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ALERT MEMORANDUM

U.S. Banking Agencies Propose Increases to Capital Requirements of Banking Institutions

July 28, 2023

On July 27, 2023, the federal banking agencies released a lengthy proposal to revise the capital rules applicable to large banks and bank holding companies. The headline news is that the banking agencies expect the proposal **to increase capital requirements in the aggregate by 16% across banking organizations that have more than $100 billion in assets (large banking organizations)**.

This alert memo offers some quick takes on a few key points based on our initial review.

- ***Not without opposition.*** The vote at the FDIC board was 3-2 for publication of the main capital proposal, and the vote at the Federal Reserve Board was 4-2, with strong dissents from some board members echoing recent comments by Congress and trade associations that increasing capital requirements is not currently necessary and is likely to harm the economy and competitiveness of the U.S. banking industry.
  - Even some of the Federal Reserve Board members who voted for publication indicated that they would need to consider comments from the public before making a final decision on the need for increased capital.
  - This underscores how important it will be for industry participants to offer well-reasoned and supported comments on the proposal.
- ***Not released as an "advance notice of proposed rulemaking" (ANPR), but banking agencies signaled that they are still collecting data on potential effects of the capital raise required by the proposal.*** The adequacy of the cost-benefit analysis done to date is likely to be a key point of industry comment.
- ***Timing.*** The comment period on the proposal ends on November 30, 2023, unless extended. The banking agencies do not anticipate making a final rule effective until at least July 2025, and the proposal suggests a three-year phase-in period after that for most provisions.

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- ***The main thrust of the proposal is to eliminate the use of models in relation to credit risk and operational risk and, for market risk exposures, to make the use of models much more difficult to be approved (and to stay approved).***
  - *Credit Risk:* Firms would be required to use a new, expanded risk-based approach for credit risk (a standardized approach with greater risk sensitivity, replacing the models-based advanced approaches), in addition to the existing, generally applicable standardized approach.
  - *Market Risk:* Internal models to measure market risk would need to be approved by the responsible banking agency, and thereafter would be required to pass back-testing and P&L attribution tests in order to stay approved; otherwise, firms would be required to use a standardized approach for market risks. Risks would be required to be modeled (and internal models approved and backtested) at the level of individual trading desks rather than at the firm level.
  - *Operational Risk:* Firms would be required to use a standardized approach, rather than internal models, to measure operational risk. The proposal would adjust the operational risk charge upward based on the firm's historical operational losses.
- ***Bank holding companies and their bank subsidiaries, as well as intermediate holding companies (IHCs), in Categories III and IV of the tailoring rules (between $100 billion and $700 billion in total assets, or that have crossed certain risk thresholds) would be subjected to the most changes.*** The proposal seeks to establish similar capital adequacy requirements across all four tailoring categories, essentially eliminating differences in relation to the calculation of capital.
  - All Category III and IV firms would be:
    - required to include the volatility of unrealized losses and gains in their available-for-sale (AFS) securities portfolio when calculating risk-weighted assets (otherwise known as the flow-through of accumulated other comprehensive income or AOCI);
    - subject to the methods for calculating the numerator (the capital component) of capital ratios that previously were reserved for advanced approaches banks, including more stringent requirements regarding mortgage servicing rights and deferred tax asset deductions from capital, limits on amounts of minority interests that could qualify as capital, and deductions of non-significant investments in unconsolidated financial institutions, among others; and
    - required to calculate derivative risk-weighted assets under the standardized approach for counterparty credit risk (SA-CCR) rather than opting to use the simple current exposure methodology.

- All Category III and IV firms would be newly required to calculate their capital based on both the new expanded risk-based approach and the existing, generally applicable standardized approach, and then measure compliance based on the more stringent of the two ratios.

- All Category III and IV firms would be newly required to take a standardized operational risk charge; operational risk charges were previously reserved for advanced approaches institutions.

- Category IV firms would also be newly subject to the countercyclical capital buffer (if activated by the banking agencies) and the supplementary leverage ratio (which is more complex than the Tier 1 leverage ratio, as it incorporates off-balance-sheet exposures).

