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ALERT MEMORANDUM

July 10, 2013 clearygottlieb.com

Final Capital Rules Adopted: Relief for Community Banks, Increased Burden for Large Internationally Active Banks

Agencies Also Propose to Increase the Supplementary Leverage Ratio for Eight U.S. Systemically Important Bank Holding Companies and Their Bank Subsidiaries

On July 2, 2013, the Board of Governors of the Federal Reserve System (the "Federal Reserve") issued a final capital rule that overhauls its existing capital adequacy rules and implements both the Basel III Capital Framework issued by the Basel Committee on Banking Supervision (the "Basel Committee") in 2010 and certain requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] While the Final Rule consolidates and largely adopts unchanged the three proposals issued by the federal banking agencies (the "agencies") last June,[2] the rule contains several significant burden-reducing modifications adopted in response to comments from community banking organizations. By contrast, the rule provides little relief for the approximately 18 banking organizations subject to the advanced approaches capital rules[3] ("advanced approaches banking organizations"), and increases the burden on these organizations in certain significant respects—most notably by expanding the application of the Collins Amendment Floor[4] to the capital conservation and countercyclical capital buffers.

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1 The final rule (the "Final Rule") is available at http://www.federalreserve.gov/aboutthefed/boardmeetings/20130702__Basel_III_Final_Rule.pdf.

2 See 77 Fed. Reg. 52,792 (Aug. 30, 2012) (the "Basel III NPR"); 77 Fed. Reg. 52,888 (Aug. 30, 2012); 77 Fed. Reg. 52,978 (Aug. 30, 2012) (collectively, the "Proposals").

3 A banking organization is mandatorily subject to the advanced approaches if it has total assets greater than or equal to $250 billion dollars or foreign exposure greater than or equal to $10 billion dollars, or it is a subsidiary of a banking organization that is mandatorily subject to the advanced approaches. However, a banking organization may also opt into the advanced approaches. The agencies clarify in the Final Rule that banking organizations that meet these thresholds or opt in need not have completed their parallel run to be considered "advanced approaches banking organizations". Even within parallel run, advanced approaches banking organizations will become subject to all provisions of the rule that apply to such banking organizations when calculating advanced approaches capital ratios, including, e.g., recognizing all components of AOCI in CET 1, as defined and described below.

4 Section 171 of the Dodd-Frank Act, 12 U.S.C. § 5371 (the "Collins Amendment Floor"). The Collins Amendment Floor requires advanced approaches banking organizations to calculate their required minimum risk-based capital ratios using both the advanced internal models-based approach and the generally applicable risk-based capital rules (currently the Basel I-based rules until the standardized approach takes effect in January 2015) and determine their compliance with the minimum ratios based on the lower, or more conservative, of the two ratios. See Final Rule, §__.10(c).

On July 9, the Federal Deposit Insurance Corporation (the "FDIC") also voted to adopt the Final Rule,[5] and was the first of the three agencies to issue an interagency notice of proposed rulemaking that would amend the Final Rule to significantly increase the supplementary leverage ratio requirement applicable to the eight U.S. banking organizations that have been identified as global systemically important banks ("G-SIBs")[6] by the Financial Stability Board (the "FSB") (the "Supplementary Leverage Ratio Proposal").[7] Under the Supplementary Leverage Ratio Proposal, the eight U.S. G-SIBs would effectively be subject to a 5% supplementary leverage ratio minimum at the parent level and a 6% supplementary leverage ratio minimum at the level of each bank subsidiary—each of which represents a significant surcharge above the current Basel III 3% minimum leverage ratio applicable from January 1, 2018 to all advanced approaches banking organizations under the Final Rule.

OVERVIEW AND KEY TAKEAWAYS

While community banks did not receive the general exemption from enhanced capital requirements that they requested, the Final Rule does provide significant relief to community banking organizations. Specifically, banking organizations that are not subject to the advanced approaches will be permitted to opt out of the requirement that banking organizations include the components of accumulated other comprehensive income ("AOCI") in common equity Tier 1 ("CET 1") capital. Similarly, banking organizations that are not subject to the advanced approaches will have more time to comply with the Final Rule. Advanced approaches banking organizations (other than savings and loan holding companies ("SLHCs")) will be required to comply with the Final Rule, subject to certain transition provisions, beginning on January 1, 2014, while all other banking organizations will have until January 1, 2015 to begin compliance, thus providing these institutions more time to accrete capital through retained earnings. In addition, banking organizations with less than $15 billion in total assets will not be subject to the phase-out of non-qualifying Tier 1 capital instruments, such as trust preferred securities ("TruPS") and cumulative preferred securities, which should further reduce the burden of compliance with the Final Rule on smaller institutions.

5 The FDIC adopted the Final Rule as an interim final rule, anticipating further revisions may be required as a result of the Supplementary Leverage Ratio Proposal (defined below). The Office of the Comptroller of the Currency (the "OCC") also approved the Final Rule on July 9.

6 The U.S. banking organizations that are currently identified as G-SIBs and that would be subject to the Supplementary Leverage Ratio Proposal are Citigroup Inc., JPMorgan Chase & Co., Bank of America Corporation, The Bank of New York Mellon Corporation, Goldman Sachs Group, Inc., Morgan Stanley, State Street Corporation and Wells Fargo & Company.

The reference to these "eight" U.S. banking organizations is derived from the list of G-SIBs published by the FSB in November 2012. See FSB, Update of Group of Global Systemically Important Banks (Nov. 1, 2012), available at http://www.financialstabilityboard.org/publications/r_121031ac.pdf. See also Basel Committee, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement (Nov. 2011). The Basel Committee recently updated their assessment methodology for classifying G-SIBs. See Basel Committee, Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement (July 2013), available at http://www.bis.org/publ/bcbs255.pdf.

7 The Supplementary Leverage Ratio Proposal is available at http://www.fdic.gov/news/board/2013/2013-07-09_notice_dis_b_res.pdf.

The Final Rule does provide some burden relief that will benefit all banking organizations by eliminating the Proposals' complex categorization and risk weighting requirements for residential mortgages, in favor of retaining the current approach in the general risk-based capital rules which weights most first-lien mortgages at 50%. The elimination of this approach to residential mortgage exposures also has substantial indirect burden-reducing benefits by simplifying the risk weight determinations for residential mortgage-backed securitization exposures, which rely on a look-through to the risk weights applicable to mortgages in the underlying pool. However, at the Federal Reserve's board meeting to adopt the rules, staff indicated that they may revisit the mortgage risk weightings after they have had an opportunity to observe the interaction between the capital rules and other rules on residential mortgage loans, some of which are still in the process of being implemented.[8]

Notwithstanding certain beneficial modifications, the agencies rejected an almost innumerable amount of comments that requested further flexibility, and proceeded to tighten the capital requirements in a number of areas. Further detail and highlights of these additional burdens are described throughout this memo, but at least one significant issue deserves immediate mention. The Final Rule disqualifies certain subordinated debt issuances by bank holding companies ("BHCs") from Tier 2 capital by indicating that subordinated debt instruments must be subordinated to the claims of trade creditors in order to qualify as Tier 2 capital. The current BHC capital rules applicable to TruPs and BHC subordinated debt explicitly permit such instruments to be pari passu with trade creditors—a feature that is important from a tax perspective to enhance the debt characteristics of the instrument. However, Federal Reserve staff have confirmed that the Final Rule reverses this past policy in order to comply with the Collins Amendment (which requires BHCs with total assets of $15 billion or more to phase out capital instruments that would not qualify as regulatory capital under the guidelines generally applicable to depository institutions). Accordingly, outstanding subordinated debt issued by BHCs in reliance on this precedent will be disqualified from Tier 2 capital (and without the benefit of a phase-out, if issued after May 19, 2010).

While there are several aspects of the Final Rule that will increase burden on advanced approaches banking organizations, the Supplementary Leverage Ratio Proposal is a more significant development, as it would considerably increase the amount of equity capital the eight U.S. G-SIBs would effectively be required to hold. The agencies estimate that if the proposed increases to the supplementary leverage ratios had been in effect as of the third quarter of 2012, these eight banking organizations would have needed to increase their Tier 1 capital by approximately $63 billion in the aggregate to meet the parent-level ratio and by approximately $89 billion in the aggregate to meet the bank-level ratio. While the agencies anticipate that "almost all" the U.S. G-SIBs and all their subsidiary banks are on track to meet the ratios by

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8 See, e.g., the definition of "qualified mortgage" in section 1412 of the Dodd-Frank Act (15 U.S.C. § 1639c(b)(2)(A)) and "qualified residential mortgage" in section 941(b) of the Dodd-Frank Act (15 U.S.C. § 78o-11(e)(4)). The definition of qualifying mortgage has been implemented in a final rule to be codified at 12 C.F.R. pt. 1026; however, the definition of qualifying residential mortgage will remain unclear until rules related to risk retention in securitizations are finalized.

At the FDIC board meeting approving the FDIC's interim final rule, FDIC Director Jeremiah Norton criticized the failure of the Final Rule to modernize risk weights for mortgage loans, suggesting at least some internal support for further revisions to the Final Rule's mortgage risk weights.

year-end 2017, when the proposal is set to take effect, they acknowledge that these higher capital standards could increase the cost and reduce the availability of credit in the wider economy.

Overall, given the Supplementary Leverage Ratio Proposal and the number of Basel Committee issuances in the last two weeks proposing further alterations to the Basel Capital Framework, the Final Rule represents a "living" document that the agencies will undoubtedly be substantially revisiting in the near future to incorporate further changes. In addition, in opening remarks on the Final Rule, Governor Tarullo alerted the eight U.S. G-SIBs[9] that there would be a series of forthcoming rules, in addition to the Supplementary Leverage Ratio Proposal, that will further ratchet up the capital requirements applicable to these banking organizations. Specifically, with regard to these and other banking organizations, he noted the following:

- A proposal should be released in the next few months imposing a combined equity and long-term debt requirement;

- A proposal to implement the G-SIB capital surcharge should be released by year-end; and

- An advanced notice of proposed rulemaking is being drafted to increase capital requirements for, and apply additional measures to, firms dependent on short-term wholesale funding.

This memorandum provides a high-level analysis of the Final Rule and the Supplementary Leverage Ratio Proposal and highlights the agencies' responses to certain key concerns addressed in the more than 2,500 comments received on the Proposals. In addition, this memorandum provides an overview of anticipated U.S. proposals (and recent Basel Committee proposals) that would further increase capital requirements for large, internationally active banking organizations in the near term.

9 Together with the Supplementary Leverage Ratio Proposal, this is the first, relatively clear indication that the U.S. agencies intend to apply additional requirements primarily to the eight U.S. institutions that meet the G-SIB criteria. In the past, for example, the Federal Reserve had stated that it would contemplate applying a "G-SIB surcharge" of additional capital to a "subset" of the greater-than-$50 billion banking organizations subject to Section 165 of the Dodd-Frank Act. See 77 Fed. Reg. 594, 599 (Jan. 5, 2012). In addition, at the time of the Proposals, the OCC stated that it was contemplating enhanced standards for a yet-to-be-determined group of large national banks. See 77 Fed. Reg. 52,792, 52,799 (Aug. 30, 2012).

TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

Page

TABLE OF CONTENTS
(continued)

Page

I. THE SUPPLEMENTARY LEVERAGE RATIO PROPOSAL

A. Operation

The Supplementary Leverage Ratio Proposal has two main operating provisions that impose higher leverage capital requirements on the eight U.S. G-SIBs and their subsidiary banks. Both provisions effectively require these banking organizations to hold additional leverage capital buffers above the Basel III 3% minimum supplementary leverage ratio requirement, although the mechanics of the two surcharges differ slightly.

- Parent-Level Supplementary Leverage Buffer: The U.S. G-SIBs would be subject to a 2% supplementary leverage ratio buffer requirement at the parent level. This parent-level surcharge would operate in the same manner as the capital conservation buffer, incrementally restricting the G-SIB parent organization's ability to engage in capital distributions such as dividends, share buybacks and discretionary bonus payments as its supplementary leverage ratio progressively descends into the buffer zone between 4.99% and 3%.

- Well-Capitalized Threshold for Subsidiary Banks: The bank-level surcharge would, in contrast, take the form of a requirement for each G-SIB subsidiary bank to meet a supplementary leverage ratio of 6% to be considered well-capitalized under the Prompt Corrective Action ("PCA") framework. Unlike the supplementary leverage buffer applicable at the parent level under the proposal, slipping below the 6% threshold would not automatically trigger incremental restrictions on capital distributions. However, maintaining well-capitalized status at the subsidiary bank level is essential to maintaining the parent's status as a financial holding company ("FHC") as well as qualifying for expedited processing of regulatory applications and notices. Therefore, the 6% well-capitalized threshold would effectively become the minimum required supplementary leverage ratio for these banking organizations.

Under the proposal, the supplementary leverage ratio calculation would remain unchanged from the Final Rule, which defines the ratio as the simple arithmetic mean of the ratio of the banking organization's Tier 1 capital to total leverage exposure calculated as of the last day of each month in the reporting quarter.[10] While the proposal does not incorporate the recent changes to the calibration of the supplementary leverage ratio proposed by the Basel Committee, the agencies have indicated they plan to make appropriate revisions after considering any final Basel Committee leverage ratio rules. As discussed in greater detail in Part VI.A below, such revisions are expected to materially increase leverage capital requirements by expanding the denominator of the supplementary leverage ratio.

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[10] The agencies did request comment, however, on whether the numerator of the leverage ratio should remain Tier 1 capital, or should be changed to another capital measure, such as CET 1 or total capital.

