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Regulatory Practice Letter
July 2013 – RPL 13-13

U.S. Basel III Implementation – Final Rule

Enhanced Supplementary Leverage Ratio – Proposed Rule

Executive Summary

On July 2, 2013, the Federal Reserve Board (Federal Reserve) approved a final rule that implements the Basel III capital framework agreed to by the Basel Committee on Banking Supervision ("*Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*," and subsequent changes, hereinafter "Basel III") in the U.S., as well as capital requirements mandated by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act). As approved, the final rule combines, with revisions, the three interagency proposed rules released in August 2012 by the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), which revise the Agencies' risk-based capital and leverage capital requirements, as well as their methodologies on calculating risk-weighted assets under the Standardized and Advanced Approaches. The final rule is substantially similar to the rule proposals, except for revisions that are generally intended to ease the compliance burden of smaller and community banking organizations. On July 9, 2013 the OCC approved the same final rule as approved by the Federal Reserve and the FDIC approved an interim final rule that is "identical in substance" to the rule approved by the Federal Reserve and the OCC.

The final rule applies to all banking organizations under the supervision of the Agencies including all insured depository institutions (bank and thrifts), U.S. bank holding companies (BHCs) with total consolidated assets of $500 million or more, and U.S. savings and loan holding companies (SLHCs) of all sizes except for SLHCs that are "substantially engaged" in insurance underwriting or commercial activities (collectively, Banking Organizations). However, the Advanced Approaches of the Basel III capital framework only apply to Banking Organizations (including covered SLHCs) meeting a consolidated total assets threshold of at least $250 billion or having consolidated total on-balance sheet foreign exposures of at least $10 billion (to be referred to as "AA Banks"). A BHC subsidiary of a foreign banking organization (FBO) that is currently relying on the Federal Reserve's Supervision and Regulation Letter (SR) 01-1 is not required to comply with the final capital requirements until July 21, 2015 (note – this date is consistent with the Federal Reserve's proposed implementation date for the FBO Intermediate Holding Company rule covered in KPMG Regulatory Practice Letter 12-23).

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The final rule will become effective on January 1, 2014 and compliance will be mandatory as of that date for AA Banks that are not SLHCs, and on January 1, 2015 for all other Banking Organizations. The requirements of the rule will be phased-in over a multiple-year schedule that will reach full implementation on January 1, 2019.

Significant revisions in the final rule from the proposed rules include:

- A one-time election by non-AA Banks not to include most elements of accumulated other comprehensive income (AOCI) in regulatory capital (in favor of the existing treatment). The election must be made with the first Call Report filed after compliance is required or it is lost.
- Retention of the current treatment for residential mortgages under the risk-based capital rules (the proposed Category 1 and Category 2 distinctions have been withdrawn).
- A permanent grandfathering of non-qualifying capital instruments (such as Trust Preferred Securities (TruPS) and cumulative perpetual preferred stock issued prior to May 19, 2010) in the tier 1 category for depository institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009 and Banking Organizations that were mutual holding companies as of May 19, 2010 (2010 MHCs).
- Exclusion of grandfathered unitary SLHCs, provided that, as of June 30 of the previous calendar year, 50 percent or more of the total consolidated assets of the company, or 50 percent or more of the total revenues of the company (calculated on an enterprise-wide basis), were derived from activities that are not financial in nature.
- Exclusion of SLHCs that are insurance underwriting companies, or SLHCs that, as of June 30 of the previous calendar year, held 25 percent or more of their consolidated assets in insurance underwriting subsidiaries.
- Delayed compliance for non-AA Banks and SLHCs until January 1, 2015.

