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Memorandum

Banking Agencies Propose Changes to Capital Buffers, Stress Testing, Leverage Ratios and Accounting Standards

April 23, 2018

The federal banking agencies recently issued several notices of proposed rulemakings that, together, would significantly revise the capital rules applicable to banking organizations, especially global systemically important banking organizations ("GSIBs") and other banking organizations subject to the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR") process. The proposed rules consist of three separate releases: one relating to capital buffers and the CCAR process issued by the Federal Reserve, another relating to the "enhanced supplementary leverage" issued jointly by the Federal Reserve and the OCC, and a third relating to bank accounting standards for credit losses issued jointly by the Federal Reserve, OCC and FDIC.

Among the recent proposals are the following significant revisions to the regulatory capital framework:

- the replacement of the static capital conservation buffer with a dynamic "stress capital buffer" and the introduction of a "stress leverage buffer," each tied to the results of a banking organization's CCAR modeling;
- adjusted CCAR stress test assumptions and review standards;
- the recalibration of the static enhanced supplementary leverage ratio applicable to each GSIB to a dynamic ratio tied to the firm's GSIB surcharge;
- the recalibration of the static minimum supplementary leverage ratio required for insured depository institution ("IDI") subsidiaries of a GSIB to be considered "well capitalized" to a dynamic "well capitalized" standard tied to the GSIB surcharge applicable to the IDI's holding company; and
- a phased-in requirement for banks to adopt a new accounting standard that would dramatically shift how banks account for credit losses.

The proposed rules generally seek to further the long-stated goal of the U.S. banking agencies to streamline and tailor the regulatory framework, with several of the proposed rules having been previewed in a

September 2016 speech by former Federal Reserve Governor Daniel Tarullo. According to Federal Reserve staff, the proposed stress capital and leverage buffers would decrease the required levels of capital for non-GSIBs subject to CCAR relative to currently required levels, and would generally maintain or, in a few cases, increase the required levels of capital required for GSIBs. Meanwhile, Federal Reserve staff and staff of the OCC, in a separate joint proposal, estimate that the proposed changes to the enhanced supplementary leverage ratio would reduce the required levels of Tier 1 capital for GSIBs by approximately $400 million (approximately 0.04% of the aggregate Tier 1 capital held by the GSIBs as of the third quarter of 2017).

Introduction of New Stress Capital and Leverage Buffers

Under the current quantitative requirements of the CCAR stress tests, the Federal Reserve may object to an institution's capital plan when stress tests reveal that the firm would not be able to maintain its post-stress capital ratios above the regulatory minimum levels over the planning horizon, taking into account its planned capital distributions. In addition to other minimum regulatory capital ratios, CCAR firms are currently required to maintain a Common Equity Tier 1 capital ("CET1") ratio of at least 4.5%, *plus* a uniform 2.5% "capital conservation buffer," *plus* potentially applicable additional buffers and surcharges (such as the "countercyclical buffer," applicable to banking organizations with more than $250 billion in assets or $10 billion in on-balance-sheet foreign exposures, and the "GSIB surcharge," applicable to the eight institutions designated as global systemically important banks).

The recently proposed rules would attempt to integrate the CCAR quantitative requirements with the existing regulatory capital regime by replacing the 2.5% fixed capital conservation buffer with a new "stress capital buffer" for banking organizations subject to CCAR. The stress capital buffer would require a CCAR firm to hold a buffer of CET1 equal to the maximum decline in a firm's CET1 ratio under the "severely adverse" scenario of the supervisory stress test, *plus* the sum of the ratios of the firm's planned common stock dividends for each of the fourth through seventh quarters of the planning horizon (as a percentage of risk-weighted assets). Thus, for example, if a firm's CET1 ratio were to decline from 13% to 9% under CCAR's severely adverse scenario, and the firm had planned to issue common stock dividends equal to, in aggregate, 1% of risk-weighted assets in the fourth through seventh quarters of its planning horizon, that firm's required stress capital buffer would be 5%. To avoid any reduction in the stringency of the regulatory capital rules, all firms would be subject to a minimum stress capital buffer floor of 2.5% (the same as the prior capital conservation buffer), regardless of their CET1 reduction under the severely adverse stress scenario.

The stress capital buffer would be in addition to 4.5% CET1 minimum baseline amount, any applicable countercyclical buffer and any applicable GSIB surcharge. Accordingly, a firm subject to a 5% stress capital

buffer and hypothetical 3% GSIB surcharge would be constrained in making any capital distributions that would bring its CET1 ratio under 12.5%.[1]

CCAR firms would also be subject to a new "stress leverage buffer" requirement, determined in a manner similar to that used to determine a CCAR firm's stress capital buffer. In particular, a firm's stress leverage buffer would be calculated as the maximum decline in a firm's projected Tier 1 leverage ratio under the "severely adverse" scenario of the supervisory stress test, *plus* the sum of the ratios of the firm's planned common stock dividends for each of the fourth through seventh quarters of the planning horizon (as a percentage of the leverage ratio denominator). Thus, for example, if a firm's Tier 1 leverage ratio were to decline from 8% to 6% under CCAR's severely adverse scenario, and the firm had planned to issue common stock dividends equal to, in aggregate, 1% of its leverage ratio denominator in the fourth through seventh quarters of its planning horizon, that firm's required stress leverage buffer would be 3%. The stress leverage buffer requirement would not have a floor, as there is currently no generally applicable leverage buffer requirement in effect.