B. Scope and Effective Date

The leverage buffer and well-capitalized leverage threshold in the Supplementary Leverage Ratio Proposal would only apply to a limited subset of the largest U.S. financial institutions. The proposal's parent company leverage buffer would apply to any U.S. top-tier BHC with at least $700 billion in total consolidated assets or at least $10 trillion in assets under custody, and the well-capitalized threshold would apply to all the bank subsidiaries of those institutions. Currently, only the eight U.S. banking organizations preliminarily identified as G-SIBs by the FSB meet these thresholds.

The Supplementary Leverage Ratio Proposal, if adopted as proposed, would not require the eight U.S. G-SIBs to meet these elevated ratios until January 1, 2018, when the 3% supplementary leverage ratio in the Final Rule will take effect as a Pillar 1 minimum requirement for all other advanced approaches banking organizations.

Comments on the Supplementary Leverage Ratio Proposal are due 60 days after publication of the proposal in the Federal Register.

C. Potential Interagency Divergence on the Appropriate Level of an Elevated Supplementary Ratio

The FDIC, and Vice Chairman Hoenig in particular, have consistently advocated for higher, more conservative leverage ratios, and this Supplementary Leverage Ratio Proposal seems to be the culmination of these efforts. Governor Tarullo has indicated that the Federal Reserve shares the view that the Basel III supplementary leverage ratio was set "too low," although his remarks emphasized the role of the leverage ratio is to be "an effective counterpart to the combination of risk-weighted capital measures that have been agreed internationally" rather than a replacement for risk-based capital requirements. Accordingly, it is unclear whether there is true interagency agreement that the proposal strikes the right balance between simplicity and conservatism in capital regulation on the one hand, and the need to maintain risk sensitivity on the other. Vice Chairman Hoenig actually opposed the adoption of the Final Rule (adopted by the FDIC as an interim final rule to accommodate comments on the interaction between the Supplementary Leverage Ratio Proposal and the Final Rule) because it did not provide for immediate adoption of the Supplementary Leverage Ratio Proposal, and his remarks made clear that he supports more substantial changes to the Final Rule to eliminate its "primary reliance on a risk-weighted asset standard" and to end "the disparity in capital requirements between and among banks". FDIC Director Norton, while voting for adoption of the Final Rule, also expressed disappointment at the inability of the agencies to reach consensus more quickly on a simpler, higher supplementary leverage ratio requirement.

II. IMPLEMENTATION OF THE BASEL III FRAMEWORK

A. Scope and Effective Dates

The Final Rule will require <u>all</u> banking organizations, regardless of size, to comply with the Basel III minimum risk-based capital requirements. However, only advanced approaches banking organizations that are not SLHCs will be required to begin compliance with the elevated minimum ratios and the revised definition of capital on January 1, 2014, subject to various transition provisions. Advanced approaches banking organizations that are not SLHCs must also begin compliance with the changes to the advanced approaches to determining risk-weighted assets on January 1, 2014, although they will not be required to adopt the standardized approach to determine compliance with the Collins Amendment Floor until the standardized approach replaces the current Basel I-based rules as the generally applicable risk-based capital rules on January 1, 2015. All other banking organizations, including all SLHCs, will have until January 1, 2015 to comply with the Final Rule. Finally, all banking organizations would become subject to the capital conservation buffer when its phase-in begins in 2016. However, certain aspects of the proposal—specifically the supplementary leverage ratio and the countercyclical buffer—remain applicable only to advanced approaches banking organizations.[11]

1. No Relief for Small SLHCs

Despite comments advocating that the Federal Reserve Board should exercise its discretion to exempt small SLHCs (under $500 million in total consolidated assets) from revised capital rules, small SLHCs would not be able to take advantage of the exemption available to small BHCs. The Federal Reserve specifically stated that they did not believe they had the authority to craft a small SLHC exemption, because the Collins Amendment does not expressly exempt small SLHCs (unlike small BHCs subject to the Federal Reserve's Small Bank Holding Company Policy Statement) from the minimum risk-based capital requirements for depository institution holding companies. The imposition of these formal capital and associated reporting requirements on small SLHCs will result in a significantly higher regulatory and reporting burden for small thrifts in a shell holding company structure and would appear to incentivize these organizations to reorganize into a BHC structure.

2. Temporary Relief for SLHCs Engaged in Commercial or Insurance Activities

The agencies did take into account comments from SLHCs substantially engaged in insurance underwriting activities or commercial activities. Accordingly, at least temporarily, the Final Rule will not apply to:

- Grandfathered unitary SLHCs with 50% or more of their consolidated assets or revenues derived from non-financial activities (although the Federal Reserve anticipates it will release a proposal in the near term, pursuant to Section 626 of the Dodd-Frank Act, that will specify the criteria for commercial companies to establish and transfer activities to intermediate holding companies and will apply the Final Rule's capital requirements in this context);

- SLHCs that are insurance underwriters; and

[11] The agencies rejected commenters' calls for an empirical study of the impact of the Proposals, which could have further delayed implementation of the rules, citing a Basel Committee quantitative impact study suggesting that stronger capital requirements help reduce the likelihood of banking crises while yielding positive net economic benefits.

- SLHCs that have more than 25% of their consolidated assets in insurance underwriting subsidiaries (other than assets in underwriting insurance for credit risk).[12]

However, Federal Reserve staff noted at the public meeting that a proposal for a supervisory framework, including capital regulations, for these institutions should be implemented before 2015.

3. Non-Bank SIFIs Not Addressed

In its proposal to implement Section 165 of the Dodd-Frank Act,[13] the Federal Reserve would require non-bank financial institutions ("Non-Bank SIFIs") that are designated as systemically important by the Financial Stability Oversight Council ("FSOC") to meet the minimum capital requirements applicable to BHCs within 180 days of their designation as Non-Bank SIFIs. Non-Bank SIFIs that meet the threshold for the mandatory application of the advanced approaches would be required to calculate their capital requirements under the advanced approaches, but would not be subject to any requirement to comply with the advanced approaches' minimum capital requirements—including the capital requirements for operational risk and credit valuation adjustments. Because Non-Bank SIFIs would not be subject to binding capital requirements based on ratios generated using the advanced approaches, they would not generally be subject to the Collins Amendment Floor and may not be considered "advanced approaches banking organizations" for purposes of the Final Rule. Accordingly, Non-Bank SIFIs might not be required to comply with aspects of the Final Rule that apply only to advanced approaches banking organizations, such as the supplementary leverage ratio and the countercyclical buffer. Also unclear is the extent to which they would be required to make the disclosures that would be required of advanced approaches banking organizations. The final rule implementing Section 165, once adopted, should help to clarify these questions. However, of the three institutions that have been designated (or proposed to be designated) to date by the FSOC as Non-Bank SIFIs,[14] it appears that each may, depending upon its own internal analysis, be able to qualify for one of the limited SLHC exemptions discussed above.

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[12] Each of these calculations regarding assets or revenues must be performed pursuant to GAAP, or based on estimates of GAAP-equivalence, subject to Federal Reserve review.

[13] 77 Fed. Reg. 594 (Jan. 5, 2012) (the "U.S. SIFI Section 165 Proposal").

[14] On June 3, 2013, American International Group ("AIG"), Prudential Financial, Inc. ("Prudential"), and General Electric Company's General Electric Capital Corporation ("GECC") were preliminarily designated by FSOC as Non-Bank SIFIs. On July 2, 2013, Prudential announced that it would appeal the FSOC's designation. AIG and GECC chose not to challenge the determination, and on July 9, 2013, the FSOC announced that it had voted to approve final designations for AIG and GECC. See Prudential, Current Report (Form 8-K) (July 2, 2013); FSOC, Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc. (July 8, 2013), available at http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf; FSOC, Basis of the Financial Stability Oversight Council's Final Determination Regarding General Electric Capital Corporation, Inc. (July 8, 2013), available at http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20General%20Electric%20Capital%20Corporation,%20Inc.pdf.

4. Foreign Banking Organizations ("FBOs")

The Final Rule affirms that a BHC subsidiary of an FBO that is currently relying on Federal Reserve Supervision and Regulation Letter SR 01-01 ("SR 01-01")[15] would not be required to comply with the proposed capital requirements under the Final Rule until July 21, 2015,[16] although the preamble notes that the Federal Reserve has proposed to apply certain enhanced prudential requirements, including capital standards, to certain U.S. subsidiaries of FBOs beginning on July 1, 2015.[17]

5. Certain Transition Periods Compressed

The Basel III NPR proposed an effective date of January 1, 2013 for all banks. Given the delay in adopting the proposal, the Final Rule implements the transition periods for increased capital ratios, for phase-out of TruPS and for deductions and adjustments to capital (including the flow-through of AOCI components to CET 1) beginning in "mid-stream" (rather than shifting the entire transition schedule out for additional years) with higher amounts of required implementation in the first year (2014 or 2015, depending upon status of the banking organization) to ensure that full phase-out will conform to the deadlines set forth in the Basel III capital framework. Similarly, banking organizations subject to the Collins Amendment's mandated 2016 phase-out of nonqualifying capital instruments will only be permitted to include 50% of the amount of such instruments in additional Tier 1 capital in 2014, although under the Proposals such banking organizations would have been permitted to include 75% of the amount of such instruments in the first year following the initially proposed effective date of January 1, 2013.[18] The implementation of the capital conservation and countercyclical buffers, however, is not affected by the delay and will begin phasing in in 2016 as proposed.

B. Small Banks Granted Exemption from Phase-out of TruPS and Cumulative Instruments; Larger Banks Also Given Some Relief

In a major concession to community banks, the Final Rule permanently grandfathers non-qualifying capital instruments that were issued and outstanding as of May 19, 2010 in the Tier 1 capital of depository institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009.[19] The Proposals would have required all banking organizations to phase-out TruPS and cumulative perpetual preferred securities from Tier 1 capital under either a 3- or 10-year transition period based on the organization's total consolidated assets. The Proposals' 10-year phase-out for depository institution holding

[15] SR 01–01 (January 5, 2001), available at http://www.federalreserve.gov/boarddocs/srletters/2001/sr0101.htm.

[16] See Section 171(b)(4)(E) of the Dodd-Frank Act (12 U.S.C. 5371).

[17] 77 Fed. Reg. 76,628 (Dec. 28, 2012) (the "Non-U.S. SIFI Section 165 Proposal").

[18] In effect, however, given the delay, all banking organizations are given the ability to not apply phase-in/phase-out amounts in 2013 or 2014, depending upon the banking organization's status.

[19] Banking organizations that are permitted to keep non-qualifying instruments in Tier 1 capital will still be subject to limits that exist in current rules, however, such as the requirement that TruPS not constitute more than 25% of an organization's Tier 1 capital.

companies with less than $15 billion in total assets would have been consistent with the Basel III framework, although not required by the Collins Amendment. Community banks strongly objected to this aspect of the Proposals arguing that they had made long term capital plans based on the Dodd-Frank Act provisions that arguably grandfathered these instruments and, with more limited access to the capital markets, they would not easily find ways to replace this capital.

The Final Rule retains the requirement that banking organizations with more than $15 billion in total consolidated assets (as of December 31, 2009) phase out of Tier 1 capital by January 1, 2016 any non-qualifying capital instruments (including TruPS and cumulative preferred shares) issued before May 19, 2010. For banking organizations with greater than $15 billion in assets that are not advanced approaches banking organizations, however, the Final Rule permits permanent inclusion in Tier 2 capital of already issued instruments (including cumulative preferred and TruPS) previously included in the banking organization's Tier 1 capital that are phased out of Tier 1 under the rule. For advanced approaches banking organizations, the Final Rule only permits such full inclusion of TruPs in Tier 2 capital for years 2014 and 2015, after which the advanced approaches banking organization must phase such instruments out of Tier 2 in 10% increments (starting at a baseline of 60% in 2016) by January 1, 2022. For advanced approaches banking organizations, cumulative preferred should continue to qualify for inclusion in Tier 2, without regard to phase out, since most cumulative preferred instruments would otherwise meet the criterion in the Final Rule for inclusion in Tier 2. However, TruPS, which allow for acceleration after five years of interest deferral, generally would not meet the Tier 2 qualifying criteria in the Final Rule. In addition, the subordinated debt underlying such TruPS issuances generally provides for the instrument to be pari passu with trade creditors, which the agencies have indicated is not consistent with Tier 2 qualifying criteria on subordination.

The following table illustrates the revised treatment of nonqualifying securities:

Capital Instrument	Type of Depository Institution Holding Company < $15 Billion in Total Consolidated Assets as of 12/31/09	> $15 Billion in Total Consolidated Assets as of 12/31/09, But Not Subject to Advanced Approaches	Advanced Approaches Banking Organizations
Does Not Meet Tier 1 Qualifying Criteria; Issued and Included in Tier 1 before May 19, 2010 (e.g. TruPS and Cumulative Preferred)	Permanently includable in Tier 1, subject to a limit of 25% of Tier 1 capital (excluding nonqualifying instruments and after regulatory capital deductions and adjustments)	Phased out of Tier 1 by year-end 2015 Permanently includable in Tier 2 without phase out, whether or not it meets Tier 2 qualifying criteria	Phased out of Tier 1 by year-end 2015 If instrument does not meet Tier 2 qualifying criteria, includable in Tier 2 fully until year-end 2015, then phase out by year-end 2021
Does Not Meet Tier 1 Qualifying Criteria; Issued and Included in Tier 1 after May 19, 2010 (e.g. TruPS and Cumulative Preferred)	Disqualified from Tier 1 without benefit of phase out Instruments must meet Tier 2 qualifying criteria for inclusion in Tier 2	Disqualified from Tier 1 without benefit of phase out Instruments must meet Tier 2 qualifying criteria for inclusion in Tier 2	Disqualified from Tier 1 without benefit of phase out Instruments must meet Tier 2 qualifying criteria for inclusion in Tier 2
Does Not Meet Tier 2 Qualifying Criteria; Issued and Included in Tier 2 before May 19, 2010 (e.g. Sub Debt with Trade Creditor Carve out)	Permanently includable in Tier 2	Phased out of Tier 2 by year-end 2015	Phased out of Tier 2 by year-end 2015
Does Not Meet Tier 2 Qualifying Criteria; Issued and Included in Tier 2 after May 19, 2010 (e.g. Sub Debt with Trade Creditor Carve out)	Disqualified from Tier 2 without benefit of phase out	Disqualified from Tier 2 without benefit of phase out	Disqualified from Tier 2 without benefit of phase out

C. Capital Conservation and Countercyclical Buffers Tightened for Advanced Approaches Banking Organizations

Over the opposition of most commenters, the agencies will require all banking organizations to maintain a capital conservation buffer of 2.5% of additional CET 1 over and above their regulatory minimums, consistent with the timeframe for phase-in in the Basel III capital framework. Once the buffer is fully phased in, if a banking organization does not maintain CET 1, Tier 1 and total capital ratios of at least 7%, 8.5% and 10.5%, respectively, its ability to pay dividends and discretionary bonuses and to engage in share repurchases would be restricted.

