Bank Capital and Related Developments

March 2014
BASEL III: Overview
Overview

• Basel III agreed internationally December 2010
  • Minimum capital requirements (quality, quantity, buffers)
  • Leverage ratio
  • Liquidity ratios
  • Counterparty credit risk
• January 2011 – BCBS published minimum requirements for loss absorbency of regulatory capital at the point of non-viability
• BCBS/FSB finalized G-SIB and D-SIB rules and assessment methodology
• Liquidity Coverage Ratio finalized January 2013
• Margin for non-centrally cleared OTC derivatives finalized in September 2013
Overview (cont’d)

• Basel framework also introduces:
  • an international leverage ratio
  • international standards for liquidity: LCR and NSFR
Recent actions

• In Dec 2013, the BCBS published a second consultation on changes to rules for banks to calculate credit risk capital requirements for securitization exposures
• The comment period closed earlier this March
• Generally, the proposal would:
  • Increase risk weights for highly rated securitization exposures
  • Decrease risk weights for lower-rated securitization exposures
  • Vary risk weights based on maturity
  • Establish a floor: any securitization exposure subject to a 15% risk weight floor
  • Permit internal-ratings based approach as well as a standardized approach
Recent actions

- In January 2014, the BCBS published an amended text for the Basel III Leverage Ratio
- Also published disclosure requirements
- Set at 3%
  - Numerator: Tier 1 capital
  - Denominator: Exposure measure
  - Exposures: include on-balance sheet assets (collateral), derivatives exposures, securities finance transactions (repo, reverse repo, etc.), and “other” off-balance sheet exposures (LCs, guarantees, etc.)
- Criticisms of the original Leverage Ratio led to some modifications
Recent actions

- Also in January 2014, the BCBS released as a consultation the NSFR framework.
- The NSFR looks at the stability of available funding and the duration of assets. The amount of stable funding that is required would depend on the type of asset (assets are assigned a stable funding factor) and the liquidity of the asset under stressed market scenarios. More stable funding is required for less liquid assets.
- The NSFR is calculated by dividing the bank’s available stable funding (numerator) by its required stable funding (denominator), and the ratio must always be greater than 1.
  - Required Stable Funding looks at the maturities of the bank’s assets and its off balance sheet exposures and assigns a category to these.
  - Available Stable Funding looks at the portion of capital and liabilities that are expected to be “reliable” over a one-year period.
Basel in 2014

- What should you expect in 2014:
  - Net Stable Funding Ratio: finalizing details
  - Measuring and controlling large exposures
  - Completing the review of the trading book requirement
  - Enhancing the treatment of securitizations
  - Revising the supervisory framework
U.S. Basel Implementation
U.S. Final Capital Rules

• In July 2013, the Federal banking agencies formally adopted final regulations that establish a new regulatory capital framework for U.S. banking organizations which implements the Basel framework.

• The Final Rules have three major elements:
  • Application of the Basel III minimum capital requirements and components of required capital to almost all U.S. banking organizations.
  • Application of a variation of the Basel II/III “Standardized Approach” for credit risk weightings to almost all U.S. banking organizations.
  • Changes to the Basel III “Advanced Approaches” framework that applies to large U.S. banking organizations.
Minimum Capital Requirements

• Applicability:
  • All U.S. banks that are subject to minimum capital requirements, including Federal and state savings banks.
  • Bank and savings and loan holding companies other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than $500 million).
  • Top-tier domestic bank and savings and loan holding companies of foreign banking organizations.

• Excluded from coverage:
  • Foreign banking organizations.
  • (Temporarily) Savings and loan holding companies substantially engaged in insurance underwriting or commercial activities (change from Proposed Rules).
Minimum Capital Requirements (cont’d)

• Components of capital
  • Tier 1 capital — common equity Tier 1 capital and additional Tier 1 capital.
  • Total Tier 1 capital, plus Tier 2 capital, would constitute total risk-based capital.

• Proposed criteria for common equity and additional Tier 1 capital instruments, and Tier 2 capital instruments, are broadly consistent with the Basel III criteria. In certain instances, the U.S. standards are more onerous.
Minimum Capital Requirements (cont’d)

• Regulatory capital adjustments – CET 1
  • Accumulated net gains/losses on specified cash flow hedges included in AOCI.
  • Unrealized gains and losses on AFS securities.
    • Unrealized gains on AFS securities includable in Tier 2 would be eliminated.
  • Unrealized gains and losses resulting from changes in banking organization creditworthiness.

