KEY POINTS

- Implementation of the Basel III framework has resulted in significantly higher capital requirements for US banks, as well as new liquidity measures.
- US banking agencies have focused on the simplicity of regulatory capital and discourage reliance by US banks on short-term wholesale funding.
- In order to facilitate orderly resolution of US banks through the single-point of entry approach outlined in the Dodd-Frank Act, US banking agencies will require that US banks that are globally systemically important banks, or G-SIBs, maintain certain minimum required amounts of long-term debt and of total loss-absorbing capital at the holding company, which will be required to function as a true holding company with limited activities and obligations.
- US banks will have to reevaluate how they finance their activities in order to comply with the totality of these requirements

Spotlight

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Fewer options for capital-raising by banks: more stability?

This Spotlight article describes the various regulatory requirements, including the regulatory capital requirements, long-term debt and total loss-absorbing capacity requirements, and liquidity measures, applicable to US banks and the manner in which these will affect how US banks finance their activities going forward.

Behavioural psychologists historically posited that, for individuals, having a broader array of choices can be empowering. However, other such studies have shown that too many choices results in sensory overload and inaction. For example, in connection with retail sales, a retailer that presents fewer choices increases its sales. Simpler is better. Will the same principles hold in banking? Will fewer capital-raising options lead to better results? Following the financial crisis, regulators around the world were concerned about the complexity of bank balance sheets. Funding tools had proliferated resulting in a lack of transparency. Banks relied, perhaps too heavily, on structured instruments that qualified for Tier 1 capital treatment. Many of these products failed to provide the type of loss-absorbency that was required to meet the needs of banks in a crisis. Also, during the financial crisis, the commitments and contingencies that had to be met by banks with little access to the capital markets surprised many. The Basel III framework improves the quality, consistency and transparency of the capital base, strengthens risk coverage through enhanced capital requirements for counterparty credit risk, implements changes to the non-risk adjusted leverage ratio, and adopts measures intended to improve the countercyclical capital framework. Basel III also implements a leverage ratio and introduces various liquidity measures. Finally, it establishes a requirement for loss-absorbing instruments to avoid the need for future taxpayer injections and facilitate the orderly resolution of failed banks. As discussed below, each requirement suggests a particular response. Often, the various requirements result in conflicting imperatives. Banks will have to adjust quite dramatically the manner in which they fund their activities and the nature of their activities to address the totality of these changes.

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REGULATORY CAPITAL REQUIREMENTS

In 2013, US banking agencies approved revisions to the regulatory capital rules applicable to all US banks and bank holding companies (except those with less than $500m in total consolidated assets). These new rules, which are being phased in through 2019, introduce Basel III standards for the components of, adjustments to, and deductions from, regulatory capital, as well as new minimum ratios under the US prompt correction action framework. US banks and bank holding companies are subject to the following minimum regulatory capital requirements: a common equity Tier 1 capital ratio of 4.5%; a Tier 1 capital ratio of 6%; a total capital ratio of 8% of total risk-weighted assets; a Tier 1 leverage ratio of 4%; and, for those US banks and bank holding companies subject to the advanced approaches rule, an additional leverage ratio of Tier 1 capital to total leverage exposure of 3%. The rules also introduced regulatory capital buffers above the minimum common equity Tier 1 ratio, including a capital conservation buffer of a further 2.5% of common equity Tier 1 capital to risk-weighted assets and, for those US banks and bank holding companies subject to the advanced approaches rule, a countercyclical buffer of up to 2.5% of common equity Tier 1 capital to risk-weighted assets that may be deployed as an extension of the capital conservation buffer. US banks that are globally systemically important banks, or G-SIBs, are subject to an additional capital surcharge, which is intended to mitigate the risk of harm resulting from a failure of a G-SIB. The US version of the G-SIB surcharge also penalises banks that rely on short-term wholesale funding.

Spotlight

In part in an effort to promote transparency, Basel III narrows the types of instruments that qualify for Tier 1 capital and establishes prescriptive criteria to be met for instruments to be considered Tier 1 or Tier 2 capital. In addition, Basel III introduces a series of regulatory capital deductions, which discourage banks from engaging in certain activities or generating certain types of assets. Regulatory deductions are required from common equity Tier 1 for, among other things, goodwill, net of associated deferred tax liabilities, deferred tax assets, and securitisation gain on sale. Deductions from Tier 1 and Tier 2 capital are also required for direct and indirect investments in the issuer's own capital instruments, as well as for reciprocal cross-holdings in financial institution capital instruments, and direct and indirect investments in unconsolidated financial institutions. In the US, we have already seen banks dispose of certain assets, such as mortgage servicing assets, and exit certain business lines.

