Enhanced Supplementary Leverage Ratio – Risk-Based Capital: Joint Final Rule and Proposed Rule

Executive Summary

The Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the Agencies) approved a final rule on April 8, 2014 that imposes an enhanced supplementary leverage ratio (SLR) requirement on any top-tier U.S. bank holding company (BHC) that has more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody (covered BHCs) as well as any insured depository institution (IDI) of those covered BHCs . Under the rule, beginning January 1, 2018:

- Covered BHCs will be required to hold additional tier 1 capital to exceed a 2 percent leverage buffer (the enhanced supplementary leverage ratio) in addition to the minimum SLR of 3 percent (which is applicable to entities subject to the Advanced Approaches risk-based capital rules (AA Banks) under the U.S. rules implementing the Basel III capital framework (US Basel III rules)); and
- IDIs of the covered BHCs will be required to meet at least a 6 percent SLR (3 percent above the minimum Basel III SLR) in order to be considered "well capitalized" for Prompt Corrective Action purposes.

Covered BHCs that fail to exceed the 2 percent enhanced SLR will face restrictions, subject to a sliding scale, with regard to dividend distributions and discretionary bonus payouts. IDIs not achieving classification as "well capitalized" are similarly subject to regulatory limitations.

Also on April 8, the Agencies adopted a proposed rule that would revise the denominator used to calculate a banking organization's SLR under the U.S. Basel III rules. The revisions would modify the treatment of on- and off-balance sheet exposures to "more closely align the Agencies' rules on the calculation of total leverage exposure with international leverage ratio standards," which were modified by the Basel Committee on Banking Supervision (Basel Committee) in January 2014. Comments on the proposed changes to the denominator are due to the Agencies no later than June 13, 2014. The proposed rule is applicable to all banks, savings associations, bank holding companies, and savings and loan holding companies that are AA Banks, including covered BHCs and their subsidiary IDIs subject to the enhanced SLR rule. It is important to understand that while the enhanced SLR applies to only the largest institutions, the proposed revisions to the denominator of the SLR would apply to a broader set of institutions. Some firms may find that the revised calculation has serious capital implications.

All AA Banks are required to begin to calculate and report the SLR beginning January 1, 2015 and to comply with the minimum ratio requirement beginning January 1, 2018.

Key Takeaways

- Most covered BHCs are expected to be well positioned to meet the increased SLR requirements over the next three years through efforts to reduce their leverage exposures and retained earnings. However, the actual capital shortfalls may differ significantly from the Agencies' estimates (which were based on projections from the Comprehensive Capital Asset Review (CCAR)) potentially placing pressure on equity returns.

- Implementation of the enhanced SLR is part of the Agencies' efforts to mitigate the threat to financial stability posed by systemically-important financial companies in much the same way as their enhanced prudential standards and heightened supervisory expectations are intended.

- Although large in proportion to the 3 percent SLR that is mandated under the Basel Committee's Basel III capital framework, the 2 percent leverage buffer is smaller than some previous suggestions, including one as high 15 percent (12 percent leverage buffer). Notably, other jurisdictions have signaled they are still evaluating calibration of the Basel III leverage ratio and could possibly take a tougher stance than the Basel Committee's 3 percent ratio or the US Agencies' 5 percent minimum.

- The proposed rule to modify the composition and calculation of total leverage exposures, the denominator of the SLR, will affect all AA Banks, a number of institutions that includes the covered BHCs and subsidiary IDIs subject to the enhanced SLR. The Agencies estimate these entities would, in the aggregate, experience a 5.5 percent increase in their total leverage exposure making the US Basel III minimum 3 percent SLR requirement, and the enhanced SLR requirement as applicable, more difficult to achieve.

- Additional capital requirements continue to be considered and may yet be imposed, including a G-SIB capital surcharge and requirements related to short-term wholesale funding.

Background

The Agencies' final rule is substantially similar to their proposed rule, which was jointly released in July 2013 concurrent with the release of the US Basel III rules. (Please refer to Regulatory Practice Letter 13-13.) At that time, the Agencies indicated the assets thresholds established for the enhanced supplementary leverage ratio were consistent with the list of banking organizations that meet the Basel Committee's definition of a global systemically important bank (G-SIB), based on year-end 2011 data. At that time, eight BHCs were expected to be covered by the rule and these same institutions are now covered by the final rule.