• Change from Proposed Rules: non-Advanced Approaches banking organizations are permitted to elect a one-time “opt out” (at the time March 31, 2015 call report or FR Y-9C is filed) not to include most AOCI components in CET1 regulatory capital adjustments.
Minimum Capital Requirements (cont’d)

• Deductions from CET 1 capital
  • Goodwill, net of associated deferred tax liabilities (“DTLs”).
  • Intangible assets other than mortgage servicing assets (“MSAs”), net of associated DTLs.
  • Deferred tax assets (“DTAs”).
  • Securitization gain-on-sale
  • Defined benefit plan assets (excluding those of depository institutions (“DIs”)).
  • Advanced approaches banks: expected credit losses exceeding eligible credit reserves.
  • Savings association impermissible activities.
  • Items subject to 10%/15% CET 1 capital thresholds (certain DTAs, MSAs, significant unconsolidated FI common stock investments).
Minimum Capital Requirements (cont’d)

- Deductions from Tier1/Tier 2 capital
  - Direct and indirect investments in own capital instruments.
  - Reciprocal cross-holdings in financial institution capital instruments.
  - Direct, indirect and synthetic investments in unconsolidated financial institutions. Three basic types:
    - Significant Tier 1 common stock investments.
    - Significant non-common-stock Tier 1 investments.
    - Non-significant investments (aggregate 10% ceiling).
Minimum Capital Requirements (cont’d)

- New minimum capital requirements
  - CET 1 capital ratio to standardized total risk-weighted assets (“TRWA”) of 4.5 percent.
  - Tier 1 capital ratio to standardized TRWA of 6 percent.
  - Total capital ratio to standardized TRWA of 8 percent.
  - Tier 1 leverage ratio to average consolidated assets of 4 percent.
  - Advanced Approaches banking organizations must use lower of standardized TRWA or Advanced Approaches TRWA.
  - For Advanced Approaches banking organizations, a supplemental leverage ratio of Tier 1 capital to total leverage exposure of 3 percent.
- CET 1 capital ratio is a new minimum requirement.
- These minimum capital ratios are unchanged from the Proposed Rules.
Minimum Capital Requirements (cont’d)

• Leverage requirement
  • Ratio of Tier 1 capital (minus required deductions) to average on-balance sheet assets for all U.S. banking organizations.
• Supplementary leverage requirement which we discuss later
Minimum Capital Requirements (cont’d)

• Capital conservation buffer
  • A new phased-in capital conservation buffer for all banking organizations equal to a ratio to TRWA of 2.5% common equity Tier 1 capital.

• Countercyclical capital buffer
  • A macro-economic countercyclical capital buffer of up to 2.5% of common equity Tier 1 capital to TRWA applicable *only* to advanced approaches banking organizations.
Minimum Capital Requirements (cont’d)

- Effective dates/transitional periods – numerator
  - Minimum capital ratios
    - Minimum CET 1, Tier 1 and total capital: January 1, 2015 for banks other than Advanced Approaches banks, and Advanced Approaches SLHCs; no phase-in.
    - January 1, 2014 for Advanced Approaches banks with a one calendar year transition (4.0 percent CET1, 5.5 percent Tier 1, and 8.0 percent total capital during the calendar year 2014).
  - Regulatory capital adjustments and deductions—transitions begin as follows and generally end as of January 1, 2018
    - January 2015 for banks other than Advanced Approaches banks, and Advanced Approaches SLHCs.
    - January 1, 2014 for Advanced Approaches banks.
    - Note: goodwill deduction is fully effective in 2015 (banking institutions other than Advanced Approaches banks) or January 1, 2014 (Advanced Approaches banks); no phase-in period.
Minimum Capital Requirements (cont’d)

- Effective dates/transitional periods—numerator
  - Non-qualifying capital instruments:
    - BHCs of $15 BB+ in assets—January 1, 2015.
    - BHCs under $15 BB and all DIs – January 1, 2015 (but note grandfathering of TruPS and cumulative perpetual preferred stock).
  - Capital conservation buffer (all banking organizations) and countercyclical capital buffer (Advanced Approaches banks), and related payout ratios are subject to a phase-in period.
    - Transition begins January 1, 2016 and ends as of January 1, 2019.
  - Supplemental leverage ratio for Advanced Approaches banks.
    - January 1, 2018; calculation and reporting required beginning January 1, 2015.
  - PCA changes: January 1, 2015; no phase-in.
Risk-Weighting Standardized Approach

- **Applicability**
  - All banking organizations.

- **Effective date**
  - January 1, 2015; there is no-phase-in for the new risk-weightings.