Very broadly, the final rule modifies the current regulatory capital rule to emphasize common equity tier 1 capital, the most loss-absorbing form of capital, implements strict eligibility criteria for regulatory capital instruments, and improves the methodology for calculating risk-weighted assets to enhance risk sensitivity. The final rule will also require:

- A new common equity tier 1 minimum capital requirement;
- A higher minimum tier 1 capital requirement;
- A new capital conservation buffer;
- A new countercyclical capital buffer (AA Banks);
- A new supplementary leverage ratio that is more stringent than the existing U.S. leverage ratio by including many off-balance sheet exposures, in addition to on-balance sheet exposures, in its denominator (AA Banks) – the current leverage ratio continues to apply to all Banking Organizations;
- Limits on capital distributions and certain discretionary bonus payments if a Banking Organization does not hold a specified amount of common equity tier 1 capital in addition to the amount necessary to meet its minimum risk-based capital requirements;
- Stricter eligibility criteria for regulatory capital instruments;
- Alternatives to credit ratings; and
- Enhanced disclosure requirements including disclosures related to regulatory capital instruments, for top-tier U.S. Banking Organizations with $50 billion or more in total assets.

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Interagency Notice of Proposed Rulemaking – Enhanced Supplementary Leverage Ratio

On July 9, 2013, the Federal Reserve, OCC and FDIC each announced the approval of an interagency notice of proposed rulemaking that would increase the supplementary leverage ratio requirements for the largest most systemically-important banking organizations, which would currently apply to eight institutions and their insured depository institution subsidiaries. In particular, the proposed rule would require these BHCs to meet a 5 percent supplementary leverage ratio (rather than the 3 percent under the final Basel III rule) and require their insured depository institution subsidiaries to meet a 6 percent supplementary leverage ratio in order to be considered "well capitalized" for prompt corrective action purposes. As proposed, the requirement would become effective January 1, 2018.

Comments are requested for a period of 60 days following publication in the *Federal Register*.

Background

The Basel Committee adopted the final Basel III rules in December 2010. Member countries, including the U.S., are expected to adopt the rules but are permitted to make adjustments to accommodate the laws and regulatory supervision within their national jurisdictions. As approved by the Basel Committee, implementation of the Basel III capital framework was to begin January 1, 2013 and become fully phased-in by January 1, 2019. The final rule's implementation schedule of Basel III in the U.S. will meet this 2019 full implementation date. Federal Reserve Board Governor Daniel Tarullo states the rulemaking "will give us a firm position from which to press our expectations that other countries implement Basel III fully and faithfully, thereby promoting global financial stability."

The Basel Committee rules included two liquidity measures, a Liquidity Coverage Ratio (LCR) and a Net Stable Funding Ratio (NSFR), that are to be phased-in beginning January 1, 2015 and January 1, 2018, respectively. The U.S. proposed rules (please refer to KPMG Regulatory Practice Letter 12-21) did not include these liquidity measures and they are not part of the final rule. Liquidity measures, however, are included in the Federal Reserve's proposed rules to implement the enhanced prudential standards under Sections 165 and 166 of the Dodd-Frank Act (see KPMG Regulatory Practice Letter 12-04). As proposed, the U.S. liquidity measures would be expected to satisfy quantitative liquidity requirements that are derived from or consistent with the Basel III LCR and NSFR. The Federal Reserve has also stated that implementation of the LCR and NSFR as part of the U.S. Basel III rules might alternatively be addressed in a separately rulemaking.

Federal Reserve Board Governor Daniel Tarullo indicated that additional rulemakings are in various stages of development that will "enhance capital requirements for the eight U.S. banking organizations already identified as of global systemic importance." These rulemakings include:

- A proposed rule "concerning the combined amount of equity and long-term debt these firms should maintain in order to facilitate orderly resolution in appropriate circumstances."

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- A proposed rule to implement, when completed, the Basel Committee's final framework for capital surcharges on banking organizations of global systemic importance.
- An advance notice of proposed rulemaking to seek input on possible approaches to requiring an additional measure that would directly address risk related to short-term wholesale funding, including a requirement for firms that are "substantially dependent on such funding" to hold additional capital.

The final rule implementation period will coincide with the AA Banks' completion of the parallel run process required by the prior Basel II US capital rule (please see Advanced Approaches for Risk-Weighted Assets below).