In the Final Rule, the agencies also maintained their discretion to apply a countercyclical capital buffer of up to an additional 2.5% to advanced approaches banking organizations. The countercyclical buffer would be added to the capital conservation buffer—if implemented, falling below the total capital conservation and countercyclical buffer would restrict discretionary distributions. Application of the countercyclical buffer would result in CET 1, Tier 1 and total capital ratios of up to 9.5%, 11% and 13%, respectively, if the agencies determined that a full additional 2.5% buffer were required after full phase-in.

Although under the Proposals, advanced approaches banking organizations would have calculated their capital conservation buffer (and any applicable countercyclical capital buffer amount) using their advanced approaches risk-weighted assets, the Final Rule unexpectedly provides that advanced approaches banking organizations must calculate their compliance with the buffers consistent with the Collins Amendment Floor. Accordingly, advanced approaches banking organizations will be required to use both the advanced internal models-based approach and the generally applicable risk-based capital rules (currently the Basel I-based rules until the standardized approach takes effect in January 2015) and determine their compliance with the buffers based on the lower, or more conservative, of the two ratios. The agencies note that this approach "is appropriate because it is consistent with how advanced approaches banking organizations compute their minimum risk-based capital ratios."

This determination conflicts with the distinctions the agencies drew in the Proposals among the proposed minimum requirements and PCA requirements on the one hand, and the buffers, which are meant to encourage but not require retention of retained earnings in times of stress, on the other. It is also not required by the statute, as the Collins Amendment Floor provision by its terms requires a dual calculation for advanced approaches banking organizations only with respect to compliance with regulatory minimums. Application of this buffer calculation methodology will also increase the divergence between the capital regimes applicable to U.S. advanced approaches banking organizations, which will be subject to the Collins Amendment Floor for both regulatory minimums and for capital buffers, and non-U.S. organizations, which likely will not be calculating their Basel III framework buffer requirements by applying a capital floor. The Final Rule's reversal of the Proposals with respect to application of the Collins Amendment Floor to the capital conservation buffer was unexpected and will further increase the burden on advanced approaches banking organizations by requiring them to hold additional capital in order to avoid restrictions on capital distributions.

D. Buffer Restrictions Clarified for Stock Redemptions

The Final Rule helpfully clarifies that a redemption or repurchase of a capital instrument is not a distribution for purposes of the buffer restrictions, so long as the banking organization fully replaces that capital instrument by issuing another capital instrument of the same or better quality based on the Final Rule's eligibility criteria for capital instruments, and provided that such issuance is completed within the same calendar quarter in which the banking organization announces the repurchase or redemption.

E. No Relief from Buffer Restrictions for S-Corps

The agencies declined to provide any accommodation for "S corporations" that often pay dividends equal to tax liabilities to assist their shareholders in paying taxes owed on profits of the S corporation—a practice that could conflict with the buffer's dividend restrictions. The capital conservation buffer in the Final Rule will subject banking organizations that have made an S corporation tax election to a significant disadvantage compared to C corporations. Specifically, if an S corporation bank is profitable and meets its minimum capital requirements—but not the full capital conservation buffer—its shareholders will still be subject to tax on the bank's profits even if the S corporation is unable to make a cash distribution. The agencies simply characterize such an outcome as a risk that accompanies the benefits of pass-through taxation.

F. Leverage Ratios Retained with Increases Signalled for G-SIBs

Consistent with the Proposals, the Final Rule will require advanced approaches banking organizations to meet two distinct leverage requirements. The Final Rule preserves the existing capital guidelines' leverage requirement and calculation methodology for all banking organizations and raises the leverage requirement for high-rated banking organizations from 3% to 4% (noting that a leverage ratio of less than 4% is not consistent with the highest supervisory composite rating). In addition, the Final Rule imposes a "supplementary" leverage ratio on advanced approaches banking organizations that is calculated (differently from the existing leverage requirement) by including off-balance sheet exposures in the denominator of the calculation.

Although FDIC Vice-Chairman Hoenig has advocated higher leverage ratios calculated using CET 1 as the numerator,[20] the Final Rule makes no modifications to the proposed calculation methodology for the general leverage ratio (Tier 1 capital, as determined under the revised guidelines, divided by average total on-balance sheet assets net of deductions from Tier 1 capital). The 3% supplementary leverage ratio is similarly adopted as proposed in the Final Rule with no significant changes to the calculation methodology. Accordingly, advanced approaches banking organizations must begin reporting their supplementary leverage ratios on January 1, 2015 and must comply with the 3% supplementary leverage minimum starting on

[20] See, e.g., Statement by FDIC Vice-Chairman Thomas Hoenig on Basel Capital Notices of Proposed Rulemaking (Jun. 12, 2012), available at http://www.fdic.gov/news/news/speeches/chairman/spjun1412.html. See also Supplementary Leverage Ratio Proposal at 27 (question 10 requesting comment on whether another capital measure should be used as the numerator for supplementary leverage ratio).

January 1, 2018. The agencies do not address the recent revisions by the Basel Committee to the Basel III leverage ratio (described in greater detail in the final section of this memorandum) which, if adopted as proposed, are expected to further increase the supplementary leverage ratio compliance burden on advanced approaches banking organizations.

As discussed in Part I above, the agencies' Supplementary Leverage Ratio Proposal would significantly increase the supplementary leverage ratio for the eight U.S. G-SIBs by adopting a 2% Tier 1 supplementary leverage buffer requirement at the G-SIB parent level and by requiring a 6% supplementary leverage ratio minimum for such G-SIBs' subsidiary banks to qualify as well-capitalized. Such a unilateral imposition of enhanced leverage limitations is expected to place U.S. banking organizations on unequal footing with non-U.S. organizations and will further call into question the agencies' commitment to engaging with the international community to create effective global capital standards.

G. Prompt Corrective Action

The Final Rule adopts without significant modifications the Proposals' revisions to the PCA framework, which is designed to place restrictions on U.S. insured depository institutions if their capital levels begin to show signs of weakness. The Federal Deposit Insurance Corporation Improvements Act of 1991 ("FDICIA") required the agencies to implement the PCA framework. Among other things, the PCA provisions provide that the agencies must by regulation establish levels at which insured depository institutions are considered "well capitalized", "adequately capitalized", "undercapitalized" and "significantly undercapitalized".[21]

Consistent with the Proposals, the Final Rule expands the PCA capital categories by incorporating the CET 1 capital requirement for all depository institutions and, beginning in 2018, the proposed supplementary leverage requirement for advanced approaches banking organizations.

The new PCA framework would not take effect until January 1, 2015. Once effective, PCA would require depository institutions to maintain a Tier 1 leverage ratio of 5%, a CET 1 risk-based capital measure of 6.5%, a Tier 1 risk-based capital ratio of 8% and a total risk-based capital ratio of 10% to be considered well capitalized. Maintenance of the minimum 3% supplementary leverage ratio would be necessary for advanced approaches banking organizations to be considered adequately capitalized beginning in 2018, but no additional leverage requirement above this 3% ratio would be necessary for such institutions to be considered well capitalized.

Commenters urged the agencies to allow an advanced approaches bank to use the advanced approaches rule for determining whether it is well capitalized for PCA purposes, on the basis that the Collins Amendment Floor does not require such banks to use the lower of its capital ratios as calculated under the general risk-based capital rules and the advanced approaches to determine whether it is well capitalized. The agencies rejected this comment without discussion, and the Final Rule provides that advanced approaches banks must

[21] The agencies' PCA regulations are codified at 12 C.F.R. pt. 6 (OCC); 12 C.F.R. §§ 208.40-.45 (Federal Reserve); 12 C.F.R. §§ 303.200-.207 (FDIC).

determine whether they are well capitalized by reference to the rule's required calculation methodology for determining compliance with the minimum ratios, which incorporates the Collins Amendment Floor.

In addressing a source of confusion in the Proposals, the agencies specifically acknowledged that the PCA minimum requirements for well-capitalized status are still below the capital ratios required to satisfy the capital conservation buffer. The agencies stated that the PCA framework "has been designed to give banking organizations the flexibility to use the buffer while still being well-capitalized" and that it was "appropriate for a depository institution to be able to use some of its capital conservation buffer without being considered less than well capitalized for PCA purposes."

The Final Rule also includes a policy statement by the agencies that all banking organizations should hold capital commensurate with their risk profiles "which may entail holding capital significantly above the minimum" and a reservation of authority permitting examiners to require that banking organizations hold additional capital.

H. Definition of Well Capitalized Unchanged for BHCs

The Federal Reserve states that the Final Rule "does not establish the standards for determining whether a BHC is 'well-capitalized.'"[22] The current definition of well capitalized for BHCs in the Federal Reserve's Regulation Y, which is preserved in the Final Rule, requires a total capital ratio of 10% and a Tier 1 capital ratio of 6%, with no reference to a leverage ratio.[23]

Although BHCs and SLHCs are not subject to PCA, Section 606 of the Dodd-Frank Act ("Section 606") requires a BHC—and not only its insured depository institution subsidiaries—to be "well capitalized" in order to become, or maintain its status as, an FHC.[24] Section 606 also requires any SLHC (other than a grandfathered unitary) that is engaged in activities otherwise permissible only for an FHC to be well capitalized "as if the savings and loan holding company was a bank holding company." Currently, the definitions of "well capitalized" for insured depository institutions under PCA and for BHCs diverge because Regulation Y does not require a BHC to maintain a 5% leverage ratio in order to be considered well capitalized.

The Federal Reserve has sole discretion to revise the definition of well capitalized for BHCs and SLHCs (in contrast to the PCA definition of well capitalized, which is determined on an interagency basis), and it remains unclear whether the Federal Reserve will later propose to (i) incorporate either or both leverage ratios into a revised definition of "well capitalized" for such

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[22] See Final Rule, p. 89 (emphasis added).

[23] The revised definition of well capitalized in Regulation Y cross-references the methodology for calculating compliance with a banking organization's minimum capital ratios, which requires banks subject to the advanced approaches to look to the lower of its capital ratios as calculated using the general risk-based capital rules and the advanced approaches, in conformance with the Collins Amendment Floor.

[24] Section 606 of the Dodd-Frank Act (12 U.S.C. § 1843(l)(1)).

entities, (ii) incorporate a CET 1 ratio for such entities, or (iii) raise the minimum required ratios to be deemed well capitalized.[25]

A critical issue for FBOs remains whether the definition of "well capitalized" applicable to holding companies will ultimately require compliance, in order to operate in the United States, with either or both of the generally applicable leverage ratio or the supplementary leverage ratio at the home country parent level. When considering FBO requests to elect FHC status, the Federal Reserve has generally evaluated an FBO's leverage capital as one of many factors without explicitly requiring FBOs to demonstrate that they meet U.S. leverage ratios, although any U.S. bank subsidiaries would be required to meet well capitalized status. However, under Section 606, not only will bank subsidiaries of a holding company be required to be well capitalized, but well capitalized status will be an ongoing requirement for the holding company as well, to maintain FHC status. In this case, the FBO is generally treated as the holding company and, accordingly, if the Federal Reserve incorporates a leverage ratio into the qualifications for BHCs and SLHCs to be considered well capitalized, FBOs that have elected FHC status could also be required to meet such a leverage test on an ongoing basis. Such a change could have a profound impact on FBOs that are not currently subject to leverage requirements as part of their home country supervision.

I. *Opt-Out of AOCI Flow-Through Permitted for Non-Advanced Approaches Banking Organizations*

In a significant concession to commenters, the agencies will permit banking organizations that are not subject to the advanced approaches a "one-time" opt-out of the requirement to include the components of AOCI in their CET 1.[26] By contrast, the Final Rule will require advanced approaches banking organizations to include, over a transition period, the components of AOCI in CET 1. For those banking organizations that exercise the opt-out, rules consistent with the current U.S. regulatory capital framework will continue to apply, including incorporating net unrealized losses on available-for-sale ("AFS") equity securities in CET 1 and allowing 45% of net unrealized gains on AFS equity exposures to be included in Tier 2 capital.

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[25] Furthermore, although the agencies acknowledged receiving comments requesting clarification on the point, the Federal Reserve declined to provide an explanation as to whether the Collins Amendment Floor would continue to be incorporated when determining whether a BHC is well capitalized for FHC status.

The Supplementary Leverage Ratio Proposal also did not propose to amend the definition of well-capitalized for BHCs or FHCs. By proposing a "buffer" requirement of 2% over the minimum leverage ratio requirement for the eight U.S. G-SIBs that would work similar to the capital conservation buffer, there does not seem to be an effect on well-capitalized status or FHC status under Section 606 if one of these U.S. G-SIBs fails to maintain the buffer at the parent holding company level. In contrast, because the bank-level supplementary leverage ratio surcharge under the proposal would determine whether the bank subsidiaries of a U.S. G-SIB are well-capitalized, a 6% leverage ratio would need to be maintained by these subsidiaries in order for their parent holding companies to maintain FHC status.