- **Core features of the standardized approach**
  - Improved sensitivity to credit risk.
  - Elimination of reliance on credit ratings.
  - Behavior modification.
  - “Lessons learned” from the financial crisis.

- Banks that are subject to the market risk capital rules also must compute their market risk-weighted assets in addition to their Standardized Approach risk-weighted assets.
Standardized Approach (cont’d)

- Risk weights – 11 broad asset classes:
  - Residential mortgages
  - Commercial lending – “high volatility” CRE loans
  - Corporate exposures
  - Off-balance sheet exposures
  - OTC derivatives
  - Cleared transactions
  - Unsettled transactions
  - Securitization exposures
  - Equity exposures
  - Sovereign, public sector entities (“PSEs”) and foreign bank exposures
  - Other assets
Disclosure Requirements

- Applicability
  - Top-tier banks with more than $50 billion in consolidated assets but not subject to Advanced Approaches.
  - Advanced Approaches banks are subject to more detailed disclosure requirements.
- Disclosure elements – qualitative and quantitative
- Formal disclosure policy is required
- Quarterly disclosure is the core requirement
  - Disclosure templates are provided.
- Location(s) of disclosures
  - May be provided on in one place (bank web site) or in more than one financial reports (with public summary table).
- Treatment of nonpublic information
- Effective date: January 1, 2015 (2014 for Advanced Approaches banks).
Advanced Approaches

- Applicability and coverage:
  - Applies to banking organizations that are subject to the Basel II “Advanced Approaches” rules as implemented in the U.S.
    - Consolidated total assets of $250 billion or more; or
    - Consolidated total on-balance sheet foreign exposure of $10 billion or more.
  - Covers banking organizations that meet size thresholds, and covered savings institutions and their holding companies.
  - Addresses counterparty credit risk, removal of credit rating references, securitization exposures, changes in treatment of certain exposures previously subject to deduction, and conforming technical changes.
- Effective date: January 1, 2014; no phase-in period.
Advanced Approaches (cont’d)

• Changes to counterparty credit risk
  • Additional capital requirement for credit value adjustments relating to OTC derivatives exposures.
  • Changes the capital requirements for qualifying and other central counterparty ("CCP") exposures, including capital calculations for CCP default fund contributions.
  • Requires application of a continuous 12-month stress period in calculating market price and foreign volatility exposures under the collateral haircut method, based on internal estimates.
• Removal of credit rating references
• Changes to securitization exposures
Market Risk Rule Changes

- Essentially add on amendments to changes in the market risk rule adopted in August 2012. Changes include:
  - Making federal and state savings banks and their holding companies that meet the market risk capital rule threshold subject to the market risk rule.
  - Includes any savings association or covered SLHC whose trading activity (the gross sum of its trading assets and trading liabilities) is equal to 10 percent or more of its total assets or $1 billion or more.
  - Applies as of January 1, 2015.
LCR

- In October 2013, the banking agencies issued the LCR proposal; comment period closes on January 31, 2014
- U.S. version of LCR is more stringent than Basel LCR
- FBOs are not affected
- Two “versions” of LCR: full LCR for large, internationally active banks, and LCR light for other large bank holding companies and S&L holding companies
- LCR would become effective January 1, 2015 (before Basel LCR date) subject to two-year phase-in period
LCR (cont’d)

• Full LCR applies to: advanced approaches banks ($250b in total consolidated assets or $10b or greater in on-balance sheet foreign exposures); non-bank SIFIs not substantially engaged in insurance underwriting activities; other institutions made subject to LCR

• LCR Light: depository institutions with $50b or less in total consolidated assets that are not: grandfathered SLHCs deriving 50% or greater of total assets or revenues from activities not financial in nature; insurance underwriting companies; or holding 25% or greater of total assets in insurance underwriting subsidiaries
LCR (cont’d)

• LCR requires HQLA stock to be at least 100% of its total net cash outflows over a 30-day standardized liquidity stress scenario
• HQLAs are categorized as Level 1, Level 2A and Level 2B
  • No limit on Level 1 assets
  • Level 2 assets are capped at 40% of HQLAs; Level 2B assets are capped at 15% of total HQLAs
Level 1 assets are not subject to haircuts. These include: excess reserves held at Fed, US Treasuries, securities guaranteed by full faith and credit of US government, etc.

Level 2A assets are subject to a 15% haircut. These include: Agency securities, claims on or guaranteed by a sovereign entity or multilateral development bank.