The stress capital buffer would be in addition to the existing minimum Tier 1 leverage ratio of 4%. Accordingly, a firm subject to a 3% stress leverage buffer would be constrained in making any capital distributions that would bring its Tier 1 leverage ratio under 7%.

A CCAR firm's stress capital and leverage buffers would be calculated by the Federal Reserve in connection with each year's stress test, and would be made public by June 30 of each year. Each CCAR firm's updated annual stress capital and leverage buffer requirements would then become effective on October 1 of each year (beginning October 1, 2019), with the resulting restrictions on capital distributions effective from October 1 through September 30 of the following year. To provide a transition between the 2018 CCAR cycle and the first stress buffer requirements, for the period from July 1 through September 30, 2019, a firm would generally be authorized to make capital distributions that do not exceed the four-quarter average of capital distributions approved by the Federal Reserve in the previous capital plan cycle.

Within two business days of being notified of its stress buffer requirements, a CCAR firm would be required to assess whether it would be able to satisfy its total minimum CET1 and leverage ratios (taking into account its stress buffers and any other applicable buffers) while making its planned capital distributions in the fourth through seventh quarters of the planning horizon, under the baseline CCAR scenario. If its planned capital distributions are inconsistent with its minimum capital and leverage requirements under the baseline scenario, a firm would be required to reduce its planned capital distributions for those quarters.

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[1] This analysis assumes a countercyclical capital buffer amount of 0%, consistent with the current level as affirmed by the Federal Reserve on December 1, 2017: www.federalreserve.gov/newsevents/pressreleases/bcreg20171201a.htm.

Adjusted CCAR Stress Test Assumptions and Review Standards

The proposed rules include the following revised assumptions that the Federal Reserve would incorporate in its CCAR stress testing process to better account for observed trends, industry responses and macroprudential goals:

- **Treatment of Planned Dividends and Share Repurchases**: The Federal Reserve currently assumes that a CCAR firm would proceed with all planned dividends and share repurchases during the two-year planning horizon, regardless of the stress level facing the firm. Under the proposed revised approach, the Federal Reserve would assume that a CCAR firm would not pay any dividends on common stock or make any share repurchases or redemptions over the stress test planning horizon. However, the proposed inclusion of four quarters of planned dividends in the calculation a CCAR firm's stress capital and leverage buffers would maintain an incentive to engage in disciplined dividend planning, effectively requiring a firm to hold capital to meet its stress losses and pre-fund on year of planned dividends. Notably, those buffers would not reflect share repurchases. As the Federal Reserve has recognized, many large bank holding companies were able to reduce their repurchases early on in the last financial crisis.
- **Balance Sheet and Risk-Weighted Asset Assumptions.** To counter the risk of a credit crunch caused by banks reducing their balance sheets through asset sales or reductions in new lending in order to maintain their capital ratios under stress, the Federal Reserve has required that banks' capital plans for the severely adverse CCAR scenario not be based on restricting the bank's supply of loans. With this requirement, the Federal Reserve's model actually operated to project an increase in the balance sheets of CCAR firms during the severely adverse scenario (by holding loan supply constant while allowing credit demand to respond to conditions in the stress scenario). In response to industry concerns that loan portfolios would not be increasing under any reasonable assumptions during a severely adverse scenario, the proposed rules would replace this aspect of the Federal Reserve's CCAR model with a simple assumption that balance sheets and risk-weighted assets would remain constant over the severely adverse scenario horizon.
- **Expansion of Global Market Shock and Counterparty Default Shock in Models.** Some industry participants have suggested that the scenario components of global market shock and counterparty default shock should be dropped from CCAR testing, as these components are required to be included in stress test modeling only for six U.S. GSIBs and are therefore potentially duplicative of the GSIB surcharge. In issuing the proposed rules, the Federal Reserve rejected these suggestions to drop the shock components from CCAR testing, noting its December 2017 modification to the global market shock component which expanded the scope of subject firms

beyond U.S. GSIBs. As a result of this modification, six U.S. intermediate holding companies of foreign banking organizations will become subject to the global market shock beginning in CCAR 2019.[2]

- **Macroprudential Assumptions Not Incorporated.** The Federal Reserve had previously indicated that it was considering two additional revisions to its stress test scenario design framework motivated by the macroprudential consideration of reducing procyclicality: reducing the assumed severity of the change in the unemployment rate during downturns, and tying the assumed path of housing prices during a downturn to disposable personal income. The proposed rules do not adopt either of these revised assumptions.