[26] Generally, the components oft-cited by the agencies for exclusion by banking organizations that have opted out, or for inclusion by other banking organizations, are the unrealized gains and losses on AFS securities, as well as other than temporary impairment on hold-to-maturity securities (to the extent such gains and losses are included in GAAP), and changes to income based on GAAP treatment of defined benefit post-retirement plans.

FDIC Director Norton noted his opposition to this opt-out provision, particularly in the context of the Federal Reserve's current monetary policies and the potential for rising interest rates in the future.

For all banking organizations, the Final Rule also adopts the proposed exclusion from capital of the effects of unrealized gains and losses on cash flow hedges that relate to the hedging of items that are not recognized at fair value on the balance sheet. Although commenters indicated that the proposed adjustment, together with the proposed treatment of net unrealized gains and losses on AFS debt securities, would create incentives for banking organizations to avoid hedges to reduce interest rate risk, the agencies stated that the adjustment is necessary to remove an element that gives rise to artificial volatility in CET 1.

To avoid arbitrage, the agencies have placed restrictions on the opt-out provisions following a merger or the acquisition of "substantially all the assets" of another banking organization. Similarly, the agencies specify that if a depository institution holding company opts out of the flow-through, all of its banking organization subsidiaries must do the same in order to eliminate any incentive to manipulate consolidated capital levels by transferring assets to optimize the flow through of gains associated with AOCI.

J. Clarifications to Qualifying Criteria for CET 1

1. Clarification of Dividend Payment Timing

In response to commenters' concerns, the agencies clarified that CET 1 criterion (vii) (requiring that dividend payments and other capital distributions on CET 1 may be paid only after all legal and contractual obligations have been satisfied, including payments due on more senior claims) should not prevent a banking organization from paying a dividend on a CET 1 instrument where it has incurred operational obligations in the normal course of business that are not yet due or that are subject to minor delays for reasons unrelated to the financial condition of the banking organization.

2. Dividends May Be Paid Out of Surplus

In response to commenters' concerns that CET 1 proposed criterion (v) (providing that dividend payments must be paid out of current and retained earnings) could conflict with the Delaware General Corporation Law, which permits a corporation to make dividend payments out of its capital surplus account, the agencies broadened the relevant criterion for CET 1, additional Tier 1 and Tier 2 instruments in the Final Rule to provide that banking organizations may make dividend payments out of surplus, although the agencies note that national banks, state member banks and state non-member banks are subject to other dividend restrictions that may separately prohibit this practice.

3. ESOP Stock Will Qualify as CET 1

In response to commenter concerns that stock issued to an employee stock option plan ("ESOP") may not satisfy the CET 1 qualifying criteria as proposed, the agencies have modified the Final Rule to exclude, from certain qualifying criteria under both CET 1 and additional Tier 1 rules, stock issued and held in trust for the benefit of the issuer's employees as part of an ESOP. These exclusions will ensure that such stock will not be disqualified on the basis that it (i) includes a put option, as required under the Employee Retirement Income Security Act

("ERISA") (for stock that is not publicly traded only), or (ii) is funded directly or indirectly by the issuing banking organization.

K. Clarifications to Additional Tier 1 Qualifying Criteria

1. Dividend Blocker On Parity Stock Permitted

Consistent with informal advice from Federal Reserve staff during the comment period, the agencies explicitly clarify in the Final Rule that restrictions on dividends on parity instruments (i.e., dividend blockers or dividend stoppers) are permissible for additional Tier 1 instruments.

2. Penny Dividends

Although the Proposals contemplated requiring banking organizations to have the ability to cancel or reduce dividends to the holders of additional Tier 1 instruments when they are paying only a penny dividend on common stock, the Final Rule does not incorporate this requirement in light of commenter concerns about the impact such a requirement would have on the hierarchy of subordination in capital instruments and the associated burden resulting from increased capital raising costs.

3. Limited Exemptions to Call Restriction

The agencies also accommodated commenter requests to revise the additional Tier 1 qualifying criteria to permit a banking organization to call an instrument prior to five years after issuance in the event that the issuing entity is required to register as an investment company pursuant to the Investment Company Act of 1940. The agencies declined to allow redemption on a "rating agency event"[27] for future issuances, but the Final Rule will permit instruments that have such a call feature and that were issued prior to the effective date of the Final Rule to continue to qualify as Tier 1 capital. The Final Rule also makes corresponding revisions to the Tier 2 capital qualifying criteria.

4. Most Contingent Capital Disqualified from AT1

Despite significant commenter objections, the agencies have determined to maintain the criterion that additional Tier 1 instruments be classified as equity under generally accepted accounting principles ("GAAP")—a significant deviation from the Basel III capital framework and one that will effectively foreclose the issuance of debt-hosted contingent convertible capital instruments in the United States. The retention of this "super-equivalent" requirement is also a significant departure from the European capital framework, where the regulation implementing the Basel III capital framework permits debt instruments to qualify as additional Tier 1 capital so

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[27] "Rating agency event" is not defined in the Final Rule but is generally considered to be a credit rating downgrade announced by a nationally recognized statistical rating agency.

long as such instruments would convert to common equity when the issuer's CET 1 ratio falls below 5.125% or such higher ratio as may be designated in the terms of the instrument.[28]

L. Additional Restrictions Applicable to REIT Preferred Securities

Under the current risk-based capital guidelines of the OCC and the Federal Reserve,[29] a bank and its parent BHC may include minority interests resulting from the issuance of real estate investment trust ("REIT") preferred securities related to a subsidiary REIT in Tier 1 capital. Despite commenters' calls to exempt tax-advantaged REIT preferred securities, the Final Rule limits the inclusion of REIT preferred minority interests in additional Tier 1 capital by applying the same limitations to be applied to other minority interests in consolidated subsidiaries.

The preamble to the Final Rule clarifies that REIT preferred securities issued to minority investors by a REIT subsidiary must meet all criteria for additional Tier 1 capital, including the ability to cancel dividends. While the agencies acknowledged that banking organizations might be reluctant to affect the tax status of a REIT by cancelling its dividend, the agencies will not deem REIT preferred instruments to be eligible for inclusion in additional Tier 1 capital unless the issuer has the discretion to cancel the entity's dividend or the ability to declare a consent dividend.[30] While the agencies note that the ability to declare a consent dividend need not be included in the documentation of the REIT preferred instrument, they would still require a banking organization to provide evidence to the relevant banking regulator that it has such an ability.

Furthermore, the Final Rule maintains the requirement that a minority interest in a REIT subsidiary may only be included in the regulatory capital of the consolidating parent banking organization if the REIT is an "operating entity". The Final Rule also maintains the definition of operating entity as "a company established to conduct business with clients with the intention of earning a profit in its own right" and provides no additional gloss on what activities will be considered to satisfy this standard other than noting the operating entity must be "actively managed"—a term that is not defined and appears to suggest the REIT must not be simply a pass-through vehicle. Given this requirement, however, the agencies specifically note that "certain REIT subsidiaries . . . are not actively managed for the purpose of earning a profit in their own right, and therefore, will not qualify as operating entities for the purpose of the" Final Rule. The preamble directs banking organizations to consult with their primary federal regulator before including REIT minority interests in capital if they are unsure as to whether this qualification is met.

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[28] Regulation 575/2013/EU of the European Parliament and of the Council (June 26, 2013) (prudential requirements for credit institutions and investment firms and amending Regulation 648/2012/EU) (OJ L 176/56, Jun. 27, 2013) (the "CRR") Art. 54.

[29] See OCC Corporate Decision 97-109 (Dec. 1997); OCC Licensing Manual: Capital and Dividends (Nov. 2007); 70 Fed. Reg. 11,827 (Mar. 10, 2005) (Federal Reserve supplementary materials accompanying final rule on risk-based capital standards: trust preferred securities and the definition of capital).

[30] A consent dividend is a dividend that is not actually paid to a shareholder but is kept as part of a company's retained earnings. A shareholder may agree to have a dividend added to the shareholder's gross income even if not paid.

M. *Disqualification of BHC Tier 2 Subordinated Debt with Subordination Carve Out for Trade Creditors*

The preamble discussion to the Final Rule notes that, in order to qualify as Tier 2 capital, subordinated debt must be subordinated to (as opposed to pari passu with) the claims of trade creditors, consistent with the agencies' current general risk-based rules for banks. Moreover, the Final Rule text applicable to BHCs requires subordination of these instruments to all general creditors with no trade creditor exception in the rule text or the preamble.

Neither the preamble nor the Final Rule text even acknowledge that the current capital rules applicable to TruPS and BHC subordinated debt permit such instruments to be pari passu with trade creditors.[31] This feature is important from a tax perspective to enhance the debt characteristics of the instrument. However, Federal Reserve staff has confirmed that the Final Rule reverses this past policy in order to comply with the Collins Amendment (which requires depository institution holding companies with total assets of $15 billion or more to phase out instruments that would not qualify under the regulatory capital guidelines generally applicable to banks). Accordingly, outstanding subordinated debt issued by BHCs in reliance on this precedent will be disqualified from Tier 2 capital (and without the benefit of a phase-out, if issued after May 19, 2010).

N. *Deduction for Investments in Unconsolidated Financial Institutions: Definition of Financial Institution Narrowed*

Many commenters advocated for narrowing the proposed definition of "financial institution" in the context of the new regulatory deductions for investments in the capital of unconsolidated financial institutions[32] by excluding, among others, Volcker covered funds, commodity pools and certain other investment funds, and ERISA plans. In addition, commenters argued that the "predominantly engaged" in financial activities prong of the agencies' proposed definition of "financial institution" should be limited to financial companies designated as systemically important by the FSOC, which are by definition "predominantly engaged" in financial activities.

In response to commenters, the agencies revised the list of defined "financial institutions" to exclude employee benefit plans, registered investment companies, and commodity pools (although the agencies note that commodity pools could be captured through the predominantly engaged test). The agencies further limited the test of whether a company is "predominantly engaged" in financial activities to a clearly defined subset of activities (lending, insurance, asset

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[31] See Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital, 70 Fed. Reg. 11,827, 11,833 (Mar. 10, 2005) (noting commenters sought clarification in the final rule that junior subordinated debt does not have to be subordinated to, and can be pari passu with, trade accounts payable and other accrued liabilities arising in the ordinary course of business; confirming that this interpretation is consistent with the Federal Reserve's subordinated debt policy statement; and confirming that junior subordinated debt may be pari passu with obligations to trade creditors).

[32] The definition of "financial institution" is also relevant to the advanced approaches' provision to apply a multiplier of 1.25 on wholesale exposures to other financial institutions.

management (not including investment advisory)[33] and underwriting, dealing, and market making). In addition, the agencies plan to apply the test only if the banking organization's investment in GAAP equity instruments of the company is greater than or equal to $10 million, or if the banking organization owns more than 10% of the company's equity interests.

O. Corresponding Deduction Approach Clarified for TruPS

The Proposals did not address how the corresponding deduction approach would be applied with respect to capital instruments that are subject to phase-out, such as TruPS and cumulative preferred securities. The agencies have clarified in the Final Rule that if a banking organization has an investment in an unconsolidated subsidiary in the form of a nonqualifying capital instrument, and that investment must be deducted under the Final Rule from the corresponding capital tranche of the banking organization, the banking organization must treat the instrument as a: (i) Tier 1 capital instrument, if it was included in the investee banking organization's Tier 1 capital prior to May 19, 2010; or (ii) a Tier 2 capital instrument, if it was included in the investee banking organization's Tier 2 capital (but not eligible for inclusion in the investee banking organization's Tier 1 capital) prior to May 19, 2010.

P. Investments in TruPS CDOs Treated as Investments in Financial Institutions

Commenters requested that the agencies confirm that a banking organization's investment in a TruPS collateralized debt obligation ("CDO") would not be treated as an investment in the capital of an unconsolidated financial institution but rather as a securitization exposure. The agencies denied this request; accordingly, the Final Rule provides that investments in TruPS CDOs are synthetic exposures to the capital of unconsolidated financial institutions and are thus subject to deduction. Under the final rule, any amounts of TruPS CDOs that are not deducted are subject to risk weighting as a securitization exposure.

Q. Greater Recognition of Mortgage Servicing Assets ("MSAs")

The Final Rule largely preserves the Proposals' required deduction of MSAs, with one significant concession to commenters. Based on requirements in FDICIA, the Proposals would have imposed haircuts on the amount of MSAs that a banking organization may include in CET 1 by requiring that MSAs eligible for inclusion in regulatory capital cannot be valued at more than 90% of their fair market value. Therefore, under the Proposals, even if a banking organization would have been able to include all of its MSAs under the Basel III framework, it would still be required to deduct at least 10% of the fair value of these MSAs from its CET 1. The agencies have eliminated this haircut in the Final Rule for all banking organizations.

Nevertheless, in the Federal Reserve's board meeting approving the Final Rule, Federal Reserve staff acknowledged that there will be firms that have a concentration in MSAs and that will "have to adjust business models" because of the partial deduction of MSAs from CET 1.

[33] The distinction between "asset management" activities and "discretionary or non-discretionary financial or investment advisory activities" may prove difficult to define going forward.

R. Clarification Regarding Netting of Deferred Tax Liabilities ("DTLs")

Many commenters advocated that banking organizations should have the option to choose to net DTLs against one of a number of asset types and that the banking organization should be able to make the same or a different choice from one reporting period to the next. However, the agencies seemingly rejected such comment and clarified that the Final Rule requires banking organizations to consistently net DTLs against either deferred tax assets ("DTAs") or against other assets subject to deduction on a going forward basis. Switching to net against different assets from the netting used in earlier periods will require approval from a banking organization's primary Federal regulator.