Description

Minimum Regulatory Capital Ratios, Additional Capital Requirements, and Overall Capital Adequacy

The final rule requires all Banking Organizations to comply, on a consolidated basis, with:

- A new common equity tier 1 capital ratio of 4.5 percent;
- A tier 1 (common equity plus additional tier 1 capital) capital ratio of 6 percent;
- A total capital ratio of 8 percent;
- A tier I capital to average consolidated assets (leverage ratio) of 4 percent (current exceptions will be phased-out as Banking Organizations become subject to the rule); and
- A capital conservation buffer of at least 2.5 percent of total risk-weighted assets (RWAs) above the minimum risk-based capital ratio.

AA Banks must begin compliance with the implementation schedule on January 1, 2014, and all other Banking Organizations must begin compliance on January 1, 2015.

AA Banks must also meet:

- A supplementary leverage ratio of 3 percent of tier 1 capital to on- and off-balance sheet exposures;
- A countercyclical capital buffer up to 2.5 percent of total RWAs, as determined by the regulators.
  - 100 percent of the countercyclical capital buffer must be added to the minimum 2.5 percent of total RWAs for the capital conservation buffer.

Supplementary Leverage Ratio. AA Banks will be required to begin to calculate and report the supplementary leverage ratio beginning January 1, 2015 and to comply with the minimum ratio requirement beginning January 1, 2018. The Agencies note that the Basel Committee is continuing to assess the Basel III leverage ratio framework and they will consider any revisions made by the Basel Committee with regard to the supplementary leverage ratio in the U.S.

Capital Conservation Buffer. Banking Organizations that fail to exceed the 2.5 percent capital conservation buffer are subject to a sliding scale of restrictions on payouts of distributions or discretionary bonus payments in the quarter following the quarter they fail to meet the minimum ratio. However, the Agencies note that although Banking Organizations that do exceed the 2.5 percent threshold would not be subject to

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limitations based on the Basel III provisions, they might otherwise be subject to limitations as of a result of supervisory actions or other laws or regulations.

Countercyclical Capital Buffer. AA Banks will be given 12 months notice of any countercyclical capital buffer to be implemented. A countercyclical capital buffer will return to zero percent 12 months after its effective date unless a decision to maintain or adjust the buffer is provided by the regulators. A decrease in a countercyclical capital buffer will be effective the day following an announcement.

Prompt Corrective Action. The Prompt Corrective Action (PCA) capital levels applicable to all insured depository institutions will reflect the new Basel III requirements. Compliance by all insured depository institutions will begin on January 1, 2015. In particular, the final rule:

- Augments the PCA capital categories ("well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized") by adding a "common equity tier 1 capital" measure to all but the "critically undercapitalized" category.
- Amends the current risk-based capital measures to reflect the new minimum risk-based capital ratios.
- Amends the current PCA leverage measure for AA Banks to include an additional leverage ratio based on the Basel III supplemental leverage ratio applicable to those institutions (beginning January 1, 2018). The added leverage measure would be considered for the "adequately capitalized" and "undercapitalized" capital categories only and an AA Bank would have to maintain a Basel III supplemental leverage ratio of 3 percent or more to be considered "adequately capitalized".
- Modifies the definitions of capital to meet new definitions.

The definition of tangible equity is revised to consist of tier 1 capital, plus outstanding perpetual preferred stock (including related surplus) not included in tier 1 capital.

Supervisory Assessment of Overall Capital Adequacy. Banking Organizations are generally expected to operate with capital positions well above the minimum risk-based ratios and to hold capital commensurate with the level and nature of the risks to which it is exposed. The supervisory assessment takes into account a Banking Organization's capital level given the quality and trends in its capital composition, including the share of common and non-common-equity capital elements. For AA Banks, the supervisory assessment will consider the bank's Internal Capital Adequacy Assessment Process (ICAAP).

Tangible Capital for Savings Associations. The final rule adopts the proposed definition of tangible capital, which mirrors the definition of tangible equity for purposes of PCA. As a result of the revision, Federal and state savings associations will calculate the "tangible capital ratio" using "average total assets" and "total assets" respectively.

