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Client Alert

July 9, 2013

# Capital Is Contagious—

## The FDIC and OCC Approve Final Risk-based Capital Rules, and the Agencies Propose a Supplemental Leverage Capital Ratio for Large U.S. Banking Organizations

Today, July 9, the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC") took two significant actions on the implementation of new regulatory capital requirements in the U.S. First, the FDIC, as expected but with one dissenting vote (Vice-Chairman Thomas Hoenig), and the OCC approved final rules ("Final Rules") to implement revised regulatory capital requirements for U.S. banks that were proposed in June 2012, following the actions of the Federal Reserve Board taken on July 2.[1] Second, the FDIC and OCC have proposed for comment a supplemental leverage capital ratio ("Proposal") for the eight largest U.S. banking organizations that are deemed systemically significant, which would implement the leverage capital provision of the 2010-2011 revised regulatory capital accord ("Basel III") adopted by the Basel Committee on Banking Supervision ("Basel Committee") in the wake of the financial crisis.[2] The Proposal, however, contains an important modification from the Basel Committee proposal, namely, a significantly more stringent leverage capital requirement.

Comments on the Proposal will be due 60 days after their publication in the Federal Register. The actual Proposal states that the leverage capital rules are being jointly proposed by the FDIC, the OCC and the Federal Reserve Board. In turn, the Federal Reserve Board, later in the day, also has announced its approval of the Proposal.

### Final Regulatory Capital Rules

As expected, the FDIC's and OCC's actions follow in quick succession the Federal Reserve Board's adoption last week of the Final Rules. The Final Rules make major changes to the U.S. regulatory capital framework in a regulatory effort to strengthen the regulatory capital of U.S. banking organizations and bring the U.S. into compliance with Basel III, albeit with some accommodations to the concerns of community banks, expressed during the preceding comment period, on (i) the risk-weighting treatment of residential mortgage exposures, (ii) the capital treatment of accumulated other comprehensive income, and (iii) the "grandfathering" as Tier 1 capital of certain trust preferred securities issued by small bank holding companies. The Final Rules will replace the agencies' general risk-based capital rules, advanced approaches rule, market risk rule, and leverage rules in accordance with modified transition provisions described in the Final Rules. Please see our discussion of the Final Rules in our July 2, 2013 memorandum, *available at* http://www.mofo.com/files/Uploads/Images/130702-Regulatory-Capital.pdf.

Comptroller of the Currency/FDIC Director Thomas Curry, and Consumer Financial Protection Bureau Director/FDIC Director Richard Cordray, fully supported the adoption of the Final Rules. Mr. Curry also stated that in his capacity as Comptroller, he has today approved the OCC's adoption of the Final Rules (and the OCC later issued a press release to that effect). In addition, FDIC Director Jeremiah Norton supported adoption of the

[1] Technically, the FDIC is adopting the Final Rules as interim final rules.
[2] Basel III: A global regulatory framework for more resilient banks and banking systems (rev. June 2011), paragraphs 151-167.

Final Rules, but expressed concerns over what he referred to as "significant shortcomings" in the Final Rules' treatment of various bank exposures (such as residential mortgage exposures and sovereign exposures).

Perhaps not surprisingly, FDIC Vice-Chairman Hoenig dissented from the adoption of the Final Rules, citing his concerns over the complexity and disparate impact of the Basel risk-based capital framework, and its failure to assure adequate levels of regulatory capital in relation to the leverage capital ratio. Mr. Hoenig's dissent and his concerns, however, are consistent with public statements that he previously has made on the subject of regulatory capital.

**The Leverage Capital Proposal**

*A. The Basel III Leverage Capital Ratio*

Basel III establishes a new non-risk-based leverage capital ratio that, when fully effective, will supplement the Basel III risk-based capital requirements. The Basel III leverage ratio is defined as the ratio, expressed as a percentage, of the "Capital Measure" (the numerator) divided by the "Exposure Measure" (the denominator). A notable feature of the Basel III requirement is that the regulatory capital denominator, or Exposure Measure, includes not only a banking organization's on-balance sheet assets, but also covers certain off-balance sheet exposures, including derivatives; certain securities financing exposures; and certain types of commitments, direct credit substitutes, and standby exposures. The Basel Committee has established, for the time being, a three percent (3%) minimum leverage capital requirement. The Basel Committee expects full substantive implementation of the leverage ratio by January 1, 2018.[3]

The U.S., which is a member jurisdiction of the Basel Committee, has committed to the implementation of the Basel III leverage capital requirement for covered banks. The Proposal thus represents an additional step in that implementation process.