III. IMPLEMENTATION OF THE STANDARDIZED APPROACH

The standardized approach would fundamentally change capital adequacy regulation for all U.S. banking organizations, as it would generally replace the Basel I risk-based capital standards that are currently in effect in the United States. For this very reason, the proposal to adopt a standardized approach received significant criticism, primarily from smaller and community banks that argued that they were not responsible for the recent financial crisis and, therefore, should not be expected to completely overhaul their systems and policies to implement a more burdensome and complex capital regime. Notwithstanding such broader attacks on the standardized approach, the agencies adopted the Basel I replacement, yet modified a number of specific elements of the approach in an attempt to reduce the burden and complexity on smaller and community banks.

A. Residential Mortgage Risk Weights Remain Unchanged from Current Rules

The Proposals would have required banking organizations to determine the risk weights for their residential mortgage exposures based on a complex categorization and loan-to-value assessment. Residential mortgages with certain indicators associated with higher credit risk were to be assigned to "category 2", while all other mortgages were to be assigned to "category 1". Risk weights for residential mortgages would have ranged from 35% to 150% depending on the loan's category and its loan-to-value ratio.

Commenters strongly opposed the approach on the basis of its administrative burden and its chilling effect on lending and noted that it represented a significant divergence from the Basel capital framework. In a significant concession to these commenters, the agencies have determined to retain the existing treatment for residential mortgage exposures in the current risk-based capital rules, assigning a 50% risk weight to high quality seasoned residential mortgages and 100% to all other residential mortgage loans (including those more than 90 days past due or on nonaccrual). At the Federal Reserve's board meeting, Federal Reserve staff made clear that this treatment could be modified in the future, if determined to be necessary after further review. And at the FDIC board meeting approving the Final Rule, FDIC Director Jeremiah Norton criticized the failure of the Final Rule to modernize risk weights for mortgage loans, suggesting at least some internal support for further revisions to the Final Rule's mortgage risk weights.

B. High Volatility Commercial Real Estate ("HVCRE") Definition Narrowed

The Proposals would have assigned a blanket 150% risk weight to HVCRE exposures in contrast to the current risk-based capital rules, which apply a 100% risk weight to such exposures. Commenters criticized the definition of HVCRE as overbroad and argued for an exclusion for certain acquisition, development and construction ("ADC") loans. In response to commenter concerns, the agencies have clarified the definition of HVCRE to provide that ADC loans that transition to permanent financing and ADC loans that qualify as community development investments will be excluded from HVCRE. In addition, the Final Rule provides that cash used to purchase land is a form of borrower-contributed capital that may be used to satisfy the requirement that the borrower contribute capital equal to at least 15% of the real estate's appraised value. The agencies also clarified the definition of HVCRE to exclude loans for the purchase or development of agricultural land.

C. Exposures to Highly-Rated Securities Firms Remain Disfavored Compared to Banks

The Final Rule maintains the Proposals' significant divergence from the Basel III framework and the current Basel I rules in its treatment of exposures to highly-rated securities firms, which will be subject to the 100% corporate risk weight. Under the current Basel I capital rules, exposures to certain U.S. and OECD country securities firms that meet net capital or consolidated supervision and regulation requirements, as well as high credit rating requirements, are assigned a 20% risk weight. The Basel III framework treats exposures to securities firms that meet certain requirements as exposures to banks, which could also be risk weighted as low as 20%. Despite significant resistance from commenters, the agencies stated that they did not believe that the risk profile of securities firms was sufficiently similar to that of depository institutions to warrant such treatment, noting it is consistent with the treatment of exposures to BHCs, SLHCs and other non-bank financial firms. This aspect of the Final Rule is expected to adversely affect securities firms by placing them at a significant disadvantage to domestic depository institutions, which will continue to be assigned a 20% risk weight under the Final Rule.[34]

D. Use of Country Risk Classifications ("CRCs") Modified

To comply with Section 939A of the Dodd-Frank Act, the agencies were required to eliminate references to and reliance upon the use of external ratings in their capital regulations. Accordingly, the Proposals deviated from the Basel capital framework's use of external credit ratings to determine the appropriate risk weight for sovereign debt exposures under the standardized approach in favor of the use of CRCs that are regularly published by the Organization for Economic Cooperation and Development ("OECD"). Following the publication of the Proposals, the OECD altered the CRC methodology to eliminate the assignment of CRCs

[34] In voting for adoption of the FDIC's interim final rule, FDIC Director Norton nevertheless noted his concern with low risk weights for financial institutions, even beyond securities firms, implying that he believes that such low risk weights perpetuate the interconnectedness of the financial system and the weaknesses exposed during the recent financial crisis.

to certain high-income OECD-member countries that had previously been assigned a CRC of 0, which is consistent with the highest investment grade rating.

The agencies have determined to maintain the use of CRCs, with a modification to provide that sovereign exposures to members of the OECD that are no longer assigned a CRC will be assigned a 0% risk weight—treatment that is consistent with the agencies' general risk-based capital rules. Similarly, the Final Rule provides that exposures to a foreign bank or a non-U.S. public-sector entity ("PSE") in a OECD-member country that does not have a CRC will continue to be assigned a 20% risk weight. However, exposures to sovereigns, foreign banks and PSEs located in non-OECD-member countries that do not have a CRC will be assigned a 100% risk weight. The agencies have proposed a corresponding change with respect to the risk weighting factors applicable to sovereign debt exposures in a banking organization's trading book in a proposal to amend the Market Risk Rule issued together with the Final Rule.[35]

E. No Separate Designation for Retail Exposures

Commenters advocated for the agencies to establish a 75% risk weight for retail exposures, consistent with the Basel Capital Framework and the European Capital Requirements Regulation.[36] The agencies declined to make this conforming change to the Final Rule, and such exposures will continue to be risk-weighted as general corporate exposures at 100%.

F. Credit-Enhancing Representations and Warranties—Safe Harbor Restored

Under the current capital rules, banking organizations that provide credit-enhancing representations or warranties on assets sold are subject to a risk-based capital requirement. However, the current rules governing certain of these recourse arrangements (such as representations that contain early default clauses that permit the return of one-to-four family first-lien residential mortgage loans) provide a safe harbor from capital requirements provided such clauses apply for no more than 120 days. The Proposals would have eliminated this safe harbor, and commenters requested that it be reinstated on the basis that its elimination would increase the cost of credit to borrowers, inhibit credit availability and generally cause confusion. In response to these concerns, the agencies have decided to restore this 120-day safe harbor in the definition of credit-enhancing representations and warranties for early default and premium refund clauses on one-to-four family residential mortgages that qualify for the 50% risk weight, as well as for premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. government, a U.S. government agency or a U.S. government sponsored enterprise ("GSE").

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[35] In another remark targeted at the possibility of "gaming" risk weights, FDIC Director Norton noted his disagreement with allowing sovereigns without a CRC to continue to enjoy a 0% risk weight.

[36] CRR, Art. 123.

G. *Treatment Modified for Certain OTC Derivative Exposures Associated with Clearing Transactions*

Despite commenter calls to retain the 50% risk-weight cap on derivative exposures in the general risk-based capital rules, the Final Rules eliminate such cap and generally adopt the treatment of OTC derivatives (bilateral derivatives that are not centrally cleared) under the Proposals. As discussed below, cleared derivatives would be subject to a separate risk-weight analysis; however, there are certain transactions embedded in clearing relationships that will be treated as OTC derivatives under the Final Rule. Specifically, OTC derivatives will include (i) any derivative between a banking organization that is a clearing member of a central counterparty ("CCP") acting as principal and its clearing member client, even if the principal trade is then back-to-backed with the CCP, and (ii) any guarantee provided by a clearing member to a CCP on the performance of a client.

Following the initial publication of the Proposals in June 2012, the Basel Committee published an interim framework for the capital treatment of bank exposures to CCPs,[37] which the agencies have incorporated into the Final Rule. Although this interim framework, and the Final Rule, would still deem the transactions noted above to be OTC derivative exposures, both modify the treatment of such client exposures by scaling back the exposure amount by a factor of 0.71 to 1.00 depending upon the banking organization's estimate of the appropriate margin holding period of risk.[38] Overall, these changes are intended to preserve incentives for banking organizations to act as financial intermediaries by facilitating central clearing of derivative and securities financing transactions.

The agencies further note that they expect to consider any necessary changes proposed by the Basel Committee to update the current exposure methodology ("CEM") that the Final Rule's standardized approach incorporates for determining the risk weights applicable to derivative contracts. Shortly before the release of the Final Rule, the Basel Committee issued a consultation paper on a proposed replacement of the CEM with a more refined non-internal-models-based methodology for calculating derivative exposure amounts.[39] In anticipation of these changes to improve the CEM, the agencies denied commenters' requests to permit the use of internal models to determine derivative exposure amounts under the standardized approach. The Final Rule also does not permit banking organizations to use the simple VaR approach to calculate their exposure amounts for eligible margin loans under the standardized approach. The Basel NIMM Paper is summarized below.

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[37] Basel Committee, Capital Requirements for Bank Exposures to Central Counterparties (the "Basel Committee interim framework") (July 2012) available at http://www.bis.org/publ/bcbs227.pdf.

[38] Advanced approaches banking organizations using the internal models methodology are permitted to make corresponding reductions to the margin period of risk to achieve the same scaling effect.

[39] Basel Committee, Consultative Document: The Non-internal Model Method for Capitalising Counterparty Credit Risk Exposures (June 2013) (the "Basel NIMM Paper"), available at http://www.bis.org/publ/bcbs254.pdf.

H. Expect Further Modifications to Cleared Derivatives and Repo-Style Transaction Exposures

The Final Rule retains the Proposals' treatment of cleared derivatives and repo-style transactions. Accordingly, a banking organization will be required to hold risk-based capital for any derivative or repo-style transaction that it has entered into with a CCP, whether a clearinghouse or an exchange. The capital requirements for such cleared transactions are generally consistent with the Basel Committee interim framework for CCP exposures, and the agencies have revised the rules to incorporate aspects of the interim framework that were not included in the Proposals. Shortly before the adoption of the Final Rule, the Basel Committee issued a further consultation paper that proposes revisions to the capital treatment of bank exposures to central counterparties.[40] The agencies indicate they plan to consider this proposal, which is briefly summarized below, and further revise the capital rules as appropriate.[41]

I. Explicit Clarification of Treatment of U.S. Omnibus Accounts at Clearing Intermediaries

Consistent with the Proposals, if collateral posted to a CCP is held in a bankruptcy-remote manner, it is not deemed exposure to the CCP (or for a banking organization that is a client of an intermediary, it is not deemed exposure to the CCP, the intermediary or the intermediary's other clients) under the Final Rule and there is no separate capital requirement for the collateral. The Final Rule also clarifies that omnibus accounts established under the regulations of the Securities and Exchange Commission and the Commodity Futures Trading Commission will be deemed bankruptcy-remote and therefore will not be subject to a separate capital requirement. Furthermore, this explicit clarification is key for meeting the definition of a "cleared transaction" under the Final Rule, and thus for obtaining the more favorable risk weights applied to such transactions.

J. Burden Remains on Banking Organizations to Determine if CCP is a QCCP

The Final Rule retains the requirement that a banking organization independently determine and document whether a CCP is a "qualifying" CCP ("QCCP") for purposes of determining the appropriate risk weights for its cleared transactions.[42] Several commenters requested that the agencies revise the definition of QCCP to provide that the agencies maintain and publish a definitive list of QCCPs rather than requiring each banking organization to demonstrate that a CCP meets the qualifying criteria. The agencies denied this request, asserting that banking organizations are better situated to make this determination and rationalizing that such determinations must be made on an ongoing basis rather than by way of a static list.

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[40] Basel Committee, Consultative Document: Capital Treatment of Bank Exposures to Central Counterparties (June 2013), available at http://www.bis.org/publ/bcbs253.pdf.

[41] See Parts VI.E and F below.

[42] Generally, trade exposure to a non-qualifying CCP would receive the 100% risk weight for corporate exposures, compared to the 2% to 4% risk weight for exposures to QCCPs.

K. CCP Default Fund Contribution Exposures Clarified

Consistent with the Basel Committee's interim framework, the agencies have modified the Final Rule to provide for two alternative methods for determining a clearing member banking organization's exposure arising from default fund contributions to a QCCP. A banking organization may either (i) calculate the appropriate risk weight applicable to its default fund contribution using a three-step process based on the hypothetical capital requirement of the QCCP, or (ii) apply a 1250% risk weight to the default fund contribution, subject to a default fund exposure cap of 18% of its trade exposure amount to that QCCP.[43] The Final Rule retains the requirement that banking organizations apply a 1250% risk weight to default fund contributions to CCPs that are not QCCPs.

The Final Rule also clarifies that if a banking organization's unfunded default fund contribution to a CCP is unlimited, the banking organization's primary federal supervisor will determine the risk-weighted asset amount for such default fund contribution based on factors such as the size, structure, and membership of the CCP and the riskiness of its transactions. However, the agencies note that the Final Rule does not contemplate unlimited default fund contributions to QCCPs because defined default fund contribution amounts are a prerequisite to being a QCCP. As discussed below, just prior to the issuance of the Final Rule, the Basel Committee proposed several methodologies for determining the capital requirement that should apply to commitments to top up the default fund of a CCP, which if adopted, could replace the discretionary agency determinations provided for in the Final Rule.