Definition of Capital

The final definitions for common equity tier 1 capital, additional tier 1 capital, and tier 2 capital are generally consistent with the proposed rules, though a number of smaller modifications and clarifications have been added. The most significant modifications address the treatment of Trust Preferred Securities and cumulative perpetual

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preferred stock that are limited by Section 171 of the Dodd-Frank Act. Under the final rule:

- BHCs and SLHCs with less than $15 billion in total consolidated assets as of December 31, 2009 and Banking Organizations that were mutual holding companies as May 19, 2010 are now permitted to include in additional tier 1 capital TruPS and cumulative perpetual preferred stock issued and included in tier 1 capital prior to May 19, 2010, subject to a limit of 25 percent of tier 1 capital elements excluding any non-qualifying capital instruments and after all regulatory capital deductions and adjustments applied to tier 1 capital.
- BHCs and SLHCs that are not AA Banks and have more than $15 billion in total consolidated assets may permanently include in tier 2 capital TruPS that are phased-out of tier 1 capital in accordance with the Dodd-Frank Act.

Similarly, the final adjustments and deductions to regulatory capital are generally as proposed, except for a significant modification that permits Banking Organizations that are not AA Banks to elect to calculate regulatory capital by using the treatment for AOCI in the Agencies' general risk-based capital rules, which excludes most AOCI amounts. Such Banking Organizations may make a one-time, permanent election to effectively continue using the AOCI treatment under the general risk-based capital rules (Opt-out Election) for their regulatory calculations when filing the first Call Report or FR Y-9 series report after the date upon which they become subject to the final rule. The Agencies reserve the authority to require a Banking Organization to recognize all or some components of AOCI in regulatory capital if an agency determines it would be appropriate given a Banking Organization's risks.

Subsequent mergers, acquisitions or purchases between two entities that have both made or not made the Opt-out Election would continue with this treatment. Mergers, acquisition or purchases with an AA Bank would not be permitted to continue an Opt-out Election, and the surviving entity from a merger, acquisition or purchase of two entities that made differing elections would have to make an Opt-in Election or an Opt-out Election by the first regulatory reporting date following consummation of the transaction.

AA Banks must recognize most components of AOCI in common equity tier 1 capital and must meet the supplementary leverage ratio when applicable without reference to whether the banking organization has completed its parallel run process.

Transitions

Minimum common equity tier 1, tier 1 and total capital ratios

- AA Banks that are not SLHCs must begin compliance on January 1, 2014 and reach full compliance levels on January 1, 2016.
- Other Banking Organizations must begin compliance on January 1, 2015.

Supplementary Leverage Ratio

- AA Banks that are not SLHCs must begin to calculate and report the supplementary leverage ratio beginning January 1, 2015 and comply with the requirement by January 1, 2018.

Capital Conservation and Countercyclical Capital Buffers

- The capital conservation buffer begins for all Banking Organizations on January 1, 2016 and will increase annually to reach full implementation on January 1, 2019.

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- AA Banks that are not SLHCs are subject to the countercyclical capital buffer, which is phased-in with the capital conservation buffer beginning January 1, 2016 and ending in January 1, 2019.
- Failure to achieve the capital conservation buffer and countercyclical buffer results in limitations on distributions and discretionary bonus payments that increase in increments based on the shortfall of the combined buffers.

Capital Adjustments and Deductions

- The transition period for adjustments and deductions from capital will begin for AA Banks on January 1, 2014 and end January 1, 2018 and vary in accordance with the schedules applicable to each type of asset and liability.
- The capital adjustments and deductions period for non-AA Banks begins on January 1, 2015 and also ends on January 1, 2018. These Banking Organizations are subject to the same schedules as AA Banks and begin compliance with the adjustments or deductions scheduled for 2015.
- Nonqualifying capital instruments issued prior to September 12, 2010 that do not meet the criteria for additional tier 1 or tier 2 capital instruments are subject to a phase-out schedule through calendar year 2022.