Pending efforts to "strengthen the supplementary leverage ratio," the Federal Deposit Insurance Corporation (FDIC) approved the US Basel III rules as interim final rules. With the release of the enhanced supplementary leverage ratio final rule and the proposed rule to modify the calculation of total leverage exposure, the FDIC concurrently approved its US Basel III rules in final form. In press statements, FDIC Chairman Gruenberg stated, "In my view, this final rule [the enhanced supplementary leverage ratio rule] may be the most significant step we have taken to reduce the systemic risk posed by these large, complex banking organizations." Separately, FDIC Vice Chairman Hoenig stated, "The supplementary leverage ratio is a more reliable measure that is simpler to calculate, understand and enforce than the subjective risk-weighted measures, and it provides a highly useful initial assessment of a bank's balance sheet strength."

The US Basel III rules introduced a minimum SLR requirement of 3 percent for AA Banks based on the leverage ratio requirement in the Basel III capital framework (Basel III leverage ratio) as it was established at the time. The supplementary leverage ratio is equal to the arithmetic mean of the ratio of an AA Bank's tier 1 capital to total leverage exposure (as defined in the US Basel III rule to include all on-balance sheet assets and many off-balance sheet exposures) calculated as of the last day of each month in the reporting quarter.

The US Basel III rules retained the U.S. minimum "generally applicable leverage ratio" requirement of 4 percent for all IDIs and depository institution holding companies. This measure consists of the ratio of a banking organization's tier 1 capital to its average total consolidated assets as reported on the banking organization's regulatory report minus amounts deducted from tier 1 capital.

Description

Final Rule on Enhanced Supplementary Leverage Ratio

The Agencies state that the leverage ratio and the risk-based capital ratios required by the US Basel III rules play complementary roles. They clarify that the enhanced SLR is intended to function in the same manner that the capital conservation buffer does for the risk-based capital ratios, such that banking organizations that fall below the capital conservation buffer threshold are limited with respect to capital distributions and discretionary bonus payments.

For covered BHCs, the 2 percent enhanced SLR functions as a leverage buffer over the 3 percent minimum SLR established by the US Basel III rules. Covered BHCs that have a leverage buffer of 2 percent or less will be subject to limitations on distributions and discretionary bonus payments.

The leverage buffer is calculated as the covered BHC's SLR minus 3 percent, calculated as of the last day of the previous calendar quarter based on the covered BHC's most recent Consolidated Financial Statement for Bank Holding Companies (FR Y–9C).

Impact

Using data from the CCAR (Comprehensive Capital Asset Review) results, the Agencies state that all eight of the covered BHCs meet the 3 percent SLR as of fourth quarter 2013. However, if the enhanced SLR were to have been in effect at the end of the fourth quarter of 2013, the CCAR data suggest that not all of the eight covered BHCs would have met the additional 2 percent ratio requirement and would have to raise, in the aggregate, an additional $22 billion in tier 1 capital.

The Agencies also estimated that, using the same CCAR data, the lead subsidiary IDIs of the covered BHCs also meet the 3 percent SLR at the end of the fourth quarter of 2013 but, again, not all would achieve the additional 3 percent enhanced SLR requirement had it been in effect at that time. The Agencies estimate these IDIs, in the aggregate, would need to increase their tier 1 capital by $38 billion to meet the additional 3 percent enhanced SLR requirement.

Proposed Rule to Modify Total Leverage Exposure

As proposed, the Agencies would modify the calculation of total leverage exposure, the denominator of the SLR, to include:[1]

- Adjustments to exposure amounts associated with derivative contracts if cash collateral received from, or posted to, a counterparty for derivative contracts does not meet specified conditions;
- The effective notional principal amount, subject to certain reductions, of sold credit protection that is not offset by purchased credit protection on the same underlying reference exposure that meets specified conditions;
- Adjustments to the on-balance sheet asset amounts for repo-style transactions (including securities lending, securities borrowing, repurchase and reverse repurchase transactions), including a requirement to include in total leverage exposure the gross value of receivables associated with repo-style transactions that do not meet specified conditions;
- A measure of counterparty credit risk for repo-style transactions; and
- The notional amount of all other off-balance sheet exposures (excluding off-balance sheet exposures associated with securities lending, securities borrowing, reverse repurchase transactions, and derivatives) multiplied by the appropriate credit conversion factor (CCF) under the standardized approach for risk-weighted assets. (For purposes of determining total leverage exposure, the minimum CCF that may be assigned to an off-balance sheet exposure is 10 percent.)

