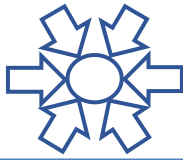

Financial Services Management

U.S. Regulatory-Capital Rewrite: Framework

Cite:
FDIC, FRB, OCC, Notice of Proposed Rulemaking, Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity

Recommended Distribution:
CFO, Treasurer, Asset/Liability Management, Policy, Corporate Development, Legal, Government Relations

Websites:
https://www.fdic.gov/news/board-matters/2023/2023-07-27-notice-dis-a-fr.pdf

Impact Assessment

- Many large banks subject to the new special assessment will face near-term capital and income challenges, exacerbating stress at weaker banks and broader procyclicality in the construct of bank regulation.

- According to regulators, the new capital rules would increase capital costs by sixteen percent for covered holding companies and nine percent for their IDIs.

- Costs would go up nineteen percent for the largest banks, six percent for Category III and IV domestic firms, and fourteen percent for IHCs.

- However, agency impact calculations are aggregate. Actual costs for individual banks will vary considerably, creating significant strategic realignment to optimize capital efficiency and resulting profitability.

- Even where costs are relatively static, portfolio rebalancing is likely, with implications for fee-based banking models likely to be particularly challenging.

- Although intended to be "holistic," the new capital framework interacts with liquidity, resolution, stress-testing, and other standards. Much in these areas remains to be revised to achieve the over-arching objectives set by the Federal Reserve's vice chairman. As a result, overall strategic implications and bank-specific costs could vary still more. Some business models could be fundamentally challenged, perhaps consolidating power in the very largest banks and almost surely increasing nonbank comparative advantage.

- "Higher-of" capital requirements impose regulatory burden and may lead to unintended outcomes based on which of the two possible weightings better captures risk. Where higher-of standards are unduly costly relative to risk, banks may respond by exiting sectors or even

©2023. Federal Financial Analytics, Inc.

major business lines.

- This and other "gold-plating" of the Basel end-game rules may put U.S. banks at disadvantage in key sectors and activities.

- Mid-sized banks that would be required to capitalize AOCI securities-related gains and losses would experience near-term capital costs and have more volatile capital ratios akin to those mandated for the biggest banks. However, the new capital standards would reduce and perhaps eliminate those that led regional banks to hold large HTM securities portfolios without ready liquidity or adequate capital.

- Mid-sized banks would also find residential-mortgage finance more costly due not only to the "higher-of" capital standards, but also as a result of coming under MSA restrictions applicable to the largest banks that have contributed to their reduced role in this sector.

Overview

In this in-depth report, we begin our analysis of the 1089-page capital proposal released by the U.S. banking agencies not only to make U.S. standards more consistent with Basel's 2017 "end-game" rules, but also to correct failings in the current capital framework the agencies believed were laid bare by recent bank failures.[1] The new standards rewrite the 2019 "tailoring" rule with regard to application of the toughest capital standards,[2] now covering all BHCs with assets over $100 billion along with their insured depository institutions (IDIs) regardless of size. For smaller BHCs, the most significant impact of the new approach requires recognition of accumulated other comprehensive income (AOCI) unrealized gains and losses related to available-for-sale (AFS) and held-to-maturity (HTM) securities; the agencies recognize this cost but believe the proposed three-year transition reduces any adverse impact. Key to the new framework is an end to reliance by the very largest banks on the "advanced" approach allowing model recognition if these internal calculations exceed those for the risk-weighted assessments (RWAs) mandated under the standardized approach (SA).[3] In its stead, all covered banking organizations would need to calculate RWAs for credit, operational, and market risk based on current SA calculations as well as a new, "expanded" SA for credit risk and the relevant Sas and certain remaining model-based conclusions for market risk. The models-based approach to calculating operational risk is eliminated in favor of Basel's standardized, retrospective approach.[4]

We focus here on the broad framework – i.e., to which firms the rules would apply, how they relate to the current construct, how the proposed changes would affect other capital-related standards, and changes to capital-ratio components. Subsequent reports will look at key changes to the ratio denominator resulting from revisions to credit-, market-, and operational-risk capital. We will also closely examine the regulators' impact assessment noted above.

---

1 See *Client Report,* **CAPITAL228,** July 10, 2023.

2 See **SIFI34,** *Financial Services Management,* October 23, 2019.

3 See **CAPITAL201**, *Financial Services Management,* July 19, 2013.

4 See **OPSRISK20**, *Financial Services Management,* January 8, 2018.

©2023. Federal Financial Analytics, Inc.

