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Finance
June 29, 2012

PROPOSED RULES ON CAPITAL RATIOS AND CAPITAL ADEQUACY

The Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency have approved a joint notice of proposed rulemaking regarding minimum regulatory capital ratios, capital adequacy, prompt corrective action, transition periods for the implementation of these provisions and related matters (the "Notice"). The comment period for these proposals ends on September 7, 2012.

The Notice groups together proposals that largely derive from the Basel III global regulatory framework and the Dodd-Frank Act. These proposals relate to the kinds and amounts of capital that banks, savings associations and most of their holding companies will be required to maintain and the deadlines by which they must be in compliance with these requirements. To address these issues, the Notice necessarily contains numerous interrelated definitions whose specific impact and effectiveness will depend on how well the analytical positions they implicitly stake out relate to the holdings of actual institutions and to the general structure of the financial markets over time.

Although all of the proposals in the Notice have histories that reflect debates among all of the interested parties, it will also be useful to sketch out how the proposals cohere with one another at this stage of their development. For this purpose, it is most useful to focus on the Common Rule, the part of the proposed regulation in the Notice that applies to covered institutions supervised by any of the three regulators.

The fundamental requirements under the so-called "standardized approach" for computing capital[1] include a common equity tier 1 capital ratio of 4.5 percent, a tier 1 capital ratio of 6 percent, a total capital ratio of 8 percent, a leverage ratio of 4 percent, and, for institutions using the so-called "advanced approaches[2]" to the calculation of their capital requirements, a supplementary leverage ratio of 3 percent.[3] These percentages lead into numerous definitional chains. Because the fundamental requirements are all ratios, their numerators and denominators have to be specified carefully.

The nature of the numerators for the common equity tier 1, tier 1 and total capital ratios is roughly apparent from the names of the ratios but will be discussed in more detail below. The denominator of

[1] A basic method which relies largely on risk weights for various assets set out in the capital regulations and on relatively simple arithmetical calculations.

[2] Advanced approaches rely on more granular evaluations of risk and the application of more complicated formulas and modeling. They also include measures that relate to operational risk as well as to credit risk. They are the subject of another joint notice of proposed rulemaking that was adopted at the same time as the Notice.

[3] §__.10(a) of the Common Rule, which, as noted above, would apply to all institutions affected by the Notice.

each of these three ratios equals the relevant company's standardized total risk-weighted assets. The numerator of the leverage ratio is tier 1 capital; its denominator, unlike that for the other three ratios, is average reported consolidated assets minus amounts deducted from tier 1 capital.

For companies using advanced approaches, the ratio to be maintained is the lower of the standardized ratio and a related ratio. The numerators of the common equity tier 1 and tier 1 capital ratios in the advanced approaches are the same as those used in the standardized approach, but the denominator in each case becomes the amount of the advanced approaches total risk-weighted assets. That same denominator is used in calculating the advanced approaches total capital ratio, but the numerator changes to the amount of the advanced approaches adjusted total capital.

The supplementary leverage ratio for an advanced approaches company is the average of the monthly reported ratio of its tier 1 capital to its total leverage exposure. Its total leverage exposure is an amount that includes its balance sheet assets, the potential future exposure amount for each derivatives exposure,[4] 10 percent of the notional amount of all unconditionally callable commitments of the company, and the notional amount of all other off-balance sheet exposures other than those for securities lending and borrowing, reverse repos, derivatives and unconditionally cancellable commitments.

The Notice provides that these fundamental capital requirements are supplemented by two buffers, one for "Countercyclical Capital" (the "Countercyclical Buffer"), and the other for "Capital Conservation" (the "Conservation Buffer"). The Countercyclical Buffer is required only of companies utilizing advanced approaches and must consist solely of common equity tier 1 capital. The size of any required Countercyclical Buffer will be adjusted by the federal banking regulators up and down between zero and 2.5 percent for US exposures in order to both counteract any perceived excessive easing of credit and provide additional capital protection if any excessive easing leads to a credit bubble. Countercyclical Buffers established by other jurisdictions will be applied to credit exposures deemed situated in those jurisdictions, which include the jurisdictions in which borrowers or guarantors are located.

The Conservation Buffer, on the other hand, is a measure of capital held beyond the minimum required level. The measure is used to determine whether, or the extent to which, capital distributions and discretionary bonus payments may be made in a particular calendar quarter. If the Conservation Buffer exceeds 2.5 percent, then such payments are generally permissible; otherwise, the amount of permissible payments as a percentage of eligible retained income is reduced proportionately. The Conservation Buffer effectively requires a company to maintain capital beyond the minimum required levels if it wishes to make distributions or pay discretionary bonuses.

An extensive set of definitions is necessary to make the calculation of these ratios and buffers reproducible across institutions and time periods. For example, in order to calculate a common equity tier 1 capital ratio, it is necessary to know what constitutes common equity and what, other than common equity, constitutes tier 1 capital. The definition of common equity tier 1 capital[5] is surprisingly extensive, given the familiarity of the general notion of common equity. The definition's components derive

[4] Exposure amounts of various sorts are computed pursuant to §§__.33, 34, 37 and 42 of Subpart D, which is found in the joint notice of proposed rulemaking, adopted at the same time as the Notice, relating to the standardized approach for risk-weighted assets.

[5] §__.20(b) of the Common Rule.

substantially from the observations of the federal banking agencies during the financial crisis as to which characteristics of capital securities provided the best capital protection for the financial institutions they regulate or assisted. Essentially, each part of the definition negates an aspect of other types of securities that might undermine or limit the ability of this type of equity to cover loss or exposure.