Under the proposal, the total leverage exposure would continue to include:

- The balance sheet carrying value of a banking organization's on-balance sheet assets, less amounts deducted from tier 1 capital as outlined in the US Basel III rules;
- The potential future exposure (PFE) for each derivative contract, including for certain cleared transactions, to which the banking organization is a counterparty (or each single-product netting set of such transactions) determined in accordance with the treatment of derivative contracts under the standardized approach for risk-weighted assets (subject to certain limitations in the US Basel III rule); and

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[1] This would affect all AA Banks, not just those subject to the enhanced SLR (covered BHCs (over $700 billion) and their subsidiary IDIs), and could have serious capital implications for these firms.

- Ten percent of the notional amount of unconditionally cancellable commitments made by the banking organization.

Calculation of Supplementary Leverage Ratio

Under the US Basel III rules, the Agencies' SLR is calculated as the arithmetic mean of the ratio of an AA Bank's tier 1 capital to total leverage exposure calculated as of the last day of each month in the reporting quarter. The proposed rule would revise the calculation of the SLR such that tier 1 capital would be calculated as of the last day of each reporting quarter and total leverage exposure would be calculated as the arithmetic mean of the total leverage exposure calculated as of each day of the reporting quarter.

Disclosures

Finally, the proposed rule would require certain banking organizations to comply with additional disclosure requirements for the calculation of the SLR. The disclosures would include information summarizing the differences between the total consolidated accounting assets reported on a banking organization's published financial statements and regulatory reports and the calculation of total leverage exposure, and detail information on the components of total leverage exposure.

Impact

The proposed modifications would generally increase the size of an entity's total leverage exposure. For the covered BHCs, the Agencies estimate, in the aggregate, total leverage exposure would increase approximately 8.5 percent. To exceed a 5 percent SLR (including the more than 2 percent enhanced SLR requirement) using the proposed definition of total leverage exposure, the Agencies estimate the covered BHCs, in the aggregate, would need to raise more than $46 billion in additional tier 1 capital (i.e., over and above the $22 billion they would need to raise to reach the enhanced SLR using the definition of total leverage exposure in the US Basel III rules.)

Separately, the Agencies estimate the proposed changes to the definition of total leverage exposure would result in an approximate 5.5 percent aggregate increase in total leverage exposure for all banking organizations subject to the revised definition.

Commentary

Industry commentary opposing the proposed enhanced SLR rule suggested the increased capital requirements will become a binding regulatory capital constraint. Some suggested that a binding leverage ratio would result in higher prices for credit products, less liquidity, and a reduction in business lines that have lower returns on assets.

Federal Reserve Board Governor Daniel Tarullo countered these arguments in opening remarks, stating that "Board staff estimates do suggest that this rule would make the leverage ratio more binding, relative to the risk-based capital ratios, for certain U.S.

systemic banking organizations" but that analysis also "suggests that these organizations could manage their capital structures to help meet the standards through certain low-cost, systemic-risk-reducing actions." He added that if the Agencies were to "increase the risk-based capital surcharge for U.S. systemically important firms to a higher level than the minimum agreed to internationally, such as by reference to dependence on runnable short-term wholesale funding, the supplemental leverage ratio would be less likely to bind in normal times." Governor Tarullo has been a strong advocate of capital charges tied to short-term wholesale funding.

Similarly, the Agencies did not accept the argument that the higher leverage ratios will adversely affect the competitive strength of US banking organizations, stating that US banking organizations have been subject to a leverage ratio framework for a long time while other jurisdictions have generally not, and this has not impaired their ability to compete at a global level.

It is clear that the Agencies are committed to mitigating the threats to financial stability posed by the largest, most globally interconnected and systemically important financial institutions and the enhanced SLR is one measure in their toolkit. They state that the 3 percent minimum SLR in the Basel III rules would have been too low to have meaningfully constrained the buildup of leverage at the largest institutions in the years leading up to the financial crisis and, as such, have imposed the enhanced SLR generally as proposed.

In addition, the Agencies issued a proposed rule (comments due July 13, 2014) to modify the composition of total leverage exposures (the denominator of the SLR), which will affect all AA Banks, a number of institutions greater than the covered BHCs subject to the enhanced SLR. The Agencies estimate these entities would, in the aggregate, experience a 5.5 percent increase in their total leverage exposure making the Basle III 3 percent SLR requirement (and the enhanced SLR as applicable) more difficult to achieve. For covered BHCs alone, the Agencies estimate the modifications to the denominator would require an additional $46 billion in capital holdings, which is nearly double the estimated impact attributable to the imposition of the enhanced SLR leverage buffer for these entities.

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