Standardized Approach for Risk-Weighted Assets

The Standardized Approach for Risk-Weighted Assets modifies the Agencies' general risk-based capital requirements for determining RWA. The changes are intended to enhance risk sensitivity and address identified weaknesses, including by incorporating certain international capital standards of the Basel Committee's Basel II framework and other proposals addressed in recent Basel Committee consultative papers. All Banking Organizations must begin calculating standardized total RWAs in accordance with the final rule (subpart D), and if applicable, the revised market risk rule (subpart F), on January 1, 2015.

In the final rule, the most significant difference from the proposal is retention of the general risk-based capital requirements for residential mortgage assets.

Advanced Approaches for Risk-Weighted Assets

The final rule amends the Agencies' Advanced Approaches for Risk-Weighted Assets primarily with regard to the treatment of counterparty credit risk, the securitization framework, and disclosures for securitizations. The revisions to the AA RWAs calculations become effective January 1, 2014.

From January 1, 2014 to December 31, 2014, an AA Bank that is on parallel run must calculate RWAs using the general risk-based capital rules and substitute such RWAs for its Standardized total RWAs for purposes of determining its risk-based capital ratios. An AA Bank on parallel run must also calculate Advanced Approaches total RWAs using the AA rule (subpart E) for purposes of confidential reporting to its primary Federal supervisor on the Federal Financial Institutions Examination Council's (FFIEC) 101 report.

An AA Bank that has completed the parallel run process and that has received notification from its primary Federal supervisor will calculate its RWAs using the general risk-based capital rules and substitute such RWAs for its Standardized total RWAs and also calculate AA total RWAs using the AA rule (subpart E) for purposes of determining its risk-based capital ratios from January 1, 2014 to December 31, 2014.

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Regardless of an AA Bank's parallel run status, on January 1, 2015, the Banking Organization must begin to apply the Standard Approach RWAs (subpart D), and if applicable, the market risk rule (subpart F, of the final rule to determine its Standardized total risk-weighted assets.

Savings and Loan Holding Companies

The final rule applies to SLHCs that are top-tier SLHCs other than a top-tier SLHC that meets the following exclusion criteria:

- A grandfathered unitary SLHC, that, as of June 30 of the previous calendar year, had 50 percent or more of the total consolidated assets of the company, or 50 percent or more of the total revenues of the company (calculated on an enterprise-wide basis), derived from activities that are not financial in nature.
- SLHCs that are insurance underwriting companies (as defined by Section 201 of the Dodd-Frank Act and including companies subject to regulation by a state insurance regulator and covered by a state insurance company insolvency law), or SLHCs that, as of June 30 of the previous calendar year, hold 25 percent or more of their consolidated assets in insurance underwriting subsidiaries (other than assets associated with insurance underwriting for credit risk).

The Federal Reserve states that it is excluding grandfathered unitary SLHCs from the capital requirements of the final rule while it "continues to contemplate a proposal for SLHC intermediate holding companies." Section 626 of the Dodd-Frank Act authorizes the Federal Reserve to require a grandfathered unitary SLHC to establish and conduct all or a portion of its financial activities in or through an intermediate holding company and the intermediate holding company would then become an SLHC subject to Federal Reserve supervision and regulation. The Federal Reserve anticipates that it will release a proposal for public comment on intermediate holding companies in the near term that would specify the criteria for establishing and transferring activities to intermediate holding companies, consistent with Section 626 of the Dodd-Frank Act, and propose to apply the Board's capital requirements in the Basel III final rule to such intermediate holding companies.

The Federal Reserve has also allowed SLHCs that are substantially engaged in insurance underwriting activities to estimate calculation of total consolidated assets for purposes of determining whether they are excluded from the final rule, subject to "possible review and adjustment" by the Federal Reserve. A framework for SLHCs that are not subject to the final rule is expected to be implemented "by the time covered SLHCs must comply with the final rule in 2015."