Level 2B assets are subject to a 50% haircut. These include: certain publicly traded corporate debt securities issued by non financial companies; certain publicly traded equities of non financial companies.
Enhanced prudential standards

• Final Rule incorporates previously-issued capital plan and stress test requirements
  • Capital plan rule adopted in 2011 imposes enhanced risk-based and leverage capital requirements on $50BB BHCs, and requires submission of an annual capital plan to the Board that demonstrates ability to maintain capital above minimum ratios under baseline and stressed conditions
  • DFA Section 165(i)(1) rules adopted in 2012 require $50BB BHCs and NBFCs to conduct annual supervisory and semi-annual company-run stress tests
  • DFA Section 165(i)(2) rules adopted in 2012 require $10BB BHCs and SLHCs and banks with more than $10BB in total consolidated assets to conduct annual company-run stress tests
Enhanced prudential standards

• Enhanced prudential standards generally apply to $50BB BHCs
• $10BB BHCs that are publicly traded are subject to risk committee requirements
• $10BB BHCs and SLHCs and banks with more than $10BB in total consolidated assets are subject to annual company-run stress test requirements
## Summary

<table>
<thead>
<tr>
<th>Size</th>
<th>Requirements</th>
<th>Subpart of Final Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10BB BHCs and SLHCs and banks with more than $10BB in total consolidated assets</td>
<td>Company-run stress tests</td>
<td>Subpart B</td>
</tr>
<tr>
<td>$10BB BHCs that are publicly traded</td>
<td>Risk committee</td>
<td>Subpart C</td>
</tr>
</tbody>
</table>
| $50BB BHCs | Risk-based and leverage capital  
Risk management  
Risk committee  
Liquidity risk-management, stress-testing and buffers | Subpart D |
|  | Supervisory stress tests | Subpart E |
|  | Company-run stress tests | Subpart F |
|  | Debt-to-equity limits (upon grave threat determination | Subpart U |
| NBFCs | Supervisory stress tests | Subpart E |
|  | Company-run stress tests | Subpart F |
Over $50bn

• Must comply with, and hold capital commensurate with the requirements of, any regulations adopted by the Board relating to capital planning and stress tests”

• Capital Plan Rule (issued Dec. 2011)
  • Must submit annual capital plan to the Board that demonstrates ability to maintain capital above the minimum risk-based capital ratios under expected conditions and stressed scenarios over a minimum nine-quarter, forward-looking planning horizon
  • Companies with unsatisfactory capital plans face limits on ability to make capital distributions

• Stress Test Rule
  • Defines tier 1 common ratio by cross-reference to the capital plan rule
  • Capital plans must reflect the results of company-run stress tests using the scenarios provided under the DFA stress test rules
  • Supervisory and company-run stress test results alone will not sufficiently address all relevant outcomes that should be covered in a satisfactory capital plan (although such results will be considered in the Board’s evaluation of the capital plan)
Over $50bn (cont’d)

- Basel III regulatory capital framework (discussed earlier)
- Capital framework was integrated into the capital plan and stress test rules
Liquidity: $50BB BHCs

• Establish and maintain a contingency funding plan
• Conduct monthly (or more frequently as the Board may require) liquidity stress tests
  • Must include, at a minimum, scenarios reflecting:
    • Adverse market conditions
    • Idiosyncratic stress event
    • Combined market and idiosyncratic stresses
  • Must be tailored to, and provide sufficient detail to reflect, a BHC’s capital structure, risk profile, complexity, activities and size
  • Policies, procedures and controls (including management information systems) for liquidity stress testing are required
• Must maintain liquidity buffer of unencumbered “highly liquid assets”
  • Must be sufficient to meet projected net stressed cash-flow need over 30-day planning horizon
Liquidity: $50BB BHCs (cont’d)

• Senior management must:
  • Establish and implement strategies, policies and procedures designed to effectively manage liquidity risk
  • Establish liquidity risk limits
  • Oversee the development and implementation of liquidity risk measurement and reporting systems
  • Approve new products and business lines based on liquidity risk
  • Periodically review the independent review function
Liquidity: $50BB BHCs (cont’d)

• Senior management must, at least quarterly:
  • Determine compliance with strategies, policies and procedures governing liquidity risk management and liquidity stress testing
  • Determine compliance with liquidity risk limits
  • Report the liquidity risk profile and liquidity risk tolerance to the board of directors or risk committee
  • Review cash-flow projections and liquidity stress testing results
  • Approve liquidity buffer
  • And upon material revision, approve liquidity stress testing practices, methodologies and assumptions
Liquidity: $50BB BHCs (cont’d)

• Board of directors must:
  • Annually approve the BHC’s liquidity risk tolerance, taking into account the capital structure, risk profile, complexity, activities and size of the BHC
  • Review information provided by senior management at least semi-annually to determine compliance with liquidity risk tolerance
  • Approve and periodically review the liquidity risk-management strategies, policies and procedures established by senior management

