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THE FEDERAL RESERVE'S NEW TAKE ON BANK CAPITAL: TWO MODEST, BUT THOUGHTFUL, PROPOSALS

To Our Clients and Friends:

Last week, the Board of Governors of the Federal Reserve System (Federal Reserve) issued two proposals relating to capital requirements for large banking organizations that provide a glimpse into its thinking on recalibrating post-Financial Crisis regulation. Not at all radical, they appear driven by two principal, and beneficial, goals – simplifying the complex maze of regulations that grew out of the Dodd-Frank Act, and seeking to tailor regulation more closely to the risks posed by particular organizations. At the same time, however, the "new" Federal Reserve's approach shows more continuity with the Yellen Federal Reserve than a drastic departure.

The first proposal (Stress Buffer Proposal) would simplify the capital rules that are applicable to bank holding companies (BHCs), including intermediate holding companies of non-U.S. banks, that have $50 billion or more in total consolidated assets. The second proposal (eSLR Proposal) would lower the enhanced supplementary leverage ratio (eSLR) that is applicable only to U.S. globally systemically important BHCs (G-SIBs) and their insured bank subsidiaries.

The Federal Reserve will be taking comments on the Stress Buffer Proposal for 60 days, and on the eSLR Proposal for 30 days, in each case after publication in the Federal Register.

Stress Buffer Proposal: Simplifying Capital Rules Applicable to Large Banking Organizations

At the heart of the Financial Crisis lay a very significant capital problem: there was an insufficient amount of capital in the banking system to absorb losses, and certain capital instruments did not end up having the loss absorbency that regulators originally contemplated. As a reaction, the Basel III capital regime and the Federal Reserve, acting under its authority to adopt enhanced prudential standards under Section 165 of the Dodd-Frank Act, substantially increased the amount of capital that large banking organizations are required to hold – but the rules that were adopted did not take into account their cumulative effects.

The result of multiple rulemakings was therefore a hodgepodge of requirements, described with some flair earlier this year by the Federal Reserve's Vice Chairman for Supervision, Governor Randal Quarles:

> There are different ways to count the number of loss absorbency constraints that our large banking firms face – which is perhaps in itself an indication of a surfeit of complexity if we can't be perfectly sure of how to count them – but the number I come up with is 24 total requirements in the framework. While I do not know precisely the socially optimal

> number of loss absorbency requirements for large banking firms, I am reasonably certain that 24 is too many.[1]

The Stress Buffer Proposal addresses this concern and would reduce the number of loss absorbency requirements to 14 – which still may be above a "socially optimal" number – by tying minimum capital requirements into the Federal Reserve's CCAR and stress testing process.

Under the proposal, the results of the Federal Reserve's annual supervisory stress test would be used to size ***specific buffer requirements*** above minimum capital requirements for particular firms – that is, there would be tailoring based on the stress test result for each firm. The Stress Buffer Proposal would replace the current static 2.5 percent capital conservation buffer under the Basel III standardized approach with a "stress capital buffer requirement." In addition, the proposal would also establish a "stress leverage buffer requirement" in addition to the Basel III minimum 4 percent Tier 1 leverage ratio requirement. Firms subject to the rules would be required to maintain capital ratios above minimum requirements ***plus*** the buffer requirements in order to avoid restrictions on capital distributions and discretionary bonus payments.

The stress capital buffer would be determined as the difference between a firm's starting and lowest projected Common Equity Tier 1 (CET1) capital ratios under the severely adverse scenario in the stress test, calculated under the Basel III standardized approach, plus the sum of the ratios of the dollar amount of the firm's planned common stock dividends to projected risk-weighted assets for each of the fourth through seventh quarters of the test's planning horizon. The stress capital buffer could not, however, be less than the current 2.5 percent capital conservation buffer. The eight U.S. G-SIBs would be required to add on their current G-SIB surcharges to the buffer amount. The stress leverage buffer would be calculated in a similar manner – that is, looking at the lowest projected Tier 1 leverage ratio under the severely adverse scenario in the stress test and considering the effects of a year of dividends.

To give an example of how the stress capital buffer would operate, if a firm has a CET1 ratio of 9 percent and it declined to 6 percent under the severely adverse scenario, the firm's stress capital buffer for the coming year would be 3 percent. This would be added to the minimum 4.5 percent CET1 requirement, and therefore the firm would be required to maintain a 7.5 percent CET1 ratio for the coming year in order to avoid restrictions on dividends and bonus payments. If the firm was a G-SIB, its minimum CET1 ratio could be as much as 11 percent.

In addition, the Stress Buffer Proposal would remove certain very conservative assumptions that are currently used in the CCAR post-stress capital assessment. The current assumption that firms would make ***all*** planned capital distributions over the nine-quarter stress planning horizon – one that appears to be questionable at best – would be removed, and replaced with an assumption that firms would cease all repurchases, and make four quarters of dividend payments. On this score, the Federal Reserve noted that, in the Financial Crisis, large BHCs ceased repurchases early, but continued to pay dividends at the pre-Crisis rate through 2008. Similarly, the counterintuitive assumption that firms would grow their balance sheets in periods of financial stress would be removed, and replaced with a more realistic one that firms would maintain asset levels for the planning horizon. In addition, the Federal Reserve would eliminate the 30 percent dividend payout ratio as a criterion for heightened scrutiny of a firm's capital

plan. The Stress Buffer Proposal would remove CCAR's quantitative objection as redundant, and, as is the case now, the qualitative objection in CCAR would apply only to large and complex firms.[2]

The new requirements would come into effect on October 1, 2019.