Impact

As noted, key to the new regulatory approach is like-kind capital regulation for categories I, II, III, and IV banks as determined by the current "tailoring" rules. The premise for this is the systemic risk regulators determined to have been caused in mid-March by the failure of two mid-sized regional banks; critics of the agencies' response argue that systemic risk resulted at least as much from supervisory lapses as from lax capital gaps. Although he voted to approve the proposal for public comment, FRB Chair Powell conditioned final support on ensuring that the rules properly strike the balance between regulation and supervision. What he means here is unclear, but another FRB governor, Christopher Waller, argued as he opposed the proposal not only that the rules are unduly burdensome, but also violate the 2018 law requiring tailoring.[5] The extent to which the rules have a firm foundation in law will be among those on which public comment likely focuses, weighing the law's express injunctions only with regard to banks between $50 and $100 billion in the context of its overall proportionate-regulation mandate.

As shall be discussed in more detail in subsequent FedFin reports on the proposal's specific provisions, the new regulatory-capital construct is also premised on a "higher-of" regulatory standard. Thus, covered banks would need to hold the higher of the current, "general" standardized approach[6] and the new, "expanded" one even though the new rules generally prevent capital determinations based on internal models which are the focus of regulatory concern about risk arbitrage. Doing so is inconsistent with the global "end-game rules, which allow what in the U.S. is called the advanced approach that deploys internal models.[7] However, the agencies no longer trust any models, but also seemingly even their own SAs. Banks would thus need not only to hold more capital than might make sense under one or the other SA, but also to calculate varying ratios that add burden to the new construct.

The "higher-of" framework also drives another premise: that big-bank capital rules should not drop when risk analytics would otherwise dictate because doing so might make big-bank capital less costly than that governing small banks. No consideration appears to have been given to rewriting smaller-bank capital standards when the analytics underpinning the new expanded approach would otherwise dictate.

As noted, a major change for categories III and IV banks would require AOCI recognition for both AFS and HTM securities. This is designed to prevent one of the proximate causes of Silicon Valley Bank's failure as the bank experienced significant losses that undermined capital ratios as it sought to handle severe liquidity stress.[8] Opponents of AOCI recognition counter that altering capital for unrealized gains and losses increases reporting volatility and presents significant

---

5 See **SIFI27**, *Financial Services Management,* June 4, 2018.

6 See **CAPITAL200**, *Financial Services Management,* July 13, 2013.

7 See **CAPITAL221**, *Financial Services Management*, January 4, 2018.

8 See *Client Report*, **REFORM221**, May 1, 2023.

© 2023 Federal Financial Analytics, Inc. All rights reserved.

strategic-planning challenges, noting also that possible changes to agency liquidity rules could prevent or at the least significantly reduce the run risk that precipitated asset sales. The approach may also be lopsided in that AOCI recognition for unrealized liability loss or gain does not count towards regulatory capital, but doing so would also increase the subjectivity with which these calculations are derived.

The proposal's impact on residential-mortgage finance may be among of its most significant issues, especially given the importance of this activity for category III and IV banks. A subsequent analysis of the new approach to credit risk will assess this issue in more detail, but the proposed approach to capital deductions for mortgage servicing assets (MSAs) discussed below with regard to capital deductions will prove particularly problematic for these companies. To the extent that they join large banks in the sector's exodus from residential-mortgage origination, nonbank mortgage companies will gain more share. This could accelerate ongoing FSOC consideration of the nonbanks sector's systemic risk.[9]

What's Next

The capital standards were approved on a 4-2 vote by the Federal Reserve Board, a 3-2 vote by the FDIC board, and the Acting Comptroller of the Currency on July 27. Comment is due November 30. The new rules will be phased in beginning on July 1, 2025 until June 30, 2028. A similar three-year phase-in is detailed for categories III and IV banks with regard to AOCI recognition.

In addition to these standards, the agencies will issue new disclosure requirements. They will also modify rules affected by the new approach to regulatory capital, including via the GSIB modification proposed in concert with this proposal.[10] Other affected rules revised by this proposal govern TLAC[11] and single-counterparty exposures, eliminating reliance on internal models.[12] The Board in 2019 also issued a long-delayed proposal governing the capital of depository institution holding companies with significant insurance operations.[13] Any final rule will reflect the new capital regime, with no time indicated for how long it may take the Board to do so once these rules are finalized. Thus, as has long been the case, these insurance-focused companies remain subject to significant uncertainty about parent-company capital standards but avert the top-down, bank-focused approach the Board once favored.

Analysis

A. Coverage

Categories I, II, III, and IV banking organizations as determined by the current "tailoring standards would come under these rules in general as would their subsidiary IDIs. Covered entities include all but exempted small BHCs that

9 See **SYSTEMIC95**, *Financial Services Management,* April 26, 2023.

10 See forthcoming *Financial Services Management.*

11 See **TLAC6**, *Financial Services Management,* December 21, 2016.

12 See **CONCENTRATION11**, *Financial Services Management*, June 25, 2018.

13 See **INSURANCE60**, *Financial Services Management,* September 17, 2019.

©2023. Federal Financial Analytics, Inc.

are U.S.-domiciled top-tier holding companies, IHCs, and federal and state IDIs that meet relevant size limits or are subsidiaries of a BHC or IHCC that does so. Foreign bank branches and agencies are not covered by these rules just as they are currently not covered by other U.S. capital standards.

