THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 39 No. 12 December 2023

AGGRESSIVE IN THE ENDGAME: THE U.S. BANK REGULATORS' PROPOSALS WOULD HIKE BANK CAPITAL

On July 27, 2023, the Federal banking agencies approved notices of proposed rulemaking to implement the remaining Basel III framework and to revise the methodology for calculating the G-SIB surcharge. The capital proposal will significantly increase required capital levels for covered banks and may have other less obvious and potentially unintentional consequences for the US banking and financial system. It also eliminates any tailoring of the capital rules for banks with $100 billion or more in assets, almost entirely collapsing current Federal Reserve categories II, III, and IV into a single category, at least for capital purposes. In addition to the impact on regional banks, the proposals will drive significant capital increases for foreign banking organizations with significant US presence, US G-SIBs, and capital markets activities. The agencies' failure to articulate a credible factual rationale for these far-reaching reforms, including their deviations from Basel and past publicly stated goals, leaves them vulnerable to policy and legal challenges.

By Jonathan Gould, Josh Sterling, Nathan Brownback, Peter Petraro, Rubina Ali, and Locke McMurray *

On July 27, 2023, the Federal banking agencies ("Agencies") approved a notice of proposed rulemaking to implement the remaining Basel III framework, referred to as the Basel III endgame (the "Capital Proposal").[1] The Agencies simultaneously approved a notice of proposed rulemaking that would revise the methodology for calculating the so-called "G-SIB surcharge," an additional capital requirement that applies to the largest and most complex banks (the "G-SIB Surcharge Proposal").[2]

The Capital Proposal would implement December 2017 standards from the Basel Committee on Banking Supervision ("Basel") and revisions to the market risk capital framework following Basel's "Fundamental Review of the Trading Book", among other things. The

[1] Federal Reserve, FDIC, OCC, "Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity," 88 Fed. Reg. 64028 (Sept. 18, 2023).

[2] Federal Reserve, FDIC, OCC, "Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)," 88 Fed. Reg. 60385 (Sept. 1, 2023).

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RSCR Publications LLC Published 12 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $650 per year in U.S., Canada, and Mexico; $695 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 1051-1741.

Capital Proposal will significantly increase required capital levels for covered banks and may have other less obvious and potentially unintentional consequences for the U.S. banking and financial system. The G-SIB Surcharge Proposal would amend the calculation of a specified capital surcharge and would only apply to the largest and most complex banks.

BACKGROUND

For the last quarter-century, the Basel Committee has made recommendations regarding bank capital requirements intended to harmonize those requirements across the world's advanced economies. There have been several "rounds" of significant amendments to bank capital rules, and the most recent major amendments, which were made in the aftermath of the global financial crisis of 2008, were known as Basel III.

The Basel Committee's recommendations are not self-executing, however, and it took until the 2017-2018 period for European bank regulators to publish rules implementing the Basel III endgame. The United States was slower, and the Capital Proposal represents the U.S. regulators' take on the Basel III endgame. However, in many respects, the Capital Proposal goes beyond or "gold-plates" the Basel requirements, raising capital requirements for U.S. banks in ways that cut against the principle of harmonization that was the animating purpose of the Basel framework.

OVERVIEW OF THE CAPITAL PROPOSAL

The Capital Proposal covers risk-weighted asset calculations for credit, market, credit valuation adjustment ("CVA"), and operational risks. It amends certain important components of the calculation of risk-weighted assets. It also seeks to align capital rules more generally for all firms with $100 billion or more in assets, but it does so by collapsing together (at least in some ways) the tiered categories created pursuant to the 2018 Economic Growth Act. The Economic Growth Act included an effort to reduce the most onerous regulatory requirements, including capital requirements, for regional banks.

The Capital Proposal explicitly rejects a "capital neutral" approach and instead gold-plates Basel standards, as the Agencies have done with previous Basel III rules (though perhaps not in as expansive a manner as in the Capital Proposal). Agency staff estimate that banking organizations with $100 billion or more in assets will see an aggregate increase of 16% for Common Equity Tier 1 capital.[3]

If adopted, the Capital Proposal (taken together with the G-SIB Surcharge Proposal) would have a substantial impact on how banks allocate capital, the pricing and availability of financial services and products, the role played by banks in the larger financial system, and the stability of the system as a whole.

