proposed rulemaking last year, the calibration adopted in the Basel Committee was toward the low end of the reasonable range suggested by economic analysis. And, as explained at some length in the paper developed by Board staff that accompanies the final rule, the calibration levels in the rule's second method are somewhat

higher and should provide substantial net economic benefits by reducing the risks of destabilizing failures of very large banking organizations.

The other significant difference is that the rule's second method departs from the Basel formula for determining systemic importance by substituting a measure of each firm's reliance on short-term wholesale funding for one of the factors in the Basel method. This substitution reflects the fact that reliance on short-term wholesale funding is among the most important determinants of a firm's systemic importance. It can leave a firm vulnerable to creditor runs that force the firm to rapidly liquidate its own positions or call in short-term loans to clients. Both of these responses can lead to fire sales that can reverberate through the financial system by creating a vicious cycle of mark-to-market losses, margin calls, forced deleveraging, and further losses. Still, important as it is to include this factor as a determinant of the potential impact of a firm's distress or failure on the financial system, it is not a substitute for measures that directly address the structure of bank funding, such as the Liquidity Coverage Ratio that we recently adopted, or the Net Stable Funding Ratio that we will be considering later this year.

While the final rule retains the basic approach of the proposed rule, the staff has suggested some changes based on comments received in the rulemaking process and additional internal analysis. Perhaps the most significant change is that the systemic score determined under the second method will be based on a fixed measure of each firm's systemic importance, rather than--as in the Basel method--on a measure relative to that of other firms of global systemic importance. As commenters pointed out, the Basel approach makes each firm's surcharge a somewhat unpredictable function of changes that a group of large firms have, or have not, made in their own systemic profile.

Finally, I would note that we will need to consider whether and, if so, how to incorporate the surcharges into the post-stress minimum capital levels required in our annual Comprehensive Capital Analysis and Review (CCAR). As members of the Board know, Board staff have been assessing a wide range of possible changes--substantive and procedural--to the CCAR, and related supervisory stress testing, exercises. We anticipate that later this year staff will develop a series of recommendations for consideration by the Board, including changes that would make the supervisory stress test and CCAR better address systemic risks arising from correlations in the exposures and activities of large financial institutions. While incorporation of some or all of the capital surcharges would be one way to account for those risks, it is only one among a number of possibilities, all of which we will want to evaluate.