The wording of the definition suggests that the requirements for common equity must be expressed in either a document or in the relevant corporate law. This could raise occasional questions of interpretation. For example, one requirement is that cash dividends be paid only out of net income and retained earnings. Ordinary common stock of a bank holding company would not necessarily satisfy that requirement in a technical sense, given that state law most likely would also permit dividends to be paid out of surplus. Is it sufficient that that ordinary common stock does not contain provisions that block banking law from restricting the source of dividend payments? A sentence in the preamble to the proposed rules is not encouraging: "The agencies believe that **most** [emphasis added] existing common stock instruments previously issued by U.S. banking organizations fully satisfy the proposed criteria."[6]

Additional extensive definitions of types of capital include those for additional tier 1 capital (*i.e.*, tier 1 capital that consists of something other than common equity) and for tier 2 capital. Instruments that constitute additional tier 1 capital differ from common equity tier 1 capital in a number of ways. For example, they are somewhat less deeply subordinated, and are permitted to be called, repurchased or redeemed if certain restrictions and requirements are observed. They need not be issued directly by the relevant banking organization, as long as neither the banking organization nor any of its affiliates guarantees or secures payment or enhances the seniority of the instrument; the proceeds of the issuance are immediately available to that banking organization or its top-tier holding company; and the issuer invests only in the capital of the banking organization. If the banking organization claiming the instrument as additional tier 1 capital uses advanced approaches, either the capital instrument or its offering documents must disclose that holders may be fully subordinated to the US in an insolvency.

Instruments representing tier 2 capital in turn differ from those representing additional tier 1 capital in a number of ways, most importantly in their degree of subordination (which does not have to be deeper than that of the banking organization's subordinated debt), and in having a maturity date, which must be at least five years). The possibility of a maturity date leads to the requirement that acceleration of maturity is possible only upon insolvency. Because of these differences between additional tier 1 and tier 2 capital, trust preferred securities should in many cases find something of a home in an institution's capital structure, rather than being excluded entirely, since they may qualify as tier 2 capital. Cumulative perpetual preferred securities would also qualify as tier 2, since tier 2, unlike additional tier 1, does not require that periodic payments be interruptible.

The amounts of the various types of capital represented by the instruments described above are adjusted in several ways in computing the various ratios. For example, differing kinds of minority interests in subsidiaries of a banking organization can be added to the common equity tier 1 capital, additional tier 1 capital or total capital of a banking organization. A large number of items must be partially or totally deducted from capital, including goodwill, intangible assets (other than mortgage servicing assets), deferred tax assets, investments in financial subsidiaries, investments in the banking organization's own capital instruments, and many others. Many of the deductions are not as general as they would appear to be from this brief listing, and some of them are deducted from specific types of capital, such as common

[6] Notice, p. 48.

equity tier 1 capital, rather than from capital in general. The importance of particular adjustments will presumably vary substantially from institution to institution.

By introducing a new class of capital, changing the definitions of the other classes, modifying the additions to and deductions from the different classes of capital, and adjusting the required minimum capital ratios, the federal banking regulators have created the need for corresponding adjustments in other regulations that establish requirements based on capital levels. The proposed changes also confront banking organizations with a potentially difficult transition from their current level and mix of capital to whatever new requirements are finally adopted. To deal with these issues, the regulators propose adjustments to the prompt corrective action regulations and a detailed set of transition provisions. The changes to the prompt corrective action rules consist largely in increasing the percentages that define leverage and capital ratios associated with being well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. The changes also include introducing the required percentages for common equity tier 1 capital, and adding in the supplementary leverage measure for insured depository institutions that are subject to the advanced approaches rule. Some of the new requirements would be fully effective without a phase-in period; others would be phased in proportionately over periods of three,[7] five[8] or nine[9] years, beginning in either 2013[10] or 2016,[11] in each case depending on the exact requirement involved.

Even with these extensive transition arrangements, the stricter capital definitions and the increased capital ratios proposed in the Notice will most likely intensify discussions that have already begun about the potential side effects these new requirements may have if adopted. For example, Working Paper No. 20 of the Basel Committee on Banking Supervision[12] summarizes studies that examined how higher capital and liquidity requirements interact with one another and how each of them and both of them together affect the availability of credit. Similar considerations appear to have influenced the views of Governor Tarullo of the Federal Reserve Board about the possible need for adjustments to the proposed liquidity coverage ratio.[13] Imposing heightened requirements on regulated institutions also raises issues regarding the competitive position of such institutions relative to the so-called shadow banking system, which has led

[7] For example, the tier 1 capital ratios.

[8] For example, the various regulatory capital adjustments and the provisions requiring the elimination, by depository institution holding companies with assets of at least $15 billion, from tier 1 or tier 2 capital of instruments that no longer comply.

[9] Elimination of non-complying capital instruments by institutions with less than $15 billion in total assets.

[10] Most of the requirements.

[11] The capital conservation buffer.

[12] "The policy implications of transmission channels between the financial system and the real economy," released on May 15, 2012; available here.

[13] Testimony of Governor Tarullo before the Senate Committee on Banking, Housing, and Urban Affairs on June 6, 2012, available here.

Governor Tarullo to discuss whether the shadow banking system should be regulated and, if so, when and how.[14]

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[14] "Shadow Banking After the Financial Crisis," speech of Governor Tarullo on June 12, 2012 at the Federal Reserve Board of San Francisco Conference on Challenges in Global Finance: The Role of Asia, available here. http://www.federalreserve.gov/newsevents/speech/tarullo20120612a.htm.