The higher capital requirements, and the reduced number of "tools", encourage banks to focus more closely on the incremental cost of capital associated with particular activities. In the US, banks generally must satisfy their Tier 1 requirements through the issuance of common stock or non-cumulative perpetual preferred stock, which, generally are more "expensive" means of raising capital. Innovative hybrid securities, like trust preferred securities or mandatorily convertible instruments, which permitted banks to raise capital on a tax efficient basis and obtain equity credit from the rating agencies, are no longer viable. US banks cannot issue instruments that are classified as debt securities, such as certain types of contingent capital instruments, for additional Tier 1 capital purposes.

LONG-TERM DEBT AND TOTAL LOSS-ABSORBING CAPACITY

Banks can, of course, continue to issue debt securities to finance their activities. Given the existence of the orderly liquidation authority framework under Title II of the Dodd-Frank Act, investors have now been made aware that the holders of unsecured debt issued by bank holding companies may bear losses (or be "bailed in") in the event of a bank failure. In fact, Title II requires that the bank holding company (BHC) be liquidated with losses imposed on the stockholders and creditors of the BHC. Stockholders of the BHC would bear the first losses and the claims of holders of the BHC's long-term debt obligations would be converted into equity that would be used to capitalise the successor entity, the bridge financial company. The bridge financial company would initially be capitalised by the bail-in of outstanding long-term debt of the failed BHC, which presumes that sufficient long-term unsecured debt would be outstanding at the holding company level in order to stabilise the bridge financial company. US G-SIBs will be required to maintain a minimum amount of loss-absorbing instruments (TLAC), including capital and a minimum amount of unsecured long-term debt, in order to capitalise this bridge institution. Eligible long-term debt will be unsecured, "plain vanilla" debt issued by the US G-SIB that has a remaining maturity of at least one year and is governed by US law. Total TLAC would be the sum of the entity's Tier 1 capital issued directly by the BHC and its eligible long-term debt. Tier 2 capital that meets the definition of eligible external long-term debt would count toward the external TLAC requirement. In addition, proposed regulations would limit the liabilities and obligations of a US G-SIB in order to ensure that it will be a "clean holding company" that can be resolved without systemic disruption. For example, a US G-SIB would be prohibited from incurring short-term liabilities, entering into certain derivatives and other qualified financial contracts, and guaranteeing obligations of subsidiaries. A US G-SIB's liabilities (other than eligible external TLAC and other than eligible external long-term debt) that are *pari passu* with or junior to its eligible external long-term debt would be capped at a maximum of 5% of the value of the entity's TLAC. This limitation would apply only at the holding company level and not to subsidiaries of the holding company.

The Financial Stability Board (FSB) also appears to have come to agreement on its requirements for TLAC. A TLAC term sheet published by various media outlets indicates the FSB will establish solely a TLAC requirement, not a long-term debt requirement. The types of instruments that would be considered "TLAC eligible" are consistent with the US proposed requirement for "plain vanilla" long-term debt. Both the FSB requirement and the US proposal would not require all G-SIBs to meet the applicable requirement with structured notes. In the US, for this purpose, a "structured note" is defined as a debt instrument that:

- has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of a reference asset or embedded derivative;
- has an embedded derivative that is linked to one or more reference assets;
- does not specify a minimum principal amount due upon acceleration or early termination; or
- is not classified as debt under US GAAP.

The proposed prohibition, therefore, applies both to principal protected and to non-principal protected structured notes; however, the definition expressly excludes non-dollar dominated instruments as well as some rate-linked notes, such as floating rate notes linked to LIBOR. Generally, structured products have been issued and sold to an investor base different from that which has purchased benchmark debt of bank holding companies. As a result, the issuance of structured notes has enabled bank holding companies to diversify their investor base. Funding diversification may not be possible when substantially all debt securities will be required to be "plain vanilla" debt that may be bailed-in.