L. Definition of Eligible Guarantor Expanded

Commenters urged the agencies to further expand the range of eligible guarantors in the Final Rule to include QCCPs, monoline insurers or financial guaranty providers, and private mortgage insurers in addition to sovereigns, certain supranational entities and multilateral development banks, insured depository institutions, depository institution holding companies, foreign banks and certain investment grade corporate entities (subject to certain limitations). The agencies have revised the Final Rule to include QCCPs in order to accommodate the use of the substitution approach for credit derivatives that are cleared transactions. However, the agencies declined to further expand the set of eligible guarantors to incorporate monoline and private mortgage insurers. This exclusion of monoline insurers from the set of eligible guarantors is a deviation from the Basel framework and the current advanced approaches rules. The agencies assert that such entities exhibit significant wrong-way risk and note their exclusion is intended to mitigate interconnectedness and systemic vulnerabilities within the financial system.

M. Standard Supervisory Haircuts Revised

In response to commenter concerns about excessive conservatism in collateral haircuts, the agencies have revised (from 25% to a range between 4%-16%) the standard supervisory

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[43] The preamble to the Final Rule also notes that an overall cap will be applied to the risk-weighted assets from all of a banking organization's exposures to a QCCP equal to 20% of its total trade exposures to the QCCP.

market price volatility haircuts for financial collateral issued by non-sovereign issuers with a risk-weight of 100%. The collateral haircut approach to credit risk mitigation permits a bank to use collateral haircuts to recognize credit risk mitigation benefits of financial collateral with respect to repo-style transactions, eligible margin loans, collateralized derivative contracts and single-product netting sets of those transactions, as well as with respect to any collateral that secures repo-style transactions that the bank includes in its VaR-based measure under the Market Risk Rule.

N. No Materiality Threshold Adopted for Netting Sets

As proposed, for certain netting sets (i) where the number of trades exceeds 5,000 any time during a quarter, (ii) with one or more trades with illiquid collateral, (iii) with any OTC derivatives that cannot be easily replaced or (iv) where there have been more than two margin disputes over the last two quarters that exceed the typical holding period associated with collateral (usually 10 business days for eligible margin loans and derivatives and five business days for repo-style transactions), the Final Rule will increase the haircuts required for the collateral to take into account the potential for a longer collateral holding period and volatility of that collateral during a holding period.[44] Given the significant impact that one trade with illiquid collateral or one hard-to-replace derivative could have on the risk weighting of a netting set and its collateral, commenters objected to such a de minimis amount "tainting" the entire netting set.

However, despite these commenter concerns, the agencies declined to include any concept of materiality in relation to this approach. Instead, the agencies note that banking organizations may exclude illiquid collateral from a particular netting set and can create a separate, individual netting set for hard-to-replace derivatives, thereby preserving the more favorable treatment for the rest of the netting set. The agencies also clarify that "margin disputes" depend solely on the timing of the resolution of such dispute, and not upon the materiality of the dispute. By way of example, the agencies note that if collateral is not delivered in the required period under an agreement, and such failure is not resolved in a timely manner, then such failure would count toward the two-margin-dispute limit, regardless of the amount in question. Where a dispute is subject to a recognized industry dispute resolution protocol, the agencies expect to consider the dispute period to begin after a third-party dispute resolution mechanism has failed.

O. Securitization Framework Largely Unchanged

The Final Rule retains the general framework in the Proposals for risk weighting securitization exposures which requires a banking organization to (i) apply the simplified supervisory formula approach (the "SSFA"); (ii) apply a gross-up approach similar to that provided under the general risk-based capital rules (provided the banking organization is not subject to the agencies' market risk rules); or (iii) assign a 1250% risk weight to its securitization exposures. The agencies reiterate in the Final Rule that a banking organization must apply the SSFA or gross-up approach consistently to all its securitization exposures and must be able to

[44] These increased haircuts will not be applied in the context of cleared transactions.

justify to its primary federal regulator on prudential grounds any transition from one approach to another.

In response to commenter concerns, the agencies provided an additional exclusion from the definition of "traditional securitization" for certain state and local government pension funds that were inadvertently captured by the Proposals' definition. The agencies also clarified that mortgage-backed pass-through securities (such as those guaranteed by Freddie Mac or Fannie Mae) that include various maturities but do not involve tranching of credit risk do not meet the definition of securitization exposure under the Final Rule.

The Final Rule also revises the SSFA to recognize common deferral features associated with student and consumer loans. Under the Proposals, these deferral features would have been treated as past due amounts, which would have resulted in higher capital requirements for securitization exposures with these types of underlying exposures. The agencies have proposed a corresponding change with respect to securitization exposures subject to the SSFA in a banking organization's trading book in a proposal to amend the Market Risk Rule issued together with the Final Rule.

P. Resecuritization Exposures Remain Disfavored but Re-REMICs Excluded

The Proposals defined a resecuritization as a securitization in which one or more of the underlying exposures is a securitization exposure. Commenters, again concerned that one securitization exposure in the underlying pool could taint the whole pool, urged the agencies to narrow this definition by adopting a materiality threshold, such as exempting resecuritizations in which 5% or less of the underlying exposures are securitizations. Although the agencies declined to adopt such a materiality threshold, the definition of resecuritization exposure in the Final Rule encompasses securitizations that have (i) more than one underlying exposure and (ii) one or more underlying exposures that are securitization exposures. The agencies clarified that the revised definition is intended to exclude the re-tranching of a single underlying exposure, such as a resecuritization of a real estate mortgage investment conduit ("Re-REMIC").

Q. No Relief from Securitization Due Diligence Requirements

The Final Rule requires a banking organization to conduct and document, at least quarterly, the due diligence and credit analysis undertaken with regard to securitizations to which it is exposed. To satisfy these requirements, banking organizations must be able to demonstrate to the satisfaction of their primary federal regulators that they have a comprehensive understanding of the features that materially affect the performance of these securitizations. Banking organizations that are not able to demonstrate such comprehensive analysis and understanding to the satisfaction of their primary federal regulators, will be required to assign a 1250% risk weight to such exposures. Commenters strongly urged the agencies to adopt a more flexible and less punitive approach, such as progressively increasing risk weight surcharges. However, the agencies declined to adopt such alternatives. By contrast, the Market Risk Rule retains substantively identical due diligence requirements, but would not automatically impose a maximum capital charge on securitization exposures whose due-diligence review was determined to be inadequate. The agencies have not proposed to conform this treatment in their proposed revisions to the Market Risk Rule issued for comment together with the adoption of the Final Rules.

R. No Dollar-for-Dollar Cap Applied to 1250% Risk Weight

When a banking organization is required to assign a 1250% risk weight to an exposure, the banking organization may in practice be required to hold capital in excess of its exposure amount because, at capital levels above 8%, a 1250% risk weighting results in a capital requirement in excess of dollar-for-dollar capital. Commenters had requested either that the agencies cap the amount of risk-based capital required to be held against a banking organization's exposure or allow modification of the 1250% standard in light of the fact that the revised minimum requirements (plus capital conservation buffer) will require most banking organizations to meet a minimum total capital requirement of 10.5%. The agencies declined to adopt such a cap, noting that a 1250% risk weight "is consistent with their overall goals of simplicity and comparability [and is necessary] to provide for comparability in risk-weighted asset amounts for the same exposure across institutions."[45]

IV. IMPLEMENTATION OF THE ADVANCED APPROACHES

The Final Rule incorporates many of the changes to the standardized approach discussed above in its revisions to the advanced approaches. Specifically, changes related to (i) the supervisory market price volatility haircuts for securitization exposures; (ii) the definitions of financial institution, securitization exposure, and eligible guarantor; and (iii) the treatment of cleared transactions generally correspond to the agencies' revisions to these aspects of the standardized approach. Far fewer comments were received specifically addressing the proposed revisions to the advanced approaches, and the agencies have made relatively few modifications to the Proposals with respect to the advanced approaches. Many of the comments received focused on the treatment of credit valuation adjustments discussed below.

A. Credit Valuation Adjustments

Consistent with the Proposals, the Final Rule would impose an additional capital requirement to address the risk arising from credit valuation adjustments ("CVA"). CVA is the fair value adjustment to reflect counterparty credit risk in valuation of an OTC derivative contract. The Basel Committee found that, during the financial crisis, only one-third of counterparty credit losses resulted from actual default; the overwhelming majority was attributable to mark-to-market losses arising from CVA. Consistent with the Basel III framework, the Final Rule requires an additional capital charge for CVA and provides a simple and an advanced methodology for determining this CVA add-on (with modifications to eliminate reliance on credit ratings in the Basel III framework's approach).

Commenters requested that the agencies exclude from the proposed CVA capital requirements exposures to sovereign, pension fund and corporate counterparties, noting that the E.U. Capital Requirements Regulation implementing Basel III provided significant capital

[45] Final Rule, p. 359.

relief in this regard.[46] Others urged the agencies to adopt a narrower exclusion for central bank, multilateral development bank and PSE counterparties that have very low credit risk. However, the agencies declined to accommodate these requests.

V. Market Risk Proposal

In addition to adopting the Final Rule, the agencies issued for comment a notice of proposed rulemaking that would make certain changes to the Market Risk Rule (adopted as final, together with the issuance of the Proposals, in June 2012) to ensure sovereign debt exposures and securitization exposures subject to the SSFA are treated consistently under the Final Rule and the Market Risk Rule (the "Market Risk Proposal").[47] Specifically, the agencies propose to revise the Market Risk Rule's treatment of sovereign exposures to provide that exposures to countries that are members of the OECD but are no longer assigned a CRC will be assigned a specific risk-weighting factor of 0.

The Market Risk Proposal would also revise the SSFA, consistent with the Final Rule, to recognize common deferral features associated with student and consumer loans. Under the current Market Risk Rule, these deferral features are treated as past due amounts, which results in higher capital requirements for securitization exposures with these types of underlying exposures.

The agencies also propose a minor change to the definition of "covered position" which currently excludes equity positions that are not publicly traded. The Market Risk Proposal would require a "look-through" approach that would include in the definition of covered position a position in an investment company registered under the Investment Company Act of 1940 that is not publicly traded, provided that all the underlying equities held by the investment company are publicly traded and the other conditions of the definition are satisfied.

Comments on the Market Risk Proposal are due on September 3, 2013.

VI. Additional Future Proposals Will Further Increase Burden on Banking Organizations

A. Basel III Leverage Ratio: Proposal for Increases for U.S. G-SIBs and Revisions to Denominator for All Advanced Approaches Banking Organizations

Two significant additional developments are on the horizon with respect to U.S. implementation of the Basel III leverage ratio.

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46 CRR, Art. 382. On July 8, the U.S. House of Representatives approved by voice vote a bill (H.R. 1341) that would require the FSOC to study and report on the effects of any differences between the U.S. and other jurisdictions on the capital treatment of CVA and recommend possible action by Congress and the FSOC's member agencies.

47 The Market Risk Proposal is available at http://www.federalreserve.gov/aboutthefed/boardmeetings/20130702__Market_Risk_Capital_Proposed_Rule.pdf.

1. Supplementary Leverage Ratio Proposal

This proposal, discussed in Part I above, would effectively subject the eight U.S. G-SIBs to a 5% supplementary leverage ratio requirement at the parent level and a 6% supplementary leverage ratio requirement at the level of each bank subsidiary—each of which represents a significant surcharge above the current Basel III 3% minimum leverage ratio applicable from January 1, 2018 to all advanced approaches banking organizations under the Final Rule. While the proposal does not incorporate the recent proposed changes to the calibration of the supplementary leverage ratio proposed by the Basel Committee (discussed immediately below), the agencies have indicated they plan to make appropriate revisions after considering any final Basel Committee leverage ratio rules.

2. Denominator Revisions

On June 26, 2013, the Basel Committee issued a consultation paper clarifying the Basel III leverage ratio framework and disclosure requirements.[48] The consultation paper sets forth a significant expansion of the denominator of the Basel III leverage ratio (the "Exposure Measure") that is expected to sharply drive up leverage capital charges for derivatives and securities financing transactions, such as repurchase/reverse repurchase agreements and securities borrowing/lending transactions ("SFTs"). These changes include (i) specification of a broad scope of consolidation for the inclusion of exposures of related entities; (ii) clarification of the treatment of derivatives and related collateral; (iii) differential treatment for written credit derivatives, and (iv) enhanced treatment of SFTs. The numerator of the Basel III leverage ratio would remain Tier 1 capital, although the Basel Committee plans to evaluate the impact of using total equity capital or CET 1 as the numerator of the Basel III leverage ratio over the next three years.[49] Notably, in this consultation paper, the Basel Committee did not propose an increase to the Basel III leverage ratio beyond the 3% ratio previously agreed within the Basel Committee.

a. Implementation Timing

Banking organizations were to begin reporting the leverage ratio and its components to supervisors beginning on January 1, 2013 (although this supervisory reporting requirement was delayed by one year in the United States and Europe). Public disclosure of the ratio is set to begin on January 1, 2015, although a 3% ratio would not become a minimum requirement for advanced approaches banking organizations until January 1, 2018, following potential recalibration of the ratio based on this consultation. The agencies are expected to issue a separate proposed rulemaking to implement any changes to the denominator calculation of the supplementary leverage ratio (as the Basel III leverage ratio is referred to in the Final Rule) once the Basel Committee's consultation is complete and a final leverage framework is issued.

[48] Basel Committee, Consultative Document: Revised Basel III Leverage Ratio Framework and Disclosure Requirements (June 2013), available at http://www.bis.org/publ/bcbs251.pdf.

