

Meeting Between Staff of the Federal Reserve Board and Representatives of the Financial Services Forum, Bank Policy Institute, and Others
May 30, 2024

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Summary: Staff of the Federal Reserve Board met with representatives of the Financial Services Forum, Bank Policy Institute, and others (collectively, FSF) regarding the Board's GSIB surcharge proposal. FSF representatives discussed concerns raised by commenters regarding the implementation of the proposal's move to measurement of average daily values for certain indicators, as described in the attachment.

Attachment



**FINANCIAL
SERVICES
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GSIB Surcharge NPR

Daily Averaging of GSIB Indicators

Operational and Governance Challenges

May 2024

Introduction



- The Federal Reserve’s July 2023 proposal would require most GSIB indicators to be computed using an average of daily values over the reporting period.
- We believe that the move to narrower GSIB buckets, combined with averaging quarter-end and monthly data will significantly reduce banks’ incentives to actively manage their GSIB scores.
- In our response to the proposal, we cited the significant operational burdens associated with the proposed daily averaging.
- In response to your request, we have worked with our members to provide additional detail on the operational, logistical, and governance challenges associated with the proposed daily averaging requirement. We have also laid out an indicative timeline to better illustrate the challenges that would be created by a daily averaging requirement.
- The following slides present several detailed and specific issues that shed light on the specific burdens associated with a daily averaging requirement. The provided examples are illustrative but not exhaustive.
- Finally, at the end of the presentation we discuss several key points from our comment letter that are important to our members but do not specifically relate to the daily averaging issue.

Overarching Considerations



- Many of the indicators in the GSIB surcharge and FR Y-15 reporting form rely upon controls, systems, processes, and governance frameworks that were designed and engineered over decades to support the SEC's quarterly reporting cycle of 10-Qs and the Federal Reserve Board's (FRB's) quarterly reporting cycle of the FR Y-9Cs, the Country Exposure Report (FFIEC 009), and more.
 - Given that the current FR Y-15 is already produced quarterly, the benefit of mandating daily calculations for the GSIB score is unclear.
- The GSIB indicators are not maintained on a daily, weekly, or monthly basis to the rigor needed for a CFO level attestation, which is what the FR Y-15 requires. In addition, some indicators are considerably more challenging to monitor at a daily frequency.
- The current reporting process, including CFO attestation, is aligned to the current quarterly FR Y-15 reporting (which often leverages other regulatory reporting, such as FR Y-9C). Requiring CFO attestation for daily calculation of metrics that are not aligned with other reporting processes (used for current regulatory and public reporting) creates additional burdens on banks where the benefits resulting from requiring daily calculation are less clear.
- Daily averaging would require banks to completely re-design and overhaul the entirety of the firm's reporting controls, systems, processes, and governance frameworks. This could bring into question the reliability of financial reporting and redirect significant resources and capacity away from proactive risk management activities.
- Our analysis suggests that averaging would increase GSIB scores by roughly 1.5% (8 points) indicating that any perceived benefit of daily averaging is small. The estimated 8 points impact is taken from our comment letter.

Indicative Reporting Timeline

One of the primary issues that renders reporting of daily averages on a quarterly basis infeasible has to do with **the amount of time required to gather, validate, and deliver data in the form required for FR Y-15 Reporting**. A step-by-step timeline for obtaining one portfolio day of data for one FR Y-15 line item is described below. To obtain a quarter’s worth of data to average, **this 15+ day process must be repeated for every business day in the quarter, exponentially increasing resource and capacity requirements.**