Although European banks have found significant investor appetite for contingent capital, or debt securities that become convertible for equity upon the breach of specified regulatory capital triggers, it is unclear how US investors will react to long-term debt and TLAC instruments of G-SIBs. Will investors understand how to value these securities? Or will they distinguish

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among the various types of bank instruments that have been introduced in recent years? European banks have issued "low trigger" and "high trigger" debt securities that become convertible into equity upon a breach of the applicable regulatory capital trigger, as well as debt that includes a principal write-down feature. European G-SIBs will also be subject to a TLAC requirement (but not a long-term debt requirement) so investors in the securities of European banks may have an even broader array of options. Given that these requirements are new, it is difficult to anticipate how banks will address them. It is, however, fair to say that meeting these new standards will require a rethink of funding strategies. This is only one side of the equation. US banks will be subject to liquidity measures that will also affect their capital-raising decisions.

LIQUIDITY MEASURES

Although US banks have long been subject to liquidity requirements, until recently, these requirements were not formalised. As part of the Basel III framework, banks now must now address the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). These two liquidity measures create complex and often conflicting incentives that affect a bank's approach to funding, as well, of course, as its willingness to undertake certain commitments. Banks will necessarily reevaluate their assets and liabilities in order to comply with these liquidity requirements.

The calculation of the LCR can be reduced to the following formula: HQLAs/Total Net Cash Outflow Amount ≥ 1. In the US, the LCR requires banking organisations with $250bn or more in consolidated assets and trust depository institution subsidiaries with more than $10bn in consolidated assets to maintain high quality liquid assets (HQLAs) sufficient to satisfy the projected net outflows computed under the rule. US and European regulators have come to differing conclusions as to which assets are of sufficiently high credit quality and sufficiently liquid to be included within the HQLA categorisation. HQLAs are grouped into three classes: Level 1, Level 2A and Level 2B assets. Level 1 assets receive 100% credit. Level 2A assets receive 85% credit. Level 2B assets receive 50% credit. Each of Level 2 assets and Level 2B assets are capped at a specified percentage of a bank's HQLAs. A bank's HQLAs must be capable of being liquidated within the 30-day measurement period in order to meet the bank's potential outflows.

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The Total Net Cash Outflow Amount is calculated by summing up total cash outflows over the 30-day period, subtracting the total cash inflows over the same period, and then, in the US, applying a maturity mismatch add-on. Cash inflows are subject to a 75% haircut so that even if inflows would match outflows in practice, a cushion of HQLAs is necessary. In order to determine inflows and outflows, a bank must measure the maturity of transactions under a prescribed set of assumptions, then apply inflow and outflow rates based on the transaction type and the maturity of the transaction. Inflow and outflow rates generally assume that all contingencies, such as option exercises, go against the institution. The resulting gap between inflows and outflows must be covered by HQLAs. The LCR calculation generally would tend to have the effect of encouraging banks to hold more liquid and lower yielding assets even though other regulatory measures, such as the supplemental leverage ratio, may discourage a bank from holding these same assets.

The NSFR, by contrast, looks at the stability of available funding and the duration of assets over a one-year time horizon. Although the Basel III NSFR standards have been released, in the US, the banking agencies have not yet addressed implementation of this requirement. It is fair to assume that the standard that will be applicable to US banks will be similar to, and perhaps more onerous than, the Basel III standard. A bank can calculate its NSFR by dividing its available stable funding (ASF) by its required stable funding (RSF). It must maintain a ratio equal to or greater than 100% at all times. ASF and RSF items are assigned multipliers that are intended to reflect the stability of liabilities and varying liquidity of assets. The NSFR specifies the amount of stable funding required to be maintained based on the type of asset. In arriving at these amounts, a number of judgements are made regarding which funding sources are believed to be most stable and which assets are believed to be most liquid under stress scenarios.

A bank would be required to assess its funding strategies, as well as its lending activities in order to address these requirements. As a general matter, compliance with the NSFR would create an incentive to place greater reliance on long-term deposits and longer term funding. At the same time, a bank also would want to reduce its longer term commitments and obligations.

CONCLUSION

Current and proposed requirements will change fundamentally the types of activities that will continue to be conducted within bank groups, as well as the way in which banks, especially those that are G-SIBs, fund their remaining operations. We should all hope that simplicity by reducing choice leads to greater stability. ■

Further Reading:

- Reinventing financial regulation: sanity is not statistical [2015] 3 JIBFL 134.
- The difference between the impact of Basel III and CRD IV on a lender's funding costs [2014] 10 JIBFL 672.
- LexisNexis Financial Services blog: What next for the Basel III leverage ratio framework?