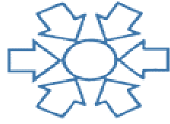

FedFin Client Report

Wednesday, September 27, 2017

Interagency Capital Rule Opens Leverage-Ratio, Advanced-Approach Comment Box

Client Report: **CAPITAL218**

Executive Summary

The FDIC Board today unanimously approved and all three banking agencies subsequently issued an NPR not only to provide modest capital relief for small banks, but also for all banks not subject to the advanced approach. We view this rule as the opening salvo to broader discussion of the overall U.S. approach to the Basel III rules, an effort that will look not only at simplified standardized weightings, but also at the way the U.S. will approach the broader capital framework following a decision next week by the Basel Committee on whether and how to change the global approach to the credit- and operational-risk rules. And, as is usual in any discussion of regulatory capital, FDIC Vice Chairman Hoenig today made it clear that he intends to use this comment process also to press for his preferred leverage ratio (LR). This proposal follows one in late August to halt aspects of the transition to full Basel III implementation (see FSM Report **CAPITAL217**). Mr. Gruenberg today also urged the banking agencies to consider more comprehensive approaches to simplifying capital rules for community banks. The FDIC today also updated DIF projections and approved its version of the FRB's QFC rule (see FSM Report **QFC6**). This report assesses today's FDIC Board meeting. We will shortly provide clients with an in-depth assessment of the capital NPR.

Analysis

Capital NPR

Reflecting Treasury Department recommendations (see Client Report **CAPITAL216**), the NPR replaces the existing high volatility commercial real estate (HVCRE) exposure category in the standardized approach. However, it does so with a new, simpler exposure category called high volatility acquisition, development, or construction (HVADC) exposure. The risk weight for the new HVADC would be

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130 percent – lower than the 150 percent under the HVCRE. In aggregate, more acquisition, development, or construction loans are likely to be captured under the new measure, which applies only to loans originated after the final rule's effective date. The agencies intend this to be capital neutral, but comment on this and the new approach's complexity is likely. Building on the other pending NPR, this NPR also make permanent changes the regulatory capital treatment of mortgage services assets, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions to allow non-advanced approaches banks to deduct any amount of these assets that individually exceeds 25 percent of common equity tier 1 capital. A 250 percent risk weight still applies to any MSAs or temporary DTAs not deducted. The NPR would also allow a simpler methodology for non-advanced approaches banking organizations to calculate minority interest limitations and makes technical changes. Comments are due sixty days after publication in the *Federal Register*.

Statements

Chair Gruenberg noted that the HVCRE issue was the most commented on item during the EGRPRA process and said he looked forward to comments on whether the rule strikes the right balance between simplicity and an appropriate level of capital. He also indicated that regulators are planning a nationwide call with bankers regarding the proposal. As noted, he emphasized that he believes simplification efforts should focus on community banks and – clearly attempting to downplay the general issues raised by this NPR – stressed that commenters should focus on small banks.

OCC Acting Comptroller Noreika applauded the rule and said that he hoped it will allow more capital to move off the side lines. He indicated that he is open to more simplification and further tailoring it to the size and complexity of different institutions while maintaining appropriate capital.

CFPB Director Cordray asked staff if they are open to letting banks apply the new methodology to existing exposures; staff indicated that this would be difficult and surely be a focus on comment.

Vice Chairman Hoenig stated that the NPR fails meaningfully to simplify U.S. capital standards. He argued that risk-based capital creates perverse incentives illustrated in the NPR through the lowering of the commercial real estate assets weighting, which he said creates incentives for further leveraging. He also criticized the agencies for failing to forecast and assign common risk-weights across the balance sheets of all banks, arguing that risk-based rules imposed an enormous, unjustified cost on the industry and public. He agreed to the NPR only because it includes a question seeking input on a simple U.S. GAAP-based leverage ratio for non-GSIB

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banks. This is a bit of a concession, given that Mr. Hoenig again yesterday pressed for an LR based on the IFRS approach which, unlike GAAP, does not permit netting.

DIF Projections

The updated DIF projections find that the DIF has a reserve ratio of 1.24 percent. Dodd-Frank requires that this ratio rises to 1.35 percent by 2020 through assessments on banks over $10 billion. The FDIC currently forecasts that it will meet this in 2018, after which surcharges will cease. If the DIF reserve ratio fails to meet 1.35 percent by 2018, then these banks will pay a shortfall assessment to bring the Fund into compliance. Vice Chair Hoenig questioned why this shortfall would be paid in 2019 if Dodd-Frank requires compliance by 2020. Staff indicated that existing regulation outlines this process. Director Cordray asked what happens if the Fund falls below a reserve ratio of 1.35 percent after it reaches this level. Staff said the Fund would have eight years under a restoration plan to reestablish the 1.35 level.

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