In addition to the above revised assumptions, the Federal Reserve would revise several aspects of its review of capital plans under the CCAR process. In particular, the Federal Reserve would eliminate its current policy of subjecting dividend payout ratios above 30% of projected post-tax net income to heightened scrutiny, in light of the proposed inclusion of four quarters of planned dividends in the calculation a CCAR firm's stress capital and leverage buffers (which the Federal Reserve views as sufficient incentive for prudent dividend payouts). To date, most CCAR firms have kept their proposed dividend payout ratios below this 30% threshold in light of this policy.

In addition, the Federal Reserve would no longer object to a CCAR firm's capital plan based on a quantitative assessment of the firm's capital adequacy, since the firm's distributions would be subject to ongoing limitations that would be automatically triggered if a firm breaches its buffer requirements. However, the proposal would not change CCAR's qualitative review process for the largest, most complex CCAR firms, or the Federal Reserve's ability to object to the capital plans of such firms on the basis of qualitative deficiencies. The Federal Reserve eliminated the qualitative review process for noncomplex CCAR firms in February 2017.

Recalibrated E-SLR and "Well Capitalized" Standard

Under current capital rules, certain large banking organizations must maintain a supplementary leverage ratio of at least 3%, in addition to the minimum Tier 1 leverage ratio of 4%. While the Tier 1 leverage ratio measures a firm's Tier 1 capital to its average total consolidated assets, the supplementary leverage ratio measures the firm's tier 1 capital to its total leverage exposure (including a number of off-balance sheet exposures in addition to on-balance sheet assets).

[2] These firms are Barclays US LLC, Credit Suisse Holdings (USA), Inc., DB USA Corporation, HSBC North America Holdings Inc., UBS Americas Holding LLC, and RBC USA HoldCo Corporation.

While this 3% supplementary leverage ratio applies to all "advanced approaches" institutions,[3] top-tier U.S. bank holding companies with more than $700 billion in consolidated assets or more than $10 trillion in assets under custody are further required to maintain an additional 2% leverage buffer to avoid limitations on capital distributions and certain discretionary bonus payments.[4] This "enhanced supplementary leverage ratio" ("eSLR") rule also requires that, in order for any IDI subsidiary of a bank holding company subject to the eSLR to be considered "well capitalized," the IDI subsidiary must maintain a 6% supplementary leverage ratio.

As the Federal Reserve and the OCC noted in the issuance of jointly proposed revisions to the eSLR, however, the current uniform eSLR standards create incentives for subject firms to reduce participation in lower-risk, lower-return businesses (*e.g.*, secured repo financing, central clearing services for market participants, and taking custody deposits).[5] The proposed rules, therefore, attempt to tailor the eSLR standards based on measures of systemic risk, by replacing the eSLR's uniform 2% leverage buffer with a leverage buffer equal to 50% of a subject firm's GSIB surcharge. In addition, the proposed rules would replace the uniform 6% supplementary leverage ratio threshold for an IDI subsidiary of a GSIB to be considered "well capitalized" with a minimum supplementary leverage ratio equal to 3% *plus* 50% of the GSIB surcharge applicable to the IDI's holding company. Conforming amendments would also be made to the Federal Reserve's "Total Loss Absorbing Capacity" rule applicable to GSIBs, which currently includes leverage and leverage buffer components designed to parallel the eSLR standards.

Phase-In for CECL Accounting Standard

The Federal Reserve, the OCC, and the FDIC are proposing a phase-in for banks to adopt a new accounting standard that would dramatically shift how they account for credit losses.

In June 2016, the Financial Accounting Standards Board issued a new accounting standard for credit losses, known as the "Current Expected Credit Losses" methodology, or "CECL," which differs from the existing incurred loss methodology for certain financial assets in several key respects. Among other things, CECL requires banking organizations to recognize lifetime expected credit losses for financial assets measured at amortized cost, not just those credit losses that have been incurred as of the reporting date.

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[3] A banking organization is an advanced approaches banking organization if it has consolidated assets of at least $250 billion or consolidated on-balance sheet foreign exposures of at least $10 billion, or if it is a subsidiary of a banking organization that is an advanced approaches banking organization.

[4] Currently, the list of bank holding companies identified by these thresholds is consistent with the list of U.S. GSIBs, and the proposed rules suggest that any banking organization subject to the eSLR would also be identified as a GSIB under the Federal Reserve's GSIB surcharge rule.

[5] The FDIC did not join the Federal Reserve's and OCC's joint proposal to revise the eSLR standards.

The effective date of CECL varies for different banking organizations and may be adopted as of January 1, 2019. However, for a banking organization that experiences a reduction in retained earnings as of the CECL adoption date, the agencies are proposing a three-year transition period to phase in the "day-one" adverse effects of CECL on a banking organization's regulatory capital ratios. An electing banking organization would indicate (for an IDI, in its Call Report, and for a holding company, in its FR Y-9C) its election to use the CECL transition provision beginning in the quarter that it first reports its credit loss allowances as measured under CECL.

For more information regarding these proposed rules, please contact any member of the Firm's Financial Institutions Group, including those listed below.

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