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Federal Banking Agencies Finalize Supplementary Leverage Ratio Standards

The next step in the adoption of new capital standards will potentially cause the largest U.S. banking organizations to face more stringent minimum capital requirements.

On April 8, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the Agencies) adopted a final rule for supplementary leverage ratio standards applicable to the largest U.S. banking organizations (the Final Rule). The Final Rule adopts as largely unchanged the supplementary leverage ratio standards proposed by the Agencies in 2013 (3% of common equity Tier 1 capital, plus a greater-than 2% surcharge for affected bank holding companies and a greater-than 3% surcharge for their depository institution subsidiaries). Along with the Final Rule, the Agencies proposed changes to the denominator calculation for the supplementary leverage ratio (the Proposed Rule), which are intended to align the calculation of the supplementary leverage ratio with changes implemented earlier in 2014 by the Basel Committee on Banking Supervision (BCBS).

The Final Rule and the Proposed Rule represent the next iteration in the implementation by the Agencies of both the enhanced capital requirements of Basel III as well as the mandate in the Dodd-Frank Wall Street Reform and Consumer Protection Act. These work to implement enhanced leverage standards on large bank holding companies and to mitigate the threat to domestic financial stability posed by systemically important financial companies through enhanced prudential standards, heightened supervisory expectations, enhanced stress testing, and higher capital requirements and standards.

The Final Rule

The Final Rule applies to any U.S. top-tier bank holding company with more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody (Covered BHC) as well as any insured depository institution subsidiary of a Covered BHC. Currently, there are eight large banking organizations that meet the asset thresholds for a Covered BHC. The enhanced supplementary leverage ratio is intended to compel these largest banking organizations to hold more Tier 1 capital, particularly to support off-balance sheet exposures that the Agencies believe present greater risks during periods of stress.

Under the final capital rules adopted by the Agencies in 2013, banking organizations that are subject to the advanced approaches risk-based capital rules (i.e., those with at least $250 billion in total consolidated assets or $10 billion in total on-balance sheet foreign exposures) are required to maintain a supplementary leverage ratio of at least 3%. This 3% minimum supplementary leverage ratio is consistent with the international leverage ratio requirements in Basel III.

Under the Final Rule, Covered BHCs will be subject to an enhanced supplementary leverage ratio of at least 2%, bringing the total supplementary leverage ratio for Covered BHCs to greater than 5%. Covered BHCs that do not maintain a supplementary leverage ratio at above 5% will face increasing limitations on their ability to make capital distributions or discretionary bonus payments, from a 60% cap to a complete prohibition on distributions. In addition, the Final Rule will require insured depository institutions that are subsidiaries of Covered BHCs to maintain at least a 6% supplementary leverage ratio in order to be considered “well capitalized” under the Agencies’ prompt corrective-action rules.

It is important to note that, as with all capital ratio requirements, the enhanced supplementary leverage ratios are viewed by the Agencies as minimum standards. Banking organizations both large and small are generally expected to maintain capital positions well above the minimum ratios. Furthermore, the Agencies reserve the right as part of their supervision function to require higher ratios if they determine that such higher ratios are needed to preserve the safety and soundness of the banking organization. Even if the minimum capital ratios are met, any payments of dividends, discretionary bonus payments, or other capital distributions are subject to the banking organization's existing policies and capital plans as well as supervisory consent or non-objection.

The Final Rule is effective January 1, 2018.

The Proposed Rule

While the Agencies were developing the guidelines for the enhanced supplementary leverage ratio, BCBS adopted revisions to the Basel III international leverage ratio in early 2014. The revisions modified the definition of "total leverage exposure" (i.e., the denominator in the leverage ratio calculation) by including the effective notational principal amount of credit derivatives or similar instruments through which a banking organization provides or "sells" credit protection, modifying the measure of exposure for derivatives and repo-style transactions, and revising the credit conversion factors (CCFs) for certain off–balance sheet exposures. The BCBS revisions also adopted additional disclosure requirements for the calculation of the international leverage ratio.

The Proposed Rule is intended to bring international consistency to the calculation of the supplemental leverage ratio by more or less adopting the BCBS revisions to the definition of total leverage exposure and the additional disclosure requirements. The Agencies take the position that adopting the BCBS changes would result in an enhanced measure of the leverage capital requirements of banking organizations and would overall increase the capital requirements of banking organizations that are subject to the advanced approaches risk-based capital rules, although the proposed changes to the CCFs would, in some cases, reduce the level of affected exposures for regulatory capital purposes.

The Agencies ask a number of questions in the Proposed Rule and seek input on all aspects of the proposal. Comments on the Proposed Rule are due no later than June 13, 2014. In accordance with the final capital rules adopted in 2013, banking organizations must disclose their supplementary leverage ratios beginning January 1, 2015. Therefore, the Agencies will likely work quickly to finalize the Proposed Rule this year.

Observations

As the Agencies state in the Final Rule, an enhanced supplementary leverage ratio serves two regulatory goals: (1) reducing the likelihood of bank failures and allowing tailored failed bank resolution efforts for banks that do fail and (2) counterbalancing possible market advantages (including funding costs) that the largest bank organizations may enjoy because of the perception that they are "too big to fail."

Although the Proposed Rule focuses on the importance of international consistency, that focus on consistency does not extend to the enhanced supplementary leverage ratio itself. Basel III does not require an enhanced supplementary leverage ratio for the largest global banking organizations. Accordingly, the eight largest U.S. banking organizations may potentially face more stringent minimum capital requirements than their foreign-based counterparts. The Agencies have taken the position that the benefits of a strong regulatory capital base and a banking system that is seen as more resilient in times of stress outweigh any potential competitive disadvantages that banking organizations may face from different capital ratio minimums.

Contacts

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