New generally applicable requirements

The Capital Proposal would replace the current "advanced approaches" that permitted banks to use their own internal models to calculate risk-weighted assets ("RWAs") with a new "expanded risk-based" approach based on the Basel III "standardized" approach that largely eliminates the use of internal models. The expanded risk-based approach would apply to all banks with $100 billion or more in assets and will raise capital costs by:

1) Gold-plating credit risk weights for residential mortgages, retail exposures, exposures to banks and credit unions, and exposures to small businesses;[4]

2) Adopting minimum haircut floors for securities financing transactions (unlike European jurisdictions that declined to adopt them);[5]

3) Eliminating the use of internal models in calculating credit and operational risk;[6]

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[3] Capital Proposal at 64169.

[4] Capital Proposal at 64038, 64048-64049 (residential mortgages), 64041-64042 (retail and small business exposures), 64051-64053 (banks and credit unions).

[5] Capital Proposal at 64063-64067.

[6] E.g., Capital Proposal at 64038, 64082.

4) Setting a floor for operational risk weights based on historical losses via the internal loss multiplier;[7] and

5) Using the standardized approach for market risk weights as a default in lieu of an internal-model approach, with internal models only permitted with new restrictions.[8]

Large banks will have to determine their capital requirements under both the expanded risk-based and existing U.S.-standardized approaches, and hold capital in excess of whichever approach would produce the higher level of capital, together with applicable buffers and surcharges.[9] The Agencies estimate that the new expanded risk-based approach will be the binding constraint for most large financial organizations, rather than the standardized approach when firms calculate their capital requirements under both approaches.[10]

REGIONAL BANKS IN PARTICULAR FACE SIGNIFICANT NEW REQUIREMENTS

As noted above, the Economic Growth Act directed the Federal Reserve to tailor its application of prudential standards. Accordingly, the Federal Reserve created categories of banks, the largest and most complex of which would have the most rigorous set of regulatory requirements, including the most stringent capital requirements. Other categories cover banks with assets of $100 billion or more that are not U.S. G-SIBs and distinguish further among them based on asset size (including nonbank assets), cross-jurisdictional activity, off-balance sheet exposures, and funding type. However, the Capital Proposal eliminates any tailoring of the capital rules for banks with $100 billion or more in assets, almost entirely collapsing current Federal Reserve categories II, III, and IV into a single category, at least for capital purposes.

These requirements that the Agencies propose to push down to Category III and IV banks include the following:

- These banks would become subject to the Agencies' market risk capital rule, regardless of their level of trading activities.[11]

- The Capital Proposal would require a "dual stack" approach to capital calculations, such that Category III and IV banks would now have to calculate capital requirements under the existing U.S. standardized approach and under the expanded risk-based approach.[12]

- The Capital Proposal would subject all of these banks to the supplementary leverage ratio and the countercyclical capital buffer.[13]

- It would also remove the option for Category III and IV banks to elect not to count "accumulated other comprehensive income" for purposes of their capital requirements.[14] Effectively, this means that all large banks would have to incorporate unrealized losses and gains on available-for-sale securities in their capital requirements. This may be the only portion of the Capital Proposal that relates directly to the bank failures and industry turmoil of early 2023.[15]

- The existing framework to determine deductions from capital for Category I banks will apply to Category III and IV banks, increasing specificity and complexity.[16]

- Category III and IV banks would be required to calculate and hold RWAs for CVA risk (that is, the change in value of OTC derivatives contracts to

[7] Capital Proposal at 64083, 64086-64089.

[8] Capital Proposal at 64032, 64092, 64109-64111.

[9] Capital Proposal at 64167-64169.