All categories I, II, III, and IV banks come under all of the new rules with regard both to capital components (e.g., AOCI) and risk weightings.

In addition, any banking organization with trading assets and trading liabilities of more than $5 billion or those where trading assets and liabilities are more than ten percent of total assets would come under the new market risk rules.

B. Capital Thresholds

Also as noted above, the proposal requires covered banks to hold the higher of the current standardized approach or the proposed "extended" SA. As a result, it is not possible to determine the new binding credit-risk charge from these standards without also consulting current rules. Similarly, the same "higher-of" approach applies to market risk, but an additional criterion – an output floor – is designed to judge all the capital rules against the impact of these market-risk models to prevent undue benefit. This output floor would be 72.5 percent of the sum of the all risk-weighted assets under each risk category other than market risk and the standardized market-risk calculation minus certain adjustments.

As noted, the advanced approach would be eliminated. All capital buffers, including the stress capital buffer[14] and counter-cyclical one,[15] would also apply to all covered banks other than those subject solely to the market-risk rules, although these buffers would be recalculated to reflect the "higher-of" genera/expanded SA construct. Categories I, II, and III banks would also need to use the new binding-SA ratio in company-run stress tests.

Similarly, categories III and IV banks would come under the supplementary leverage ratio (SLR);[16] this would not adjust the applicable leverage ratio (which would remain three percent), but require its calculation based not only on on-balance sheet assets, but also most off-balance sheet ones.

C. Capital-Ratio Calculation

1. Binding Ratio

Total RWAs under the expanded SA comprise the sum of RWAs calculated

14 See **STRESS29**, *Financial Services Management,* April 18, 2018.

15 See **CCYB**, *Financial Services Management,* December 5, 2019.

16 See **LEVERAGE8**, *Financial Services Management,* October 1, 2014.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com

© 2023 Federal Financial Analytics, Inc. All rights reserved.

for credit, equity, market, credit valuation, and operational risk minus adjusted loan-loss reserves not included in Tier 2 capital and allocated transfer-risk reserves. As noted, ratios must be determined under both the general and expanded SAs, with each applicable capital ratio the lower of the one determined by these methodologies incorporated into the output-floor calculation.

2. Capital Definition

Categories III and IV banks would come under the capital definition now applicable to bigger banks. This would require, among other things, recognition of AOCI unrealized gains and losses for purposes of common-equity Tier 1 capital (CET1) other than with respect to certain cash-flow hedges and other assets. Current rules allow loan-loss reserves to count towards Tier 2 capital up to 1.25 percent of total standardized risk-weighted assets and minus certain instruments. However, current rules also allow certain other calculations for categories I and II banks; with the end of the advanced approach would come the end of this treatment; the new approach would refine the rule to reflect new accounting treatment for loan-loss reserve calculations and generally allow covered banks to add 1.25 percent of their reserves to total capital.

In addition, TLAC holding deductions now count to category III and IV deductions, a requirement clearly intended to ready the capital definition once these banks are brought under the TLAC standards recently proposed to enhance regional-bank resolvability.

Categories III and IV banks would also come under new requirements tightening treatment of mortgage servicing assets (MSAs) and certain other assets (e.g., holding certain financial institution or GSIB obligations) to require deduction from capital of each asset that exceeds ten percent of CET1, with an aggregate limit requiring deduction of all covered items above fifteen percent of CET1. The current individual limit for categories III and IV banks is 25 percent of CET1 with no aggregate limit.

D. Request for Comment

Views are sought on many matters, including:

- the proposal's interaction with other rules, with particular regard to changes to the single-counterparty credit limit;
- bringing categories III and IV banks into all these requirements;
- whether banks with certain business models should be treated differently, i.e., by virtue of a market-risk materiality threshold. The agencies also seek comment on the need to impose the counter-cyclical capital buffer and SLR on categories III and IV banks;
- the proposed transition periods;
- the need for two SA methodologies;
- the output floor;
- the new stress-test framework, with the Board particularly interested in whether it would make sense to calculate stress-capital buffers separately for the general and expanded SAs. Transition questions

©2023. Federal Financial Analytics, Inc.

specific to the buffer are also laid out;
- the new AOCI requirement and its application to HTM securities; and
- the new approach to loan-loss reserves.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com

© 2023 Federal Financial Analytics, Inc. All rights reserved.