[49] Compare, e.g., Basel Committee, Consultative Document: Supervisory Framework for Measuring and Controlling Large Exposures (Mar. 2013), available at http://www.bis.org/publ/bcbs246.pdf (proposing that denominator for large exposure calculation be CET 1, rather than another capital measure).

b. *Expansion of the Denominator*

The consultation paper defines the Exposure Measure to include (i) all on-balance sheet exposures; (ii) derivative exposures; (iii) SFT exposures, and (iv) other off-balance sheet exposures, and includes a specific treatment for each exposure type. On-balance sheet exposure includes on-balance sheet assets, as well as on-balance sheet derivative collateral and collateral for SFTs. The consultation also clarifies that on-balance sheet assets that are deducted from Tier 1 capital should also be deducted from the Exposure Measure. On-balance sheet assets are not permitted to be reduced by physical or financial collateral, guarantees or other credit risk mitigants.

c. *Derivative Exposures*

The consultation paper would require banking organizations to calculate their derivative exposures as the replacement cost of the transaction (equal to the mark-to-market where the contract has a positive value) plus an additional charge for potential future exposure ("PFE"). The PFE add-on is calculated by multiplying the notional principal of the transaction by a fixed, regulator-set percentage, which varies based on the asset class and maturity.[50] Although banks may take into account bilateral netting contracts that meet certain criteria, the resulting exposure may not be reduced to reflect collateral received, even though U.S. GAAP would permit banks to use any collateral received to offset derivative exposure. Moreover, banking organizations would be required to gross up their derivative exposure measure by the amount of collateral provided if delivery of such collateral reduced their on-balance-sheet assets. Accordingly, the Exposure Measure for derivative exposures has the potential to significantly overstate a bank's derivative exposure and substantially increase its leverage requirements for such exposures. If adopted as proposed, this exposure measure could cause banks to consider retreating from certain derivative business lines where increased capital costs could exceed profit margins.

Credit derivatives will generally be added to the Exposure Measure at their full effective notional value. Credit derivative notional value may be reduced by the notional value of purchased credit protection on the same reference entity at the same level of seniority. Any PFE add-on for credit derivatives is permitted to be omitted from the Exposure Measure, considering that these derivatives are already included at full notional value.

d. *Securities Financing Transactions*

The exposure measure for SFTs when the bank is acting as principal is calculated as the sum of (i) gross SFT assets (with no recognition of netting under GAAP or IFRS, and the exclusion of the value of securities received and recognized as an asset where re-hypothecation is permitted but has not occurred) and (ii) a measure of counterparty credit risk calculated as current exposure without a PFE add-on. The proposed exposure measure for SFTs has the potential to create a perverse incentive to hold illiquid collateral that cannot be re-hypothecated

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[50] The consultation paper acknowledges that the replacement cost + PFE methodology is generally the CEM, and indicates that the Basel Committee is considering alternatives and/or changes to the CEM. See discussion below regarding the Basel NIMM Paper.

for cash since any cash received would then be reflected on the balance sheet and subject to a leverage capital requirement.

The consultation paper also proposes additional measurement metrics for SFTs. First, a qualifying master netting agreement is permitted to be used to net down exposure of SFTs. Second, any SFT that achieves sale accounting under applicable GAAP must be reversed and counted as a financing transaction for purposes of the Exposure Measure. Third, an agent in securities lending transactions must count the difference between the value of the security or cash its customer has lent and the value of the collateral the customer has borrowed, if it has provided a guarantee to its customer and has limited the guarantee to such difference. If the guarantee is not so limited, then the full exposure amount of the guarantee must be included in the Exposure Measure.

Comments on the Basel III Leverage Ratio consultation are due on September 20, 2013.

B. Convertible Long-Term Debt Requirements

At the Federal Reserve board meeting approving the Final Rule, Governor Tarullo also noted that the Federal Reserve will issue "in the next few months" a proposal "concerning the combined amount of equity and long-term debt these firms should maintain in order to facilitate orderly resolution in appropriate circumstances." While it is difficult to evaluate the impact of such a requirement given the sparse detail provided, it seems likely that this proposal will impose significant additional costs on subject banking organizations as a result of the potential need for an increased coupon rate if investors are to find a significant increase in issued debt to be attractive, and if investors understand that these instruments are likely to be converted to the equity base for a "bail-in" under the "single point of entry" and bridge bank concepts favored by the FDIC under Title II of the Dodd-Frank Act. Undoubtedly, this will also create additional burdens associated with maintaining compliance with another, separate formal capital requirement, and has the potential to conflict with increased minimum leverage ratios.

C. D-SIB and G-SIB Surcharges

The Final Rule does not implement certain other reforms to bank capital and liquidity regulation proposed by the Basel Committee. Specifically, the Final Rule does not implement the so-called "G-SIB Surcharge", which would apply a CET 1 capital surcharge on G-SIBs ranging from 1% to 2.5% (with a possible incremental surcharge of 1% on the largest G-SIBs if they continue to grow).

Governor Tarullo indicated that the Federal Reserve (presumably together with the other agencies) will issue a proposed rulemaking to implement the G-SIB framework after the Basel Committee has completed final methodological refinements to its G-SIB framework. The Basel Committee issued its final G-SIB framework shortly after the Final Rule, on July 3, 2013.[51]

[51] See Basel Committee, Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement (July 2013), available at www.bis.org/publ/bcbs255.pdf.

Moreover, after the Proposals' release in June 2012, the Basel Committee issued a consultative document on its proposed framework for domestic systemically important banks ("D-SIBs").[52] The D-SIB proposal is intended to supplement the G-SIB framework by imposing a capital buffer on certain banks that may not be significant from an international perspective, but nevertheless have an important impact on their domestic economies. The framework establishes a minimum set of principles against which the agencies would evaluate whether a bank is a D-SIB and determine the amount of additional capital that a D-SIB is required to hold and/or whether D-SIBs should be subject to other policy tools. However, the Final Rule does not indicate whether any, or to what extent, banking organizations that are not designated as G-SIBs by the FSB may be subject to a D-SIB surcharge. In line with its stated objective that the D-SIB framework complement the G-SIB framework, the Basel Committee has proposed that it be implemented in line with the G-SIB phase-in beginning in January 2016. It is possible that implementation of the D-SIB framework could be folded into the U.S. and Non U.S. SIFI Section 165 rulemakings, which propose enhanced capital, liquidity and other prudential requirements for Non-Bank SIFIs and BHCs and IHCs with total assets of $50 billion or more.

D. Additional Regulation and Capital Requirements for Entities Dependent on Short-Term Wholesale Funding

Governor Tarullo also mentioned in his opening remarks that Federal Reserve staff is preparing to release an advance notice of proposed rulemaking ("ANPR") to "seek comment on possible approaches to requiring additional measures that would directly address risks related to short-term wholesale funding, including a requirement that large firms substantially dependent on such funding hold additional capital."[53] Although Governor Tarullo did not provide any details on the contents of the ANPR, in recent speeches he has indicated that failure to address systemic risks arising from institutions dependent on the use of short-term SFTs is the most important "gap" in regulatory reform.[54] The Federal Reserve's concerns with the reliance on short-term wholesale funding center on the risk of destabilizing funding runs that can result when collateral values become uncertain or the perceived risk of counterparty default increases and a "negative feedback loop" of mark-to-market losses, margin calls, and fire sales ensues.

Governor Tarullo has suggested that an effective regulatory measure to address these risks should apply to all uses of short-term wholesale funding, without regard to the form of the transaction or whether the borrower was a prudentially regulated institution, and be implemented in such a way as not to stifle this important source of liquidity in the financial market. However, because of the need for coordination among multiple regulators and open questions as to where and whether regulatory authority exists to address entities not otherwise

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[52] Basel Committee, A Framework for Dealing with Domestic Systemically Important Banks (Oct. 2012), available at http://www.bis.org/publ/bcbs233.pdf.

[53] Section 165 of the Dodd-Frank Act gave the Federal Reserve discretionary authority to impose short-term debt limits on BHCs and FBOs with total assets of $50 billion or more and on Non-Bank SIFIs.

[54] Governor Daniel K. Tarullo, Evaluating Progress in Regulatory Reforms to Promote Financial Stability (Peterson Institute for International Economics, May 3, 2013), available at http://www.federalreserve.gov/newsevents/speech/tarullo20130503a.htm.; Governor Daniel K. Tarullo, Remarks on the Dodd-Frank Act before the House Committee on Financial Services (Feb. 14, 2013), available at http://www.federalreserve.gov/newsevents/testimony/tarullo20130214a.htm.

subject to prudential regulation, he has conceded that a "single, comprehensive regulatory measure" may not be achievable in the near term. Some options that Governor Tarullo has discussed to mitigate risks in the short-term wholesale funding markets include:

- Higher Capital Requirements. Governor Tarullo posits that the best approach for addressing the risks associated with overreliance on wholesale funds is through the imposition of a significantly higher liquidity requirement or a significantly higher capital requirement, noting that "the relationship between the two also matters." He suggests that increased capital requirements could take the form of surplus common equity capital requirements or a higher, generally applicable capital charge applied to SFTs. In addition, Governor Tarullo suggests that stress tests be revised to provide for comprehensive stressing of trading books, which would be a means of effectively imposing higher minimum capital requirements for SFTs before a formal elevated capital requirement could be adopted.

- Further Revised Liquidity Requirements. Governor Tarullo also advocates requiring higher levels of capital for large firms unless their liquidity position is substantially stronger than minimum requirements. He states that his suggested "approach would allow a firm of systemic importance to choose between holding capital in greater amounts . . . or changing the amount and composition of its liabilities." He also advocates significantly reworking the Basel III net stable funding ratio proposal to take into account the macroprudential implications of wholesale funding.

- Universal Minimum Margining Requirements for SFTs. Governor Tarullo has suggested that such overcollateralization requirements are necessary, in accordance with the recent FSB consultation paper on strengthening oversight of the "shadow banking" sector,[55] and could be applied "regardless of whether the lender or borrower was otherwise prudentially regulated."

- Limits on the Rehypothecation of Collateral Involved in SFTs. Although the Securities and Exchange Commission has long limited, though not prohibited, rehypothecation of customer securities, he suggests that the "logical… next step" is a review of U.S. rules and adoption of rules by other relevant countries where no formal limits on rehypothecation are in place.

E. Additional Revisions to the Basel Capital Framework—Non-Internal Model Method for Capitalizing Counterparty Credit Risk Exposures

On June 28, 2013, the Basel Committee released a consultation paper proposing a new method for calculating capital charges for derivative counterparty exposure without using internal models.[56] The agencies are likely in the future to incorporate all or most of any final

[55] FSB, Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (Nov. 18, 2012), available at http://www.financialstabilityboard.org/publications/ r_121118b.pdf.

[56] See Basel NIMM Paper.

Basel Committee rules on derivative counterparty exposure into the capital rules, as well as into other related regulations such as lending limits or single counterparty credit limits.

The current Basel II framework for calculating derivative capital charges provides two "non-model methods" for calculating credit exposure from derivatives—the Current Exposure Method ("CEM") and the more complex Standardized Method ("SM").[57] These exposure calculations are multiplied by the risk weight of the counterparty to arrive at a final risk-weighted asset value. The Basel NIMM Paper would replace the CEM and SM with a single supervisory formula approach, named the "non-internal model method" ("NIMM"). In proposing the NIMM, the Basel Committee's stated goals are to address the known deficiencies of the CEM and SM—for example, their failure to distinguish margined from unmargined transactions and their relative lack of risk sensitivity—while also minimizing discretion for banks and national implementing authorities.

The NIMM is substantially more complex than either the CEM or the SM, although it draws on concepts from both. The Basel Committee will be performing a quantitative impact study on the NIMM to assess the effectiveness of the formula, as well as the "difference in exposure and overall capital requirements under the NIMM as compared to the CEM." The Basel Committee also anticipates that the NIMM may be used in calculating exposure under both bilateral (OTC) derivatives and cleared derivative transactions.

The NIMM follows the basic structure of the CEM and calculates exposures as the sum of two components—a current value or mark-to-market ("MTM") component described as "replacement cost" ("RC"), and a PFE component. Exposure is calculated as the sum of RC and PFE multiplied by a factor of 1.4, carried over from the IMM. In the proposed methods for calculating RC and PFE, the NIMM would distinguish between margined and unmargined trades, account for excess collateral, and, depending on asset class, provide for different levels of partial or full offsets for long and short positions in the same asset or, in some cases, across positions in similar, but not identical assets. More specifically:

- The calculation of RC would occur at the netting set level (i.e., all transactions with a counterparty subject to a qualifying master netting agreement), and would distinguish between unmargined and margined transactions. Margin received can reduce the exposure amount, but the posting of margin (whether initial or variation) is also added to the exposure in the transaction. Margin collateral posted to a segregated, bankruptcy remote account does not, however, attract an additional exposure amount. RC can never be less than zero.

- The PFE calculation for any netting set requires the aggregation of multiple PFE "add-ons" calculated at the "hedging set" level, adjusted by a multiplier that provides credit for over-collateralization and negative net MTM positions. The Basel NIMM Paper's formula for factoring in over-collateralization and negative MTM values would, however, never fully eliminate PFE—the lowest permitted PFE multiplier is set at 5%.

[57] Banks can also choose to use an internal model method ("IMM") with supervisory approval. In the United States, the SM is not available, and only advanced approaches banking organizations may use the IMM.

- The method of calculation of PFE "add-ons" and the availability of partial or full offsets for long and short positions within or across "hedging sets" depends on the asset class of the hedging set. The Basel NIMM Paper proposes five broad categories of asset class: (1) interest rate derivatives, (2) foreign exchange derivatives, (3) credit derivatives, (4) equity derivatives, and (5) commodity derivatives. Hedging sets are subsets of transactions within a netting set that are of the same asset class and share common attributes.[58] Although partial offsets are sometimes permitted between different assets within an asset class, no offset is permitted across asset classes. The definition of hedging set and the extent of permitted offset within or across hedging sets reflect the Basel Committee's attempt to establish a conservative, yet risk sensitive, method for recognizing the effect of offsetting positions in the calculation of PFE.

- Derivatives transactions subject to a qualifying margining agreement are given substantially more favorable treatment in the calculation of PFE add-ons (presumably to reflect the mitigating effect of margin on PFE). Margined netting sets would also benefit from a time risk horizon adjustment reflecting shorter time horizons over which PFE is required to be calculated (1 year for unmargined, 10 or 5 days for margined derivatives).

