Regulatory Practice Letter
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Supplementary Leverage Ratio – Revisions to the Final Rule

Executive Summary

The Federal Reserve Board (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (collectively, the Agencies) approved a joint final rule on September 3, 2014 (September Final Rule), which revises the definition of "total leverage exposure" that serves as the denominator of the supplementary leverage ratio (SLR) adopted by the Agencies as part of their July 2013 final rule to implement the Basel III capital framework in the United States (U.S. Basel III rule). All banks, savings associations, bank holding companies (BHCs), and savings and loan holding companies (together, Banking Organizations) that are subject to the Agencies' Advanced Approaches risk-based capital rules (AA Banks), as defined in the U.S. Basel III rule, are subject to the SLR.

The September Final Rule is similar to the proposed rule released in April 2014 (please refer to Regulatory Practice Letter 14-08) though certain clarifications and adjustments have been made in response to the comments received. Broadly, the definition of "total leverage exposure" has been revised to:

- Include the effective notional principal amount of credit derivatives and other similar instruments through which a Banking Organization provides credit protection (sold credit protection);
- Modify the calculation of total leverage exposure for derivative and repo-style transactions; and
- Amend the credit conversion factors (CCFs) applied to certain off-balance sheet exposures.

The revisions also change the frequency with which certain components of the SLR are calculated (i.e., on-balance sheet items must be calculated as the average of each day of the reporting quarter and off-balance sheet items must be calculated as the average of the three month end amounts for the reporting quarter) and establish the public disclosure requirements of certain items associated with the SLR.

AA banks must disclose their SLRs beginning January 1, 2015 and comply with a minimum SLR of 3 percent beginning January 1, 2018. Certain Banking Organizations that are deemed to be globally systemic will also be expected to meet an enhanced SLR (equal to the minimum SLR plus a leverage buffer) beginning January 1, 2018. The new definition of "total leverage exposure" becomes effective January 1, 2015 and is to be used in each of these calculations.

Key Takeaways

- Modifying the composition and calculation of total leverage exposure, which is employed as the denominator of the SLR, will affect all AA Banks and, in general, make meeting the SLR and the enhanced SLR (refer to Background section) more difficult to achieve. However, the Agencies now estimate the total leverage exposure for the eight AA Banks subject to the enhanced SLR will increase in the aggregate 2.6 percent compared to the 8.5 percent previously estimated in the proposed rule. They suggest the decline in the aggregate increase reflects "a lower estimate of the impact of including the notional amount of credit derivatives, resulting from trade compression and possibly more offsetting of credit derivatives in response to the proposed rule."

- The Agencies "believe" the revisions to the definition of total leverage exposure "should not affect" the calibration of the 5 and 6 percent thresholds applicable to enhanced SLRs for entities subject to that rule.

- The SLR requires a banking organization to hold a minimum amount of capital against total assets and off-balance sheet exposures, regardless of the riskiness of the individual assets (excluding central bank deposits). The complementary relationship between the leverage and risk-based capital ratios "is intended to mitigate any regulatory capital incentives for Banking Organizations to inappropriately increase their risk profile in response to a strict" SLR. The Agencies, however, continue to also consider imposing additional capital requirements, such as a capital surcharge for Banking Organizations of global systemic importance and requirements related to short-term wholesale funding.

Background

The SLR is equal to the ratio of an AA Bank's tier 1 capital to total leverage exposure (as defined in the U.S. Basel III rule to include all on-balance sheet assets and many off-balance sheet exposures). Beginning January 1, 2018, AA Banks must maintain a minimum SLR of 3 percent. Certain Banking Organizations that are deemed to be globally systemic must hold an additional leverage buffer in excess of the minimum 3 percent SLR. The leverage buffer, referred to as the enhanced SLR, applies to top-tier U.S. BHCs that have more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody (covered BHCs - currently eight BHCs meet these thresholds) as well as any insured depository institution (IDI) of those covered BHCs. Covered BHCs will be required to hold additional tier 1 capital to exceed a 2 percent leverage buffer (resulting in an SLR in excess of 5 percent) and IDIs of the covered BHCs will be required to meet at least a 6 percent SLR (please refer to RPL 14-08).

The Agencies' revisions to the definition of "total leverage exposure" are intended to "better reflect" a banking organization's economic exposure to its off-balance sheet activities and 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. In press statements, FDIC Chairman Martin Gruenberg said, "This final rule completes a series of important leverage ratio rulemakings. The supplementary leverage ratio developed by the Basel Committee is an important part of the overall Basel III capital rules that the FDIC approved in interim form in July 2013, and finalized in April 2014. In contrast to the generally applicable leverage ratio that has long applied to U.S. IDI's, the supplementary leverage ratio includes certain off-balance sheet exposures in the denominator. This is particularly important since the advanced approaches banking organizations that are subject to the supplementary leverage ratio tend to have large amounts of off-balance sheet activity."

Description

The Agencies intend the SLR generally to require a Banking Organization to hold a minimum amount of capital against total assets and off-balance sheet exposures, regardless of the riskiness of the individual assets. The September Final Rule does not exempt or limit any category of balance sheet assets from the definition of total leverage exposure, including cash, U.S. Treasuries, and Federal Reserve deposits.

