‘No Creditor Worse Off’: Resolution Mechanisms Update

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The New Basel III Rules and its Implications for US Banks

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As expected this month the US Board of Governors of the Federal Reserve Board (FRB) announced its adoption of a revised version of the Basel III Accord for implementation in the United States.

The Fed believes that by using Basel III, which is the international regulatory capital framework, as a foundation and with additional supporting provisions using its own ‘made in the USA’ rules it can build greater confidence in the banking system. (Basel III was issued by the Basel Committee on Banking Supervision which is a committee of the Bank for International Settlements (BIS)).

Basel III is an international agreement designed to improve stability in the banking industry in the aftermath of the 2007-09 financial crisis by addressing shortcomings in capital requirements and other matters, particularly for larger, internationally active banking organizations.

The determination of capital is an important one for banks as the result of additional capital requirements means increased costs as well as limiting banks’ ability for further growth. When banks are required to hold more capital, then there is either less...
money available for giving out loans or higher interest rates need to be charged to borrowers.

The Basel III capital rules bring significant changes to the US financial system by ensuring the maintenance of strong capital positions and other related enhancements.

More specifically, the FRB approved the “Final Capital Rule” (final rule) which increases bank regulatory capital requirements and implements defined elements of the Basel III capital reforms in the U.S. as well as certain other changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (which covers derivatives, proprietary trading—the Volcker Rule-, consumer lending, etc.). Together, these requirements are in many ways tougher than those in most other jurisdictions worldwide as the combined impact of all these American regulatory changes is very significant.

The Final Capital Rule

The Federal Reserve has taken a strict oversight approach with the Big Banks by introducing new capital and risk-related requirements as part of this overriding effort to make the financial system safer. In addition, even tougher regulations are being put in place for U.S. global systemically important banks and for other large banks in America.

The Final Capital Rule includes regulations to assess risk-based capital surcharges and to impose additional specified capital requirements. The final rule establishes an integrated regulatory capital framework requiring banking organizations to hold more and higher quality capital, which acts as a financial cushion to absorb losses, while reducing the incentive for firms to take excessive risks. The goal is to ensure that banks will be better able to withstand periods of financial stress, thus contributing to the overall health of the U.S. economy.

Under the final rule, minimum requirements will increase for both the quantity and quality of capital held by banking organizations. Consistent with the third international Basel framework, the rule includes a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5 percent and a common equity tier 1 capital conservation buffer of 2.5 percent of risk-weighted assets that will apply to all supervised financial institutions. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4 percent to 6 percent. On the quality of capital side, the final rule emphasizes common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments.

The Final Rule adopts the capital conservation buffer for all banking organizations, as well as another, known as a “countercyclical capital buffer,” for advanced approaches banking organizations (ranging between 0 to 2.5 percent). The capital conservation buffer is intended to ensure that institutions are able to absorb losses in stress periods lasting for a number of years. One the other hand, the countercyclical capital buffer’s goal is to achieve the broader macro-prudential goal of protecting the banking sector and the real economy from the system-wide risks stemming from the boom-bust evolution such that a buffer is required during periods of excessive credit growth and is released in an economic downturn.

To help prevent an excessive build-up of leverage on institutions’ balance sheets, the final rule introduces a new non-risk based leverage ratio to supplement the risk-based capital framework. The leverage ratio’s purpose is to counter the build up of extreme on- and off-balance sheet leverage. Therefore, in addition to the risk-weighted capital rules, a minimum leverage ratio of 4 percent will apply to all banks, with a supplementary 3 percent for the “advanced approaches” firms—the largest, most internationally active banks. Thus, with the new supplementary leverage ratio, the final US-based leverage ratio is significantly higher than the minimum original Basel III leverage ratio. In addition, for the largest, most internationally active banking organizations, the final rule includes a new minimum supplementary leverage...
(sometimes called gearing) ratio that takes into account off-balance sheet exposures.

The final rule also improves the methodology for calculating risk-weighted assets to enhance risk sensitivity. Banks and regulators use risk weighting to assign different levels of risk to various classes of assets—riskier assets require higher capital cushions and less risky assets require smaller capital cushions.

**Applicability**

The Final Rule generally applies to all U.S. banking organizations (including national and state-chartered banks, federal and state-chartered thrifts, bank holding companies, and savings and loan holding companies), subject to a few specifically identified exceptions.

The Final Capital Rule has special provisions and timelines for community banking organizations.

**Start Dates and Timetable**

The final rule is effective as of January 1, 2014, with an initial mandatory compliance date of January 1, 2014 for most banking organizations subject to the advanced approaches risk-based capital rule, and January 1, 2015 for all other banking organizations subject to U.S. risk-based and leverage capital requirements.

More specifically, there are two main start dates:

January 1, 2014 – For advanced approaches banking organizations (generally those with consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion), this is the start date for compliance with the revised minimum regulatory capital ratios and for determining risk-weighted assets under the “advanced approach.”

January 1, 2015 – For non-advanced approaches banking organizations and covered SLHCs, this is the start date for compliance with the revised minimum regulatory capital ratios and for determining risk-weighted assets under the “standardized approach.”

Basel III generally gives banking organizations a choice between two methods for calculating risk-weighted assets, which comprise the denominator of a banking organization’s risk-based capital ratios. One is the “standardized approach” that permits them to measure credit risk using metrics and risk-weightings prescribed by regulation. Another is the “advanced approach” (or internal ratings-based approach) that allows banking organizations to use their internal models and ratings systems to measure credit risk, subject to regulatory approval. The Final Rule requires that the standardized approach will serve as the “floor” (mandated by the Collins Amendment) with respect to any leverage and risk-based capital requirements that the FSB may impose on banking organizations and non-bank Systemically Important Financial Institutions (SIFI).

The Fed has eased the regulatory burden on some requirements that would have been tough on community banks. Community banks will also have a longer transition period to meet the new requirements.

There are a number of different start dates and transitional arrangements in the “U.S. Basel III”.

**Other Issues**

Interestingly, the Fed has added more rules aimed at big U.S. banks such that these new requirements go beyond the international Basel III requirements as many believe that the third accord by the Basel Committee did not go far enough in terms of protecting the financial system.

Importantly, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC) and the FRB have coordinated their adoption of the US-based revised version of Basel III.

The Financial Stability Oversight Council (FSOC) has also mandated
that insurers will also be subject to the same new increased Tier 1 capital buffer where they have been designated as “systemically important”.

Conclusion

Overall, the Final Rule attempts to codify the U.S. banking agencies’ regulatory capital rules, which have previously resided in various regulations, into a single harmonized integrated and heightened regulatory framework using the international Basel III Accord as its base.

The Final Rule replaces the general risk-based capital rules of the different banking agencies that currently apply to banking organizations with a single integrated regulatory capital framework that emphasizes not only higher capital cushions for banks to absorb losses but also more stringent criteria for what qualifies as regulatory capital. There are also additional new standards in other areas such as leverage.

With these new requirements, the US looks to build greater confidence in its financial and banking system. All banks should review their controls, processes and business models in the light of these changes to ensure that they will be able to outpace their competitors on the opportunities and threats that will develop.

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