*B. The Proposed Supplemental Leverage Capital Rules*

The Proposal would apply to all top-tier U.S. bank holding companies ("covered banking organizations") with more than $700 billion in total assets as reported on the bank holding company's most recent Consolidated Financial Statement for Bank Holding Companies (FR Y-9C), or more than $10 trillion in assets under custody as reported on the company's most recent Banking Organization Systemic Risk Report (FR Y-15). According to the Proposal, these are the banking organizations that would be treated as global systemically important banks ("G-SIBs") under the Basel Committee's and Financial Stability Board's framework for the assessment and supervision of such banking organizations.[4] Currently, there are eight top-tier U.S. bank holding companies that meet these thresholds.

The Proposal—which was unanimously approved by the FDIC Board—includes the following elements:

- A minimum supplemental leverage ratio of six percent (6%) of Tier 1 capital for any insured subsidiary bank of a covered banking organization, in order for the bank to be considered "well-capitalized" for purposes of the regulatory "prompt corrective action" ("PCA") framework. This requirement would be fully effective as of January 1, 2018.

[3] The Basel Committee recently published a consultative document that specifies the elements of the "exposure measure" (the leverage capital denominator) for calculating leverage capital requirements. Basel Committee on Banking Supervision, Consultative Document, Revised Basel III leverage ratio framework and disclosure requirements (June 2013). Please see our alert on the Basel Committee's June 2013 consultative document, *available at* http://www.mofo.com/files/Uploads/Images/130701-Basel-Capital-Framework.pdf.
[4] See, http://www.bis.org/publ/bcbs207.pdf, and http://www.financialstabilityboard.org/publications/r_121031ac.pdf.

- A minimum supplemental leverage ratio of three percent (3%), plus an additional "leverage buffer" of two percent (2%), or a total five percent (5%) supplemental leverage ratio, of Tier 1 capital to be maintained at the holding company level, for covered banking organizations. Failure to meet this five percent ratio would subject the covered banking organization to limitations on capital distributions and discretionary bonus payments. In this respect, the proposed leverage buffer would follow the same general mechanics and structure as the capital conservation buffer contained in the Final Rules. This requirement also would be fully effective as of January 1, 2018.

Notably, these proposed ratios are significantly higher than the general three percent (3%) leverage capital ratio proposed by the Basel Committee. The Proposal notes that the U.S. agencies have weighed the burden and complexity of imposing a leverage buffer and enhanced PCA standards against the benefits to financial stability and addressing the concern that some banks may be viewed as "too big to fail." The Proposal also notes that the higher supplementary leverage ratio for covered banking organizations and their subsidiary banks should provide "meaningful incentives to encourage these banking organizations to conserve capital" and reduce the likelihood of their instability or failure, and resulting negative impact on the financial system.

**Observations**

In light of the Federal Reserve Board's action last week, the FDIC's and OCC's adoption of the Final Rules was entirely expected. During today's FDIC Board meeting, however, Board members highlighted some continuing differences of opinion on the adequacy and efficacy of the new risk-based capital framework and the relative importance of the separate leverage capital ratio.

The Proposal addresses exclusively the amount of leverage capital (the numerator) that will be required for covered banking organizations, but does not discuss the nature of the on-balance sheet assets and off-balance sheet exposures against which the minimum leverage capital requirements will have to be calculated. Although the Proposal summarily notes that total leverage exposure includes "all on-balance sheet assets and many off-balance sheet exposures for banking organizations subject to the agencies' advanced approaches risk-based capital rules," there is no discussion of the specific elements or metrics of the exposures that are subject to the leverage capital requirement. Presumably, and especially in light of the Basel Committee's June 2013 action on the leverage denominator issue, further U.S. regulatory guidance on the leverage capital denominator will be forthcoming in due course.

The proposed supplemental leverage ratio for covered banking organizations in concept was to be expected, but the higher minimum leverage capital ratios being proposed may not be welcome news to the banking organizations that will be subject to these requirements. In turn, the affected banking organizations may be expected to weigh in during the comment period on, among other things, the Proposal's impact on the cost and availability of credit in the U.S. financial markets, although the Proposal notes that the U.S. agencies did take these considerations into mind in developing the higher leverage ratio requirements. At the same time, the broader U.S. banking community may derive comfort from the fact that the U.S. regulatory agencies at this time are proposing to limit the Basel-based supplemental leverage ratio to the top-tier U.S. banking organizations.

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