Calendar Day	Complexity: <i>Level 3 Assets</i>	Interconnectedness: <i>Intra-Financial System Assets and Liabilities</i>	Cross-Jurisdictional Activity: <i>Total Foreign Claims on an Ultimate Risk Basis</i>
1-3	General Ledger is “closed” by the finance team.		
4-8	Approved Data Sources (ADS) responsible for storing balance and transactional data are validated against General Ledger results at the individual counterparty level.		
9-11	Regulatory Reporting team processes ADS data to standardize data received from multiple ADS.		
12-14	Regulatory Reporting team must gather position data and apply leveling and classification data to each asset manually to validate Level 3 status. Certain data is not available daily.	Regulatory Reporting team must manually review all counterparty information and cross-reference with existing lookup tables to determine whether a counterparty is financial or non-financial; New counterparties must be manually researched and classified as FI or non-FI according to existing waterfall logic.	Regulatory Reporting team applies risk transfer analysis/process to standardized ADS data to determine applicable cross-border exposures and eligible cross-border collateral. Example: a cross-jurisdictional transaction was identified earlier in the process because the counterparty was located in France. Upon manual review, the collateral supplied was U.S. Treasury collateral. Thus, this transaction must be excluded from “Total Foreign Claims on an Ultimate Risk Basis” because the collateral is U.S.
15+	Once data has been finalized, adjusted and validated, an averaging process must be run on this portfolio day as well as all of the days in the calendar quarter to determine the quarterly average of daily data.		

Specific Challenge: Interconnectedness



- Regulatory reports use multiple related, but different, definitions of financial institution (FI):
 - FFIEC 009: Non-bank financial institution: “primarily engaged;”
 - FR Y-15: Financial institution: specific list of counterparty types;
 - FR Y-9C: Non-depository financial institution: different specific list of counterparty types; and
 - Capital Rule (12 CFR 217 Section 2): Financial institution: different specific list of counterparty types with ownership test.
- Finance companies are non-bank financial institutions on the FFIEC 009, non-depository financial institutions on the FR Y-9C are not financial institutions on the FR Y-15 and may be financial institutions under the capital rules, depending on an ownership and financial statement test.
 - Each determination of a financial institution requires a different process across reports.
- Some of the counterparty types (e.g. hedge fund) are not clearly defined and therefore require manual review during on-boarding (e.g. we cannot rely on NAICS codes or LEIs).
 - For funds deposited with or lent to other financial institutions, quarter-end data is sourced from regulatory capital processes, which includes the indicative data necessary to identify exposures with other FIs. To move to daily calculation, we would have to eliminate reliance on well-established and controlled quarter-end capital processes and establish new daily data sourcing from systems of record; then apply FR Y-15 transformational logic (e.g., FI Mapping) in order to calculate reportable balances.

Specific Challenge: Interconnectedness

- In sum, differing definitions of financial institutions across regulatory reports make automation highly complex, lack of clear definitions for counterparty types makes manual intervention necessary and these definitional differences combine to make daily calculation overly burdensome.
- **Another example** relates to measuring preferred shares and other forms of subordinated funding not captured in item 15 in the Securities Outstanding portion of the FR Y-15. Banking organizations regularly engage external dealers to ensure an arm's-length valuation of these unlisted securities.
 - A daily requirement would present significant operational challenges because of the dependence on the timely delivery of information from third parties to report accurate data. Given this dependency on external data providers and the amount of time required to receive the external data, well-controlled daily valuations are very challenging.
 - Finally, because an unlisted securities portfolio is granular and comprised of many tranches, providing a daily valuation across all the capital instruments would require a substantial operational burden for third parties and internal stakeholders to attest to the accuracy. The operational challenges of ensuring processes are rigorous enough for a CFO-level attestation are also particularly difficult where current processes require manual data submissions from lines of business or where position-level data sourcing may be required.

Differing definitions of financial institutions across regulatory reports make automated counterparty identification extremely challenging.

Specific Challenge: Complexity

Level 3 Assets: Overview

- Level 3 assets should be left as a Quarterly requirement.
- Level 3 assets are the most difficult types of assets to value and liquidate because they are often highly unique in structure, and there is no active two-way market for trading them. Examples include complex structured derivatives, illiquid loans and mortgage servicing rights.
- Level 3 assets cannot be easily traded in and out of over key reporting dates, and were not featured in Basel's Working Papers on GSIB (either WP41, the 10-year assessment or WP42 on "window dressing"), other than to report that while indicator denominators have grown on average by 42% in nominal terms, the values reported for Level 3 assets declined by 2%*.
- It is unfeasible, as a practical matter, to comprehensively remeasure their value on a daily basis, which would be inconsistent with current SEC reporting requirements (i.e., quarter-end).
 - The 10-Q statutory reporting deadlines for GAAP indicate that the SEC understands the time needed for GAAP disclosures, including for Level 3 assets.
- Increasing Level 3 asset remeasurement from quarterly to daily or monthly would face significant operational constraints, in particular due to:
 - The complexity of determining the significance of unobservable inputs for derivatives, known as 'the significance test'
 - Significant manual processing
 - Increased burden on the governance framework

