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Regulatory Alert

Financial Services Regulatory Insight Center

May 2018

Federal banking agencies propose changes to regulatory capital rules affecting large banking organizations

Key points

- Proposed changes to the regulatory capital rules governing the stress testing requirements and the enhanced supplementary leverage ratio (ESLR) would tailor these rules to reflect the business activities and risk profile of large banking organizations.
  - New stress buffer requirements would integrate the quantitative assessment of the Federal Reserve's CCAR and stress test rules with the regulatory capital buffer requirements.
  - Modifications to the ELSR applicable to GSIBs would replace the leverage buffer with an amount based on a firm's risk-based capital surcharge; corresponding changes would be made to incorporate this new amount into the "well-capitalized" threshold applicable to Covered IDIs and to the TLAC requirements.

Summary

Federal Reserve Board (Federal Reserve) Vice Chairman for Supervision Randall Quarles has advocated tailoring the post-crisis regulations to better reflect the risk posed by individual institutions. Although the focus has primarily looked to reducing the regulatory burden of community banks, two recently proposed rules would tailor certain regulatory capital requirements for very large banking institutions and tie those requirements to the firms' business activities and risk profiles. Key features of each proposal are summarized below.

Capital and stress test requirements

The Federal Reserve has proposed to integrate the quantitative assessment of its Comprehensive Capital Analysis and Review (CCAR) with the buffer requirements in its capital rules to create "stress buffer requirements," including a "stress capital buffer" and a "stress leverage buffer." The rule would apply to bank holding companies (BHCs) with total consolidated assets of $50 billion or more and intermediate holding companies of foreign banking organizations. A firm's stress buffer requirements would be effective on October 1 of each year, and remain in effect until September 30 of the following year. As proposed, the rule would become effective on December 31, 2018 with the first stress capital buffer and stress leverage buffer requirements becoming generally effective October 1, 2019.

- **Stress capital buffer:** The stress capital buffer would be calculated as the difference between a firm's starting and lowest projected common equity tier 1 (CET1) ratio under the severely adverse scenario of the supervisory stress test calculated using the standardized approach, plus the firm's planned common stock dividends for each of the fourth through seventh quarters of the planning horizon (expressed as a percentage of risk-weighted assets (RWAs)). The stress capital buffer would be subject to a floor equal to 2.5 percent of RWAs.
  - The stress capital buffer would replace the 2.5 percent of RWAs portion of the capital conservation buffer under the standardized

approach; the advanced approach would continue to use the 2.5 percent of RWAs measure in the capital conservation buffer.

— **Stress leverage buffer:** The stress leverage buffer would be calculated as the difference between a firm's starting and minimum projected tier 1 leverage ratio under the severely adverse scenario of the supervisory stress test plus planned common stock dividends for each of the fourth through seventh quarters of the planning horizon (expressed as a percentage of RWAs). The stress leverage buffer requirement would replace the CCAR requirement that a firm demonstrate its ability to maintain capital levels above minimum leverage requirements on a post-stress basis. It would have no floor and would be additive to the 4 percent minimum required CET1 leverage ratio.

— **CCAR changes:** The proposed rule would make three adjustments to CCAR: (1) firms would be required to prefund only four quarters of planned common stock dividends; (2) a firm's balance sheet would be assumed to remain constant under stress; and (3) the 30 percent dividend payout ratio threshold for heightened supervisory scrutiny would be removed.

— **Objections to stress test results:** The proposed rule would eliminate the Federal Reserve's ability to object to a firm's CCAR results based on quantitative measures. A pattern of materially underperforming baseline projections for earnings, capital levels, or capital ratios may be indicative of weaknesses in the firm's capital planning and result in heightened scrutiny in the qualitative assessment.

Enhanced Supplementary Leverage ratio

The ESLR is applicable to U.S. global systemically important banking holding companies (GSIBs) and their Federal Reserve- and OCC-regulated insured depository institutions (Covered IDIs). For these entities, the proposed changes would:

— **Replace the ESLR buffer:** The 2 percent leverage buffer would be replaced by a leverage buffer equal to 50 percent of a firm's GSIB risk-based capital surcharge (GSIB surcharge). The current minimum 3 percent supplementary leverage ratio requirement would not change.

— **Change IDI "well-capitalized" threshold: T**he current "well-capitalized" threshold of 6 percent applicable to covered IDIs under the prompt corrective action framework would be changed to a threshold of 3 percent plus 50 percent of the GSIB surcharge applicable to the IDI's GSIB holding company.

— **Make corresponding changes to TLAC:** Calculation of the external Total Loss-Absorbing Capacity (TLAC) leverage buffer and long-term debt requirement would be amended to incorporate 50 percent of the firm's GSIB surcharge, consistent with changes to the ESLR.

Closing Thoughts

Federal Reserve staff estimate the proposed stress buffer requirements would decrease the amount of capital required for non-GSIBs subject to CCAR relative to current requirements, and generally maintain or, in a few cases, increase the amount of capital required for GSIBs. With regard to the ESLR proposal, Federal Reserve and OCC staff estimate that the changes would lead to a reduction in CET1 capital requirements of approximately $400 million. Firms would continue to be expected to meet minimum capital requirements plus minimum buffer requirements to avoid limitations on capital distributions and discretionary bonus payments.

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