[10] Capital Proposal at 64168 ("In general, the expanded risk-based framework would produce greater overall risk-weighted assets than either of the current approaches. The overall increase would lead to the expanded risk-based framework becoming the binding risk-based approach for most large banking organizations. As a result, the most commonly binding capital requirement would shift from the current standardized approach to the expanded risk-based approach.").

[11] Capital Proposal at 64095.

[12] Capital Proposal at 64030-64031, 64033.

[13] Capital Proposal at 64032-64033. Although currently set to zero, it is nevertheless curious that the Capital Proposal would seek to expand the reach of the countercyclical capital buffer at a time when (1) the banking system has recently suffered a significant dislocation and (2) the Federal Reserve is tightening monetary policy and slowing the economy. The purpose of the buffer is to expand capital requirements when economic growth is robust and banks are stable and profitable.

[14] Capital Proposal at 64036.

[15] Silicon Valley Bank had significant unrealized losses on its available-for-sale securities, which it did not have to realize as a loss for purposes of its capital calculations. These losses were realized when SVB went to the market to improve its liquidity position and sold portions of its available-for-sale securities portfolio at a loss.

[16] Capital Proposal at 64036-64037.

reflect counterparty credit risk) and would be required to use the standardized approach to counterparty credit risk rather than having the option (as under current requirements) to use the current exposure methodology instead.[17]

- These banks would also have to calculate and hold RWAs for operational risk.[18]

- In quantitative terms, the Agencies estimate a capital increase of 6% of RWAs for regional banks, with $550 billion of additional RWAs required to meet operational risk requirements alone.[19]

In sum, with regard to the collapsing of the categories for capital purposes, the Capital Proposal appears to flout the Congressional intent of Section 165 of the Dodd-Frank Act, as modified by the Economic Growth Act, that the Federal Reserve tailor prudential standards for banks of $100 billion or more in assets.

EFFECTS ON FOREIGN BANKING ORGANIZATIONS

Under current rules, non-G-SIBs with more than $700 billion in assets are Category II banks, but smaller non-GSIBs can also fall into Category II if they have more than $75 billion in "cross-jurisdictional activity."[20] The G-SIB Surcharge Proposal would amend the methodology for calculating cross-jurisdictional activity in a way that would "substantially increase the reported value of cross-jurisdictional activity" for most foreign banking organizations ("FBOs").[21] Under the current capital framework, derivatives exposures are not included in the calculation of cross-jurisdictional assets (or liabilities) for purposes of determining whether an FBO is in Category II. Under the G-SIB Surcharge Proposal, derivatives exposures would instead be included.[22]

FBOs can be categorized as Category II either be virtue of their combined operations or on the basis of operations within their U.S. intermediate holding companies ("IHCs") alone. In the G-SIB Surcharge Proposal, the Agencies indicate that:

- Seven FBOs that are currently in Category III and IV would be "bumped up" and become subject to Category II standards and

- Two U.S. IHCs of FBOs that are currently in Category III would become Category II organizations.[23]

As discussed above, the differences between the categories are largely being reduced by the Capital Proposal. However, there are some remaining areas in which FBOs being moved up to Category II are likely to have a material impact. In the preamble to the G-SIB Surcharge Proposal, the Agencies specify some of the impacts of being "promoted" to Category II:

> "requirements for daily liquidity reporting (rather than monthly or no liquidity reporting); monthly (rather than quarterly) internal liquidity stress testing; and full (rather than reduced) liquidity risk management. This change would have the benefit of enhancing the liquidity positions and liquidity risk management of these foreign banking organizations' U.S. operations at the cost of somewhat higher administrative expenses."[24]

The Agencies estimate that U.S. IHCs of FBOs will see an aggregate increase in risk-weighted assets of approximately 25% under the Capital Proposal.[25]

EFFECTS ON U.S. G-SIBS

The Capital Proposal will significantly raise G-SIB capital requirements, largely due to changes in market and operational RWAs and the fact that the expanded risk-based approach would supplant the current standardized approach as the binding constraint. In fact, the Agencies estimate that capital requirements for these firms will increase by 19%.[26]

[17] Capital Proposal at 64056.