- The proposal contains the footprints of the March 2023 banking turmoil, with the banking agencies emphasizing the potential effects of Category III and IV banking organizations on financial stability. A focus on resiliency of institutions through capital strength in the wake of that turmoil appears to be one driver behind the banking agencies' departure from prior "capital neutrality" statements and the greater-than-expected increase in capital under the proposal. The proposal's standardization of credit risk and operational risk components also is intended to increase the transparency and comparability of capital requirements, something that the banking agencies argue will be helpful to supervisors as well as market participants.

- ***All large banking organizations would now apply market risk capital rules,*** which is likely to include some firms that were previously excluded because they did not cross the thresholds based on amount of trading assets/liabilities. For smaller firms below Category IV, the trading asset/liability threshold was raised, so it is likely that there will be fewer firms included in the market risk capital requirements on that basis (*i.e.*, from outside the large banking organizations).

- ***The G-SIB surcharge would be revised, which is expected to increase requirements for U.S. GSIBs.*** The Federal Reserve approved a separate proposal to:

  - reduce "cliff effects" from changes in risk tiers, moving to 10bp increments instead of 50bp;

  - measure indicators on an average basis over the past year, rather than a snapshot at year-end, to (as stated by the Federal Reserve) reduce "window-dressing" adjustments at year-end; and

  - adjust certain of the systemic risk indicators.

- ***No changes were proposed to:***

  - stress testing requirements (other than how the stress capital buffer is calculated under the new dual standardized calculation frameworks) – therefore, for example, Category IV

institutions would still participate in CCAR on a two-year cycle, in contrast to the every-year cycle for Categories I through III;

  - the supplementary leverage ratio (other than extending it to Category IV firms) or the enhanced supplementary leverage ratio;

  - the countercyclical capital buffer (other than extending it to Category IV firms); or

  - total loss-absorbing capacity (TLAC) or long-term debt (LTD) requirements (other than how the risk-weighted asset denominator may affect the amount needed); on the other hand, the banking agencies have signaled that there likely will be a separate proposal on TLAC and LTD, including potentially to make some amount of TLAC and/or LTD applicable to Category II through IV firms.

- ***Mixed effects on foreign banks operating IHCs in the United States.***

  - The Federal Reserve highlighted, in its approval meeting, that other jurisdictions may continue to permit models for credit risk, but the proposal would eliminate the advanced approaches and models for credit risk in favor of two standardized approaches. This is one of several provisions in the proposal that are "gold-plated" over those required by the international Basel agreement. This divergence is likely to be a key area of focus in industry comments, not only for domestic banking organizations but also for IHCs of foreign banks.

  - The Federal Reserve's current Regulation YY exempted IHCs from needing to apply the advanced approaches (unless an IHC were to opt in). The proposal would eliminate the exemption/opt-in and require both the expanded risk-based calculation and the standardized approach calculation for all IHCs that are large banking organizations, including requiring that the IHC measure compliance based on the more stringent of the two ratios.

  - Many IHCs are in Category III and IV where, as noted above, most of the proposed changes will have significant effects and increase capital requirements.

    - Based on the Federal Reserve's own data, domestic Category III and IV firms would likely see an average increase of 6% in capital requirements, whereas IHCs in Categories III and IV would likely see an average increase of 14% in capital requirements.

    - The Federal Reserve also predicted that the changes to the numerator (amount of capital) calculations would yield "somewhat larger increases for foreign firms and smaller increases for domestic ones."

  - Also, as the result of a somewhat hidden impact, certain changes to the systemic risk indicators in the GSIB surcharge proposal, such as including derivatives in the calculation of "cross-jurisdictional activity", are estimated to elevate the combined U.S.

operations of seven foreign banks into Category II and two foreign bank IHCs into Category II, while (according to the Federal Reserve) not affecting the categorization of domestic firms.

The following are links to the key documents released yesterday:

- Federal Reserve Board
- FDIC
- Office of the Comptroller of the Currency

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