In the September Final Rule, the Agencies have generally adopted the modifications to the definition of total leverage exposure substantially as proposed. The modifications change the measure of total leverage exposure by:

- Adding the amount of cash collateral received or posted for derivatives contracts, except for cash variation margin that meets certain conditions.
- Adding the effective notional amount, subject to certain reductions, of each written credit derivative (that is, credit derivatives for which the banking organization acts as the credit protection provider) or other similar instrument to the extent that the exposure is not offset by purchased credit protection that meets certain conditions.
- Adding the gross value of receivables of any repo-style transactions that do not meet certain conditions.
- Adding the counterparty credit risk associated with repo-style transactions.
- Revising the treatment of other off-balance-sheet exposures; rather than including the full notional amount of each exposure, the revised measure of total leverage exposure would use the credit conversion factors set forth in the standardized approach in the U.S. Basel III rule, provided that no credit conversion factor can be less than 10 percent.

In addition, the September Final Rule preamble provides a number of clarifications with regard to the:

- Circumstances under which a Banking Organization may use cash variation margin to offset the mark-to-fair value of derivative contracts;
- Criteria to reduce the effective notional amount of sold credit protection;
- Criteria for recognizing the GAAP (generally accepted accounting principles) offset for repo-style transactions;
- Forward agreements associated with a repurchase or securities lending transaction that qualifies for sales treatment under GAAP; and
- Circumstances when a clearing member Banking Organization would be required to include in total leverage exposure an exposure to client-cleared transactions.

Calculation of the Supplementary Leverage Ratio

Under the U.S. 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 have revised the calculation of the SLR such that tier 1 capital would have been calculated as of the last day of each reporting quarter and the total leverage exposure would have been calculated as the arithmetic mean of the total leverage exposure calculated as of each day of the reporting quarter.

Under the September Final Rule, the SLR is calculated as the ratio of tier 1 capital to total leverage exposure, where total leverage exposure is calculated as the sum of:

- The mean of the on-balance sheet assets calculated as of each day of the reporting quarter; and
- The mean of the off-balance sheet exposures calculated as of the last day of each of the last three months.

Impact

Unlike the proposed rule, the Agencies do not provide an estimate of any aggregate increase in the total leverage exposure anticipated for all Banking Organizations subject to the revised definition. They do, however, estimate that total leverage exposure across the eight covered BHCs subject to the enhanced SLR would increase by an average of 2.6 percent under the September Final Rule over the amount required using the definition under the U.S. Basel III rule. The Agencies had estimated in the proposed rule that these BHCs would experience an 8.5 percent increase in total leverage exposure and they suggest the lower 2.6 percent aggregate increase reflects "a lower estimate of the impact of including the notional amount of credit derivatives, resulting from trade compression and possibly more offsetting of credit derivatives in response to the proposed rule."

Using data as of the second quarter of 2014, the Agencies further estimate the covered BHCs will need to raise in the aggregate approximately $14.5 billion of tier 1 capital beyond what would have been required using the definition in the U.S. Basel III rule in order to exceed a 5 percent SLR (the 3 percent SLR plus the greater than 2 percent enhanced SLR requirement). Using data as of the fourth quarter of 2013, the Agencies had previously estimated an incremental requirement of $46 billion. The Agencies state the change is the result of the BHCs' capital raising (an increase in tier 1 capital of 9.3 percent) in combination with a 2.9 percent increase in total leverage exposure between the fourth quarter of 2013 and the second quarter of 2014.

Disclosure

AA Banks are required to publicly disclose information related to their SLR on a quarterly basis using a template included in the September Final Rule as Table 13. The template consists of two parts:

- Part 1 summarizes 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.
- Part 2 collects detailed information on the components of total leverage exposure, similar to Schedule A of the Form FFIEC 101.

Banking Organizations must disclose and explain the source of material differences between their total consolidated assets, as reported in published financial statements and regulatory reports, and their reported on-balance sheet assets for purposes of calculating the SLR. Banking Organizations must also explain the key drivers of any "significant" changes in SLRs from one reporting period to another.

The Agencies indicate they have future plans to reconsider the regulatory reporting requirements related to the SLR on Form FFIEC 101, Schedule A, to reflect the disclosures and the revisions to the calculation of the total leverage exposure.

Commentary

In final form, the denominator of the SLR increases the stringency of the SLR and the enhanced SLR. Based on their use of second quarter 2014 data, the Agencies, however, now estimate that meeting the requirements will be much easier, in part, they suggest, because Banking Organizations are adjusting to the new definition.

The Agencies state they are evaluating the calculation methodology for the leverage ratio applicable to all Banking Organizations (the standard leverage ratio) and may seek comment on a proposal that would be applicable to AA Banks and would align the methodology for calculating on-balance sheet assets for purposes of the standard leverage ratio with the SLR.

The Agencies also state they are participating in the Basel Committee's development of the international leverage ratio standards, and will consider the extent to which any changes should be made to the calculation of total leverage exposure for derivative contracts in the United States once the Basel Committee has reached an agreement on whether and how to incorporate the standardized approach for measuring counterparty credit risk exposures (SA-CCR) into its leverage ratio. If adopted, the SA-CCR would replace the current exposure method (CEM) to measure the total leverage exposure associated with derivative contracts that is included in the September Final Rule.

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