Specific Challenge: Complexity



Level 3 Assets: Operational Complexities

- The existing U.S. GAAP Fair Value Hierarchy framework involves a complex quarterly process. Banks have stringent governance and escalation requirements that need to be adhered to which is unfeasible for a daily process.
- Level 3 valuation models use unobservable inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset, developed based on the best information available in the circumstances. These are unlikely to change on a daily/monthly basis.
- Per U.S. GAAP, if these unobservable inputs are significant to the overall fair value measurement of the instrument, the instrument is classified as Level 3. Just one significant unobservable input can result in the entire asset being classified as Level 3.
- As such, determining the Fair Value Hierarchy level of an instrument can be arduous due to the application of significance testing - it isn't simply a case of mapping each product to a pre-determined level but rather an instrument level model input-based analysis.
 - Testing the significance of model inputs is a subjective and complex process involving: instrument level sensitivities; defining and applying unobservable parameter shocks; analysis, aggregation, consolidation, and reporting.
 - This process is typically performed by a control function independent of the Front Office and subject to external audit validation.
 - The assessment of significance should remain quarterly to avoid an inaccurate application of the fair value hierarchy

Specific Challenge: Cross-Jurisdictional

- The cross-jurisdictional schedule currently leverages the data found in the Country Exposure Report (FFIEC 009), which is prepared on a quarterly basis. Maintaining the same level of controls necessary for CFO-level attestation for daily calculation of this reporting would be highly complex and would require entirely new reporting and attestation practices.
- **For example**, the foreign claims on a guarantor basis (e.g., ultimate risk) requirement is challenging given that additional, often manual, analysis is required to determine when the ultimate risk is cross-jurisdictional.
 - Currently this determination can be automated from the FFIEC 009 process. If daily averaging was required, firms could no longer retrieve data automatically from FFIEC 009 and would instead have to source daily data from systems of record; then apply FR Y-15 transformational logic to calculate reportable balances based on daily values.
 - For one firm, data is currently sourced directly from 60+ external data providers. These data providers may not have the systems capable of meeting a new daily requirement, which may require updates and redesigns of systems of record.
 - Determining ultimate risk, assigning and determining country of domicile often requires manual intervention to ensure that both counterparty and collateral are cross-jurisdictional.
- **Another example** is a margin loan to a hedge fund domiciled in the Cayman Islands but operating in New York.
 - Often manual intervention is necessary to confirm country of domicile and to adjust from immediate to guarantor basis for the underlying debt and equity securities that are guaranteed by the issuer of the securities.

Specific Challenge: Cross-Jurisdictional



Derivative Exposure

- Derivatives are already included in the Size, Interconnectedness and OTC derivative categories.
- Including foreign derivatives in the score a fourth time is not only repetitive but also overly burdensome, particularly when it comes to the cross-jurisdictional score daily.
- The Agencies themselves have previously acknowledged the complexities and challenges involved in producing this type of data. For example, similar to the FR Y-9C discussed above, banks are given 45 days (or 50 days for the December 31 as of date) to report the FFIEC 009 data.
- It is not feasible for GSIBs to adjust to a daily or even a monthly calculation with the same level of control necessary for CFO-level attestation.

Cross-Jurisdictional data ties directly to the FFIEC 009 which is a quarterly report; requiring daily calculation conflicts with other regulatory reporting standards.