Proposed Reduction in the Enhanced Supplementary Leverage Ratio

The Federal Reserve's second proposal, which was issued jointly with the Office of the Comptroller of the Currency, relates to reducing the eSLR, which is applicable only to G-SIBs and their insured bank subsidiaries. Traditionally, a leverage ratio, which does not take into account the particular risks of a bank's assets – or, in supplementary form, a bank's off-balance sheet exposures – has been thought of as a "backstop" to risk-weighted capital ratios. That is, the leverage ratio has not been intended to be the ultimate determinant of how much capital a bank must hold. If, by contrast, the leverage ratio becomes that determinant – the binding capital constraint – it may encourage a bank to engage in riskier activities because the same amount of capital is required for such activities, which promise greater rewards, than safer, less profitable activities.

The eSLR is currently set a 5 percent for G-SIBs, and at 6 percent for their insured depository institution subsidiaries – in contrast to 3 percent for non-G-SIBs.[3] As a result, certain institutions have commented that the eSLR is likely to be the binding capital constraint, and the Federal Reserve noted that, based on third quarter 2017 data, the current eSLR was a binding constraint for four of the eight U.S. G-SIBs and all of their lead insured bank subsidiaries.

The eSLR Proposal does not seek to change the current manner in which the eSLR is calculated – which itself has not insubstantial complexity in terms of certain off-balance sheet exposures. Rather, it proposes reducing the overall ratio by replacing the current 2- and 3-percent supplements with a supplement equal to one-half of a particular BHC's G-SIB surcharge. The maximum G-SIB surcharge is currently 3.5 percent, and so for such a G-SIB, the eSLR would be reduced from 5 percent to 4.75 percent at the holding company level, and from 6 percent to 4.75 percent at the bank level. BHCs with lower G-SIB surcharges would have lower required eSLRs – thus, as with the Stress Buffer Proposal, there would be tailoring of the amount of required capital to the overall perceived risk of a particular BHC.

The Federal Reserve estimated that the eSLR Proposal would reduce the amount of required capital only marginally at the holding company level, $400 million across all eight G-SIBs. The effects would be more pronounced at the bank level, where the eSLR Proposal was estimated to reduce required capital by a total of $121 billion.

Perhaps for this reason, the eSLR Proposal was more controversial. Federal Reserve Governor Brainerd voted against it, and so it passed 2-1,[4] and outgoing FDIC Chair Gruenberg issued a statement noting his disagreement with it.

Conclusion

Taken together, the proposals appear to be a prudent course change given what are perhaps the two most significant issues with 2010-2016 Dodd-Frank implementation – multiple regulatory requirements adopted without an overall consideration of their cumulative effects, and a failure fully to heed the statutory policy that enhanced prudential standards should be tailored to the quantity of risk created by particular financial firms. Given the effects of the Financial Crisis and the obligations that the Dodd-Frank Act imposed on bank regulatory agencies, these issues are not surprising. It is nonetheless welcome to see a broader and more nuanced view.

For those expecting significant change, the two proposals may surprise. Indeed, the concept of a stress capital buffer was previewed by Governor Daniel Tarullo.[5] And the Stress Buffer Proposal contains the concept that it is appropriate to add on the G-SIB surcharge during stress (also previewed by Governors Tarullo),[6] even though the stress tests themselves include certain tests only for G-SIBs – the result being that the Stress Buffer Proposal is likely to result in more capital being held by G-SIBs even as it is likely to reduce, modestly, the amount of capital to be held by large banks that are not G-SIBs.

Because the U.S. banking system is currently strongly capitalized, it is difficult to see the proposals as increasing systemic risk: the Federal Reserve noted that the common equity capital ratio of the BHCs in the 2017 CCAR was 12.1 percent in the fourth quarter of 2017, more than double 2009 levels. The increase was the result of these BHCs having increased their common equity – the most dependable form of capital – more than $720 billion. For this reason, the dissenting positions of Governor Brainerd and FDIC Chair Gruenberg are difficult to justify.

Notwithstanding this simplification effort, capital regulation remains highly complex, as may be seen in the eSLR Proposal itself. The proposal would need to amend the Total Loss Absorbing Capacity (TLAC) rule to conform the TLAC leverage buffer with the proposed revised eSLR standard and to recalibrate the TLAC rule's minimum Long Term Debt requirement, which itself is calibrated off of the eSLR. For those who agree with the proposition that "the [c]onfusion and compliance burden that results from overly complex regulation does not advance the goal of a safe financial system,"[7] the two proposals are a step in the right direction, but there is more work to be done.

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[1] "Early Observations on Improving the Effectiveness of Post-Crisis Regulation," Speech by Vice Chairman for Supervision Randal K. Quarles, January 19, 2018. .

[2] These are any BHC with average total assets or at least $250 billion or average total nonbank assets of at least $75 billion.

[3] As an example of the current over-complexity of capital regulation, the minimum eSLR is a requirement to avoid limitations on capital distributions and bonus payments at the G-SIB level, but it is a requirement for "well capitalized" status at the insured bank level. The eSLR requests comments on whether such an approach should continue to be followed.

[4] Although President Trump has nominated three other persons to fill Federal Reserve vacancies, none has been confirmed, and so there are only three of seven Governors currently serving.

[5] "Departing Thoughts," Speech by Governor Daniel K. Tarullo, April 4, 2017.

[6] *Id.*

[7] Vice Chairman for Supervision, Randal K. Quarles, Semiannual Supervision and Regulation Testimony, Committee on Financial Services, U.S. House of Representatives, April 17, 2018.

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Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or any of the following:

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