Enhanced Supplementary Leverage Ratio – Proposed Rule

The Agencies approved a proposed rule that would require BHCs with more than $700 billion in consolidated total assets or $10 trillion in assets under custody (covered BHCs) to maintain a tier 1 capital leverage buffer of at least 2 percent above the minimum supplementary leverage ratio requirement of 3 percent, for a total of 5 percent. The 2 percent leverage buffer would function much like the capital conservation buffer for the risk-based capital ratios such that a covered BHC that maintains a leverage buffer of tier 1 capital in an amount that is greater than 2 percent of its total leverage exposure would not be subject to limitations on its discretionary bonus payments and capital distributions. In addition, the proposed rule would require

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insured depository institution subsidiaries of covered BHCs to meet a 6 percent supplementary leverage ratio to be considered "well capitalized" for prompt corrective action purposes.

The proposed rule would become effective January 1, 2018. The Agencies indicate that, as proposed, the eight largest U.S. BHCs would be covered by the proposed rule. Comments are requested for a period of 60 days following publication in the *Federal Register*.

Commentary

The Final Rule implementing the U.S. Basel III capital framework is a milestone in the Agencies' post-crisis efforts to make the financial system safer and to reinforce capital requirements.

As noted by Governor Tarullo, the new rule will have several important consequences:

1. It will consolidate the progress that has been made by banks and regulators post-financial crisis in improving the quality and quantity of capital held by banking organizations.
2. It will remedy shortcomings in the existing risk-weighted assets calculations that became apparent during the financial crisis.
3. Its adoption meets international expectations for U.S. implementation of the Basel III capital framework.

The Agencies have strived to address the enhanced capital adequacy requirements of the Dodd-Frank Act for systemically important Banking Organizations on the one hand, as well as considered the implications for the thousands of smaller Banking Organizations, on the other by reducing the number of, and simplifying, those modifications from current regulatory capital standards that apply to those smaller Banking Organizations.

With the release of final rule, all Banking Organizations should give consideration to, among other things:

- Assessing the impact of the final rule, either through the use of internal models or the *Regulatory Capital Estimation Tool* released by the Agencies. Focus should include capital planning, earnings projections, risk-weights, and profitability analyses;
- Evaluating and testing the adequacy of internal capital and liquidity models and assessing the need for modifications (e.g., data quality, data inputs);
- Evaluating and modifying as needed capital and liquidity management strategies to meet the new requirements, including defining relevant capital objectives, capital transactions, business structure, strategies and product offerings, as well as analyzing capital raising strategies; and
- Assessing and implementing modifications to policies and procedures, systems, data and management reporting, and management incentives.

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The largest U.S. Banking Organizations, and particularly the eight U.S. Banking Organizations identified as globally systemically important, will also need to take preparatory efforts to address the additional challenges and requirements posed by the proposed Enhanced Supplementary Leverage Ratio and the additional proposed rulemakings which are still in development. Notably, the Supplementary Leverage Ratio includes on- and off-balance sheet exposures in its denominator, which makes it more stringent than the existing U.S. leverage ratio. As proposed, these largest Banking Organizations would be required to hold an additional 2 percent leverage ratio buffer over and above the 3 percent supplementary leverage ratio required under the U.S. Basel III final rule and by most countries adopting Basel III rules internationally.

The Supplementary Leverage Ratio proposal has been criticized from two sides with some saying that it is too high and may inhibit credit availability and economic recovery and others saying that the ratio is not nearly high enough. The situation is further complicated by the Basel Committee's recent proposal to modify the denominator of the supplementary leverage ratio, including enhanced treatment of certain derivatives among other things, which would expand the denominator and make it more difficult to meet the ratio requirements. The U.S. Agencies have indicated they would incorporate into their own rules any revisions made by the Basel Committee to the leverage ratio – clarifying that the components of what comprises capital and assets is at least as important as the required ratio thresholds. These global and U.S. regulatory proposals, stimulated by increased political pressure, leads one to believe that "Basel IV" is on the horizon.

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