U.S. GSIB NPR Pro-forma

- Current GSIB surcharge as of 4Q23 was 2.69% across banks. Utilizing the most recent 1Q24 reporting would suggest a +0.26% increase in the average score using the bucketing methodology from U.S. NPR.
- Adjusting for changes in FRY-15 likely further increases the score based on QIS compiled by FSF/GARP for U.S. GSIBs. It's not clear what is driving any differences with Fed U.S. NPR estimates due to limited disclosure in the proposal.

U.S. GSIB Assessment				
Bank	Current Surcharge (4Q23)	1Q24 Score	Final B3 U.S. NPR Surcharge	Change
BAC	3.0%	653	3.4%	+0.4%
BONY	1.5%	287	1.5%	0.0%
C	3.5%	733	3.8%	+0.3%
GS	3.5%	721	3.7%	+0.2%
JPM	4.5%	1,009	5.1%	+0.6%
MS	3.0%	627	3.2%	+0.2%
STT	1.0%	215	1.2%	+0.2%
WFC	1.5%	312	1.7%	+0.2%
Average	2.69%		2.95%	+0.26%



Table 2—Proposed Revised Method 2 Surcharge Score Band Ranges

Method 2 score range	Method 2 surcharge		Method 2 score range	Method 2 surcharge	
	Current (percent)	Proposed (percent)		Current (percent)	Proposed (percent)
Less than 189	1.0	1.0	630–649	3.5	3.3
190–209		1.1	650–669		3.4
210–229		1.2	670–689		3.5
230–249	1.5	1.3	690–709		3.6
250–269		1.4	710–729		3.7
270–289		1.5	730–749	4.0	3.8
290–309		1.6	750–769		3.9
310–329		1.7	770–789		4.0
330–349	2.0	1.8	790–809		4.1
350–369		1.9	810–829		4.2
370–389		2.0	830–849	4.5	4.3
390–409		2.1	850–869		4.4
410–429		2.2	870–889		4.5
430–449	2.5	2.3	890–909		4.6
450–469		2.4	910–929		4.7
470–489		2.5	930–949	5.0	4.8
490–509		2.6	950–969		4.9
510–529		2.7	970–989		5.0
530–549	3.0	2.8	990–1009		5.1
550–569		2.9	1010–1029		5.2
570–589		3.0	1030–1049	5.5	5.3
590–609		3.1	1050–1069		5.4
610–629		3.2	1070–1089		5.5
			1090–1109		5.6
			1110–1129		5.7

Update M2 Denominators

- Current U.S. GSIB M2 denominators are based on values from 2012-2013 despite substantial growth in the U.S. economy and banking industry since then.
- By way of analogy, if the SCB was set based on RWA from 2012-2013. A representative U.S. GSIB would see its SCB **increase from ~2.9% today to ~4.0% (~\$99B) simply assuming a constant “denominator” in the SCB buffer**; this is no different than what is occurring with the U.S. GSIB M2 score (most U.S. GSIBs show similar sensitivity of ~+30% increase).
- We recommend adjusting **U.S. GSIB M2 denominators by ~+30% to reflect growth in U.S. banking RWA and the economy (e.g., GDP growth)** since the initial GSIB calibration (reduces coefficients by ~-30%). With this adjustment, U.S. GSIB M2 scores would remain higher than current M1 scores, but the differences would be more in line with the “anticipation of future B3 RWA updates” noted when the initial M2 score was finalized.
- Lastly, although the initial intention of the Method 2 score was to set the Short-Term Wholesale Funding (STWF) weight to represent 20% of a bank’s total GSIB score, similar to other categories, the STWF component ended up with a weight closer to 30% in aggregate, further reinforcing the need to recalibrate the denominators.

Other Alternatives to Daily Averaging

Over-the-Counter (OTC) Derivatives

- Another alternative to reducing the incentive to “window dressing” could be reducing the impact of OTC derivatives (the exposure for which potential window dressing was most evident in the BCBS working paper*) on the overall systemic risk score.
- Under the proposal, OTC derivatives are picked up by four indicators: size, complexity, interconnectedness and cross-jurisdictional activity. This framework design creates an undue incentive to reduce OTC derivative exposures to reduce scores. Arguably, fixing this distortion would also reduce any incentive to window-dress.