• Risk committee (or a designated subcommittee thereof composed of members of the board of directors) must:
  • Approve the contingency funding plan at least annually or upon revision
Debt-to-Equity Limits

• All U.S. BHCs:
  • A conditional debt-to-equity limit of not more than 15-to-1, upon a determination by the U.S. Financial Stability Oversight Council that a BHC poses a “grave threat” to U.S. financial stability, and that the debt-to-equity limit is necessary to mitigate that risk
  • A company generally would be expected to make a good faith effort to increase equity capital through limits on distributions, share offerings, or other capital raising efforts prior to liquidating margined assets in order to achieve the required ratio
Anticipated U.S. developments in 2014

- Supplementary leverage ratio to be finalized
- LCR to be finalized
- Items that were deferred (like single-counterparty credit limits, remediation standards) to be addressed
- New regulatory requirements to be proposed
Supplementary leverage ratio

- In July 2013, the banking agencies released a notice of proposed rulemaking seeking comment on a proposal for a new minimum supplementary leverage ratio that takes into account off-balance-sheet exposures for the eight largest, most internationally active banks.
- Applies only to advanced approaches banking organizations. BHCs with more than $700 billion in assets or $10 trillion in assets under custody would be required to maintain a Tier 1 capital leverage buffer of at least 2% above the minimum supplementary leverage ratio requirement of 3% for a total of 5%.
- Ratio of Tier 1 capital (minus required deductions) to average on-balance sheet assets, plus certain off-balance sheet assets and exposures:
  - Future exposure amounts arising under certain derivatives contracts.
  - 10% of notional amount of unconditionally cancelable commitments.
  - Notional amount of most other off-balance sheet exposures (excluding securities lending and borrowing, reverse repurchase agreement transactions, and unconditionally cancelable commitments).
Supplementary leverage ratio (cont’d)

• Should this minimum be breached, regulators would impose restrictions on discretionary bonus payments and capital distributions.

• Moreover, the proposed rule would include a minimum 6% supplementary leverage ratio at the insured depositary institutions of the BHCs to be considered "well capitalized" for prompt corrective action purposes.

• The effective date for these requirements would be Jan. 1, 2018.
Additional U.S. requirements

- **Long-term debt requirement:**
  - A requirement for large internationally active financial institutions to have minimum amounts of long-term unsecured debt outstanding to absorb losses
  - Expectation is that this will help counteract moral hazard by providing sufficient equity/debt to absorb losses in an insolvency—sufficient to capitalize a bridge bank and sufficient to avoid taxpayer losses
  - Tarullo has discussed that this requirement might be met by debt convertible by its terms to equity (contingent capital)
Additional U.S. requirements (cont’d)

- Measures to address reliance on short-term wholesale funding:
  - Regulators have noted that risks may arise in connection with short-term financing transactions, such as repo, reverse repo, securities borrowing and hedging transactions, and margin loans
  - Reliance on short-term funding may lead to fire sales/runs
  - Alternatives that have been discussed include:
    - Requiring a liquidity linked capital surcharge or tax
    - Modifying liquidity regulation
    - Imposing a universal margining requirement
Issuance activity

• US banks are limited in the types of securities that they may issue
• Financial institutions issued approx $475b in 2013; an increase over 2012
• US banks overwhelmingly issued debt securities—5 and 10-year maturities dominated. Some floating rate issuance.
• More BHCs funded at the bank level (approx. $37.3 bn in 2013, up 338% from 2012)
• Most of the redemptions of hybrids had occurred in 2012; during last half of 2013, there was some issuance of new non-cumulative perpetual preferred (approx $8bn)
• The most interesting development was the issuance activity undertaken by foreign (non US) banks. Foreign banks were active issuers into the US market. They issued subordinated debt as well as AT1 securities.
• The AT1 market continues to evolve
Issuance activity

• European banks have found significant investor interest in principal write down securities as well as in debt convertible into equity securities
  • There is little standardization of the market yet
  • Some “low” trigger issuance; some “high” trigger issuance
  • Not clear that investors are demanding pricing differences
• In Europe, the BRRD has been finalized
  • We will continue to see additional issuance of AT1 and T2 securities by European banks
Interaction of various requirements

- Banks are still assessing the various interactions resulting from the requirements that have been finalized.
  - The “cumulative” effect of these requirements will not be felt for some time; however, it is apparent that at least in certain respects, the requirements may create somewhat inconsistent incentives or disincentives for banks.