- No internal modeling would be used in the NIMM—all supervisory factors intended to reflect correlation, volatility, etc. are set forth in a table in the Basel NIMM Paper.

Comments on the Basel NIMM Paper are due by September 27, 2013.

F. *Additional Revisions to the Basel Capital Framework—Capital Treatment of Bank Exposures to Central Counterparties*

On June 28, 2013, the Basel Committee released a consultation paper proposing additional changes to the Basel Committee interim framework for bank exposures to CCPs ("Proposed QCCP Framework").[59] These proposed changes would apply only to QCCPs and were developed in close cooperation with the Committee on Payment and Settlement Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO"). The Proposed QCCP Framework would overhaul the interim framework's approach to bank exposures to QCCPs by:

- replacing the interim framework's methods for risk weighting a bank's contributions to QCCP default funds with either:
  - a "ratio approach" that sets the risk weight on clearing members' contributions to prepaid default funds according to a ratio of the size of member contributions to

[58] For example, a hedging set might consist of all USD interest rate swaps within the one-to-five year maturity bucket.

[59] Basel Committee, Consultative Document: Capital Treatment of Bank Exposures to Central Counterparties (June 2013), available at http://www.bis.org/publ/bcbs253.pdf. See also Basel Committee interim framework.

either (a) a set minimum level of default resources the QCCP must maintain or (b) a hypothetical level of default resources calculated using the NIMM (discussed above) which the Proposed QCCP Framework notes is intended to set a floor under other calculations of required default resources, or

  - a "tranches approach", which is intended to simplify the hypothetical capital approach to risk-weighting clearing members' contributions to prepaid default funds set forth in method 1 of the interim framework and adopted in the Final Rule;

- replacing the 2% risk weight for bank trade and margin exposures to QCCPs set forth in the interim framework and adopted in the Final Rule with a more risk sensitive approach (although such approach may increase risk weights to QCCPs to as much as 20%);

- revising the treatment of posted initial margin; and

- addressing the risk-weighting of unfunded commitments to top up QCCP default funds, while also enabling such commitments potentially to serve as credit risk mitigants for trade and margin exposures to QCCPs.

The agencies indicate that they plan to revisit the treatment of exposures to QCCPs once the Proposed QCCP Framework is finalized.[60] Given that the interim framework was adopted without significant modifications in the Final Rule, it appears likely that the Final Rule will be revised in the future to incorporate the revised QCCP framework once it is finalized. However, the Basel Committee indicated that they are conducting a quantitative impact study on the appropriateness of certain aspects of the Proposed QCCP Framework, and therefore further developments in this area are likely. Each of the proposed revisions is briefly summarized below

1. <u>Revised Risk Weights for Default Fund Contributions</u>

Under the "ratio approach", a dollar-for-dollar capital charge would be assessed against clearing member contributions to a default fund that is exactly equal to the minimum level of funds the QCCP must maintain to satisfy its minimum "cover" requirements under the CPSS-IOSCO *Principles for financial market infrastructures*[61] or, if higher, the hypothetical level of default resources calculated using NIMM (where there is no junior contribution to the default fund by the CCP itself). If clearing members' contributions to the default fund exceed the QCCP's minimum "cover" requirement, the capital charges applicable to all contributions would decrease in a proportional manner. A QCCP's own junior contributions to the default fund would also reduce the members' relative capital charges. The key advantages of the ratio

[60] <u>See</u> Final Rule, p. 299.

[61] Basel Committee, <u>Principles for Financial Market Infrastructures</u> (Apr. 2012), available at http://www.bis.org/publ/cpss101.htm.

approach are that it avoids the interim framework's material disincentives toward increasing a QCCP's default fund and is both relatively simple and risk sensitive.

The "tranches approach" is a modified and simplified version of the interim framework's "method 1" which, as implemented in the Final Rule, requires a clearing member bank to calculate the appropriate risk weight applicable to its default fund contribution using a three-step process based on the hypothetical capital requirement of the QCCP. Under the tranches approach, clearing member contributions to the default fund are split into two tranches: the portion below the hypothetical capital level and the portion above that level. A capital charge is calculated on each tranche. The key difference from the interim framework's approach is that the hypothetical level is calculated using the higher of the QCCP's "cover" requirement and its hypothetical level of default funds calculated under NIMM (rather than CEM), after taking into account any junior contribution to the default fund by the QCCP itself. The main advantage of the tranches approach is also enhanced risk sensitivity. If the NIMM or "cover" calculation indicates that a QCCP needs a high level of default resources, and the QCCP itself makes little contribution to these resources, there will be a correspondingly higher capital charge for clearing members. If NIMM and "cover" calculations indicate that smaller default resources are required (because the QCCP's exposures to its members after allowing for margin are small), or the QCCP itself contributes significant default resources as a junior tranche, capital charges on clearing members will be correspondingly smaller.

2. <u>Capital Treatment of Bank's Trade Exposures to QCCP</u>

In place of the interim framework's fixed 2% risk weight for a clearing member bank's trade exposures to a QCCP, the Proposed QCCP Framework would establish risk weights for trade exposures that depend on the level of prefunded default resources available to the QCCP relative to a benchmark level of prefunded resources. Under the two proposed formulae, the risk weight on trade exposures would decrease as actual prefunded default resources increased in relation to either the amount of default resources required to achieve "cover" or the hypothetical amount of default resources required by the QCCP under a NIMM analysis. The applicable risk weight could range between 2% and 20%, but (according to the Basel Committee) likely in practice would not to be higher than 5%. In order to achieve a 2% risk weight, however, the level of the prefunded default fund would have to be 2.5 times the amount needed to "cover" the default resource requirements. The Basel Committee did express the concern that, when combined with a 100% capital charge on default fund contributions, a 20% risk weight might conflict with the objective of incentivizing central clearing of OTC derivatives.

3. <u>Treatment of Posted Initial Margin</u>

A 0% risk weight will still be applied to initial margin if collateral is posted in a bankruptcy remote manner, thereby preventing a clearing member from losing its initial margin. Where collateral is not posted in a bankruptcy remote manner, a capital charge ranging from 2% to 20% would apply, similar to the proposed capital charge for trade exposures noted above. However, the Basel Committee proposes to maintain a 2% risk weight on non-bankruptcy remote posted initial margin if a QCCP has legally enforceable rules establishing that losses beyond its prefunded default resources will fall first on surviving clearing members' mark-to-market exposures—for example through variation margin haircutting—and only thereafter on surviving members' initial margin.

4. Capital Treatment of Commitments to Top Up Default Funds

If prepaid default resources are exhausted, members' committed (but unfunded) contributions, which are senior to prefunded default fund contributions, can serve as protection for both the QCCPs and their participants. Nevertheless, such unfunded commitments would also attract a capital charge on the clearing member. Therefore, the Proposed QCCP Framework suggests ways in which the capital charge against the unfunded commitment could be accomplished under each of the ratio and tranches approaches. In addition, the Basel Committee is considering ways in which such commitments could reduce the capital that would have to be held against trade and margin exposures to QCCPs. The Proposed QCCP Framework notes that, while such commitments could reduce the risks associated with trade and margin exposures, they are less reliable than prefunded contributions. As a result, the proposal suggests that commitments could be applied as a risk mitigant to the trade and margin exposure capital charge, but based on a fractional multiplier that would weight the unfunded commitment less than a prefunded default fund contribution.

Comments on the Proposed QCCP Framework are due by September 27, 2013.

G. Capital Requirements for Banks' Equity Investments in Funds

On July 5, 2013, the Basel Committee published a set of proposals that would revise the prudential treatment of banks' equity investments in funds to require a look-through approach to better capture risks associated with a fund's leverage.[62] The revised standard is also intended to address risks associated with banks' interactions with "shadow banking" entities. Comments on the proposals are due on October 4, 2013.

Under the Final Rule, a 600% risk weight is applied to equity investments in hedge funds.[63] However, in the European Union, a full internal-ratings-based look-through approach is mandatory for advanced approaches banking organizations and, where banks are not able to apply it, a 370% maximum risk weight plus 2.4% deduction for expected losses is applied. The Basel Committee seeks to harmonize the treatment of such exposures by proposing three potential alternative approaches to determine the appropriate risk weight: (i) a look-through approach which would require the banking organization to determine the risk weight based on the fund's underlying assets; (ii) a mandate approach, which would base applicable risk weights off of the fund's investment mandate; or (iii) a fall back approach which would apply a 1250% risk weight to the exposure when the other approaches are not feasible. In addition, the consultation paper would require a "leverage adjustment" to capture the risks associated with

[62] Basel Committee, Consultation on Capital Requirements for Banks' Equity Investments in Funds (July 2013), available at http://www.bis.org/publ/bcbs257.pdf.

[63] Although the advanced approaches provides for a look through approach for certain exposures to investment funds, the agencies have explicitly prohibited advanced approaches banking organizations from using this approach for exposures to hedge funds, or any investment fund with material liabilities.

the fund's leverage. If adopted as proposed, the consultation paper would require a more risk-sensitive approach to a fund's leverage that could potentially increase the risk weights applicable to hedge fund exposures under the Final Rule, although the Basel Committee proposes a cap to ensure that the applicable capital charges would not exceed 1250%.

H. Additional Revisions to Trading Book Rules

The Basel Committee issued a consultative paper in May 2012—*A Fundamental Review of the Trading Book*—which raises the possibility of eliminating the VaR-based approach in the current market risk framework because of its inability to capture "tail risk". The consultation paper considers alternative risk metrics, in particular expected shortfall models, and also discusses the use of standardized (non-models-based) requirements as an alternative to models-based approaches, or as a floor under these approaches. While the paper is focused on the market risk framework, its preliminary findings were at the start of a wave of recent criticism of the use of models-based approaches to determining capital requirements.

In remarks at the Federal Reserve's meeting in June 2012 to issue the Proposals, Governor Tarullo supported adoption of the long-delayed Market Risk Rule implementing Basel II.5, but indicated that the Federal Reserve was already considering additional revisions to this rule.[64] Specifically, he signaled preliminary support for further amendments to the market risk framework to establish standardized capital requirements for market risk as a back-up to model-derived risk weights. Other regulators have echoed his concerns,[65] and Governor Tarullo reiterated, at the Federal Reserve's board meeting approving the Final Rule, that the Basel Committee will likely be simplifying and standardizing the market risk and trading book rules and establishing a "back up" to models-based approaches. It therefore appears likely that additional significant revisions to the Market Risk Rule are on the horizon.

I. Liquidity Requirements

The agencies are also expected to propose implementing regulations for the Basel Committee's framework for a Liquidity Coverage Ratio ("LCR") in the near term.[66] On January 7, 2013, the Basel Committee released revised rules governing the LCR.[67]

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[64] Statement by Governor Daniel K. Tarullo (June 7, 2012), available at http://federalreserve.gov/newsevents/press/bcreg/tarullo20120607a.htm.

[65] See, e.g., Remarks by Comptroller Thomas J. Curry before the Exchequer Club (May 16, 2012), available at http://www.occ.treas.gov/news-issuances/speeches/2012/pub-speech-2012-77.pdf.

[66] Basel Committee, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 2010), available at http://www.bis.org/publ/bcbs188.pdf. The Basel III liquidity risk framework requires banking organizations to comply with two measures of liquidity risk exposure: (i) the LCR and (ii) the "net stable funding ratio" ("NSFR"). The LCR is based on a 30-day time horizon and is calculated as the ratio of a banking organization's "stock of high quality liquid assets" divided by its "total net cash outflows over the next 30 calendar days" and must be at least 100%. The NSFR is calculated as the ratio of a banking organization's "available amount of stable funding" divided by its "required amount of stable funding" and also must be at least 100%. The LCR will not be introduced as a requirement until January 1, 2015 and will phase in over several years. The NSFR has an even longer implementation horizon; it will not be introduced as a requirement until January 1, 2018, with expected additional revisions in 2016.

The Federal Reserve has already proposed to require BHCs with assets equal to or in excess of $50 billion, IHCs and U.S. branches of FBOs with global consolidated assets equal to or in excess of $50 billion and Non-bank SIFIs to maintain a "liquidity buffer" similar to the LCR, although the Federal Reserve stated at that time that it expects these provisions would be amended in the future as the Basel Committee and the agencies study, finalize and adopt appropriate liquidity measures.[68]

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[67] Basel Committee, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (Jan. 2013), available at http://www.bis.org/publ/bcbs238.pdf. These revisions to the LCR are discussed in our alert memos, Significant Revisions to Liquidity Coverage Ratio Expected to Reduce Burden on Banking Organizations (Jan. 11, 2013), available at http://www.cgsh.com/significant_revisions_to_liquidity_coverage_ratio_expected_to_reduce_burden_on_banking_organizations; and Basel Committee on Banking Supervision Release of January 6, 2013: Outline, Summary and Analysis of Changes to the Liquidity Coverage Ratio (Jan. 11, 2013), available at https://cgshare.cgsh.com/download/attachments/8684002/CGSH+Alert+-+BCBS+-+Liquidity+Release+-+1-6-2013+-+Analysis.pdf.

[68] The liquidity buffer applicable to Covered Companies is discussed in our alert memos, The Federal Reserve Board's Heightened Prudential Requirements for Systemically Important Financial Institutions (Jan. 24, 2012), available at http://www.cgsh.com/federal_reserve_boards_heightened_prudential_requirements/; and the Federal Reserve's Proposed Framework for Regulation of Foreign Banks: Issues for Comment and Consideration (Jan. 2, 2013), available at http://www.cgsh.com/the_federal_reserves_proposed_framework_for_regulation_of_foreign_banks_issues_for_comment_and_consideration.

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