[18] *See*, e.g., Capital Proposal at 64030 (expanded risk-based approach applies to all banking organizations with total assets of $100 billion or more; approach includes more types of risk, including operational risk).

[19] Capital Proposal at 64168.

[20] Capital Proposal at 64293.

[21] G-SIB Surcharge Proposal at 60397.

[22] G-SIB Surcharge Proposal at 60391-60392.

[23] G-SIB Surcharge Proposal at 60397.

[24] G-SIB Surcharge Proposal at 60397.

[25] Capital Proposal at 64168.

[26] Capital Proposal at 64169. The Agencies' estimate applies to Category I and II firms, which include the U.S. G-SIBs plus at least one other firm. 19% is therefore an approximation with respect to the U.S. G-SIBs.

Additionally, the G-SIB Surcharge Proposal would require G-SIBs to make changes to their current capital calculations. G-SIBs currently are required to measure their G-SIB surcharge requirements under two methods (method 1 and method 2). The G-SIB Surcharge Proposal would make changes to the required calculations for method 2, in order to smooth "cliff effects."[27] Calculations under the G-SIB Surcharge Proposal would be measured on a daily average basis rather than as a snapshot at the end of a quarter (and annually on the basis of an average of the quarters).[28] "Score bands" would be narrowed and made more granular.[29]

CAPITAL MARKETS ACTIVITIES

The Capital Proposal's triple whammy of market risk, CVA risk, and operational risk RWA changes will have a dramatic impact on the capital markets activities of banks. Although banks may still use an internal models approach[30] to calculate RWAs for market risk, the path to securing supervisory approval under the Capital Proposal will narrow. Passing a profit and loss attribution test and meeting back-testing requirements would now be necessary to gain the diminished benefits of the internal models approach, and then only on a trading desk-by-trading-desk basis.[31] And in the case of certain exposures like equity positions in investment funds, internal models will be prohibited. Unlike other aspects of the Capital Proposal, which only apply to firms with $100 billion or more in assets, these market risk changes would also apply to firms with trading assets and liabilities equal to 10% or more of total assets or $5 billion.

CVA risk requirements, new to Category III and IV firms, would no longer allow the use of internal models. Nor, importantly and unlike other jurisdictions, would the Capital Proposal permit exemptions for commercial end-users. The Capital Proposal would also eliminate the option of using the current exposure methodology for OTC derivatives exposure calculations for both RWA calculations and the supplementary leverage ratio, instead mandating the use of the standardized approach to counterparty credit risk for all large banks, including Category III and IV.

Although not specifically targeted at capital markets activities in the same way as the foregoing risk frameworks, the Capital Proposal's operational risk requirements will be another factor weighing on bank's capital markets activities. The operational risk framework, which will apply for the first time to Category III and IV firms, eliminates the internal models approach and instead captures operational risk charges through a standardized measurement approach. Unlike the interest, lease, and dividend components, the services and financial components of the business indicator under this approach are not capped and are more likely to reflect business volume associated with a bank's capital markets activities. This will increase the relative capital cost, at least from an operational risk standpoint, of capital markets activities.

By the Agencies' own estimate, these changes will increase RWAs for trading activities by around $880 billion.[32] The Capital Proposal estimates the market risk capital changes alone will drive aggregate RWAs for Category I and II banks from $430 to $760 billion and for Category III and IV banks from $130 to $220 billion.[33] The Agencies note that "higher capital requirements on trading activity may also reduce banking organizations' incentives to engage in certain market-making activities and may impair market liquidity."[34] The Capital Proposal would likely accelerate banks' continued retreat from capital markets activities with ramifications for financial stability and the U.S. economy.

THE PATH FORWARD

The Agencies' failure to articulate a credible factual rationale for its far-reaching reforms, including its deviations from Basel and past publicly stated goals, leaves the Capital Proposal vulnerable to policy and legal challenge. FDIC and Federal Reserve principals

[27] G-SIB Surcharge Proposal at 60397.

[28] G-SIB Surcharge Proposal at 60387-60388.

[29] G-SIB Surcharge Proposal at 60389-60390.

[30] Now based on an expected shortfall method (rather than value-at-risk) to cover tail risk better and incorporate changed liquidity horizon assumptions.

[31] Given that there are both threshold definitional overlaps and organizational overlaps between the market risk capital framework and the Volcker Rule, firms may need to reassess optimal trading desk organization under both sets of requirements, capital, and Volcker.

[32] Capital Proposal at 64170. There are obvious flaws in the Agencies' methodology that likely understate the impact including reliance on quantitative impact studies based on the Basel version versus the Agencies' actual gold-plated proposal.

[33] Capital Proposal at 64168.

[34] Capital Proposal at 64170.

who voted against the Capital Proposal highlighted the many deviations from Basel that would result in more stringent capital requirements than the capital neutrality originally contemplated, the rejection of the tailoring framework directed by Congress in the Economic Growth Act, and redundancies between the Capital Proposal's treatment of operational and market risks, on the one hand, and the scenarios and assumptions of the existing stress testing framework, on the other.[35] Even some Federal Reserve governors who supported the release of the Capital Proposal for public comment expressed reservations about aspects of it.[36]

Critics will undoubtedly raise concerns that the Capital Proposal violates statutory tailoring requirements[37] or otherwise exceeds the Agencies' authorities given the magnitude of the changes they are proposing in the absence of (and contrary to) a clear congressional mandate. Further, the stress testing framework of which this Capital Proposal would be part has been characterized as "illegal" by no less than the Federal Reserve's immediate past vice chair for supervision.[38] A flawed and apparently cursory economic impact analysis, undisclosed data and analyses that underlie the Capital Proposal, inadequate recognition of or explanation for the about-face from prior Agency posture, ill-defined or circular standards for eligibility for certain RWA treatments, and widespread use of so-called "reservations of authority" suggest a rarely-seen level of regulatory hubris.

Together with the Agencies' recent proposals on resolution planning and long-term debt requirements,[39] the emerging regulatory framework for banks with $100 billion or more in assets marks a wholesale rejection of the spirit, if not the letter, of the Economic Growth Act and the tailoring framework finalized by the Federal Reserve a mere four years ago. Underlying these changes to the regulatory framework is an effort to redefine common conceptions of what constitutes a systemically important institution to include regional banks under the new and conclusory moniker of "domestic systemically important bank." These efforts are unmoored from any statute. ■

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The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

35 *See*, e.g., Statement by Travis Hill, Vice Chairman, FDIC, on the Proposal to Revise the Regulatory Capital Requirements for Large Banks (July 27, 2023), *at* https://www.fdic.gov/news/speeches/2023/spjul2723b.html.

36 *See*, e.g., Statement by Chair Jerome H. Powell, Federal Reserve Board (July 27, 2023), *at* https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20230727.htm.

37 Indeed Michael Barr, now Federal Reserve Vice Chair for Supervision and the primary advocate for the Capital Proposal, warned that the Economic Growth Act would "hand[] large banks a litigation tool against stricter standards. . . ." Michael Barr, "Dear Congress: Reg relief bill is a giveaway for large banks," *The American Banker* (March 5, 2018).

38 *See* "Quarles 'Very Convinced' Fed's Stress Tests Are Illegally Run," *Law360* (July 13, 2023), *at* https://www.law360.com/articles/1699387/quarles-very-convinced-fed-s-stress-tests-are-illegally-run.

39 *See* OCC, Federal Reserve, FDIC, "Long-term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions," 88 Fed. Reg. 64524 (Sept. 19, 2023); FDIC, "Resolution Plans Required for Insured Depository Institutions with $100 Billion or More in Total Assets; Informational Filings Required for Insured Depository Institutions with At Least $50 Billion but Less Than $100 Billion in Total Assets," 88 Fed. Reg. 64579 (Sept. 19, 2023). One might also include skepticism for M&A deals, including those involving regional banks, in this emerging regulatory framework. Changes to other enhanced prudential standards, such as liquidity requirements and capital stress testing, may be on the way.