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Federal Banking Agencies Propose New Rules to Strengthen Capital Requirements for Large Banks

On July 27, 2023, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) issued an interagency notice of proposed rulemaking (Proposed Rule or the proposal)[1] to implement aspects of the final components of the Basel III agreement, also known as the Basel III end game.

The Proposed Rule would (1) substantially revise the regulatory capital framework for large banking organizations -- banking organizations[2] with more than $100 billion in total consolidated assets, as well as their subsidiary depository institutions, and (2) provide a newly revised market risk capital rule applicable to smaller banking organizations with trading assets and trading liabilities that exceed $5 billion or 10% of total assets. **Capital requirements for community banks would not be impacted by the Proposed Rule**.

[1] The Proposed Rule was issued in conjunction with the Federal Reserve Board's notice of proposed rulemaking to amend the method for calculating the capital surcharge for global systemically important banking organizations. However, this GT Alert covers only the Proposed Rule.

[2] The Introduction to the Proposed Rule defines the term "banking organization" to include, among other institutions, national banks, state member banks, state nonmember banks, federal savings associations, state savings associations, U.S. intermediate holding companies of foreign banking organizations, and top-tier savings and loan holding companies domiciled in the United States.

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The Agencies will accept comments on both proposals through **Nov. 30, 2023**.

Overview of the Proposed Rule

The Proposed Rule aims to enhance the U.S. banking system's resilience by applying a consistent set of capital requirements across large banking organizations, particularly in light of the banking turmoil of March 2023.[3] Table 1 below[4] provides additional details on the Proposed Rule's scope for large banking organizations.

Category I	Category II	Category III	Category IV
U.S. global systemically important banking organizations (GSIBs) (and their depository institution subsidiaries)	Banking organizations with ≥ $700 billion in total assets or ≥ $75 billion in cross-jurisdictional activity (and their depository institution subsidiaries)	Banking organizations with ≥ $250 billion in total assets or ≥ $75 billion in nonbank assets, weighted short-term wholesale funding, or off-balance-sheet exposure (and their depository institution subsidiaries)	Other banking organizations with $100 billion to $250 billion in total assets (and their depository institution subsidiaries)

Table 1

The Proposed Rule includes changes that would:

- Enhance consistency in risk measurement for large banking organizations. The Proposed Rule suggests replacing current internal-models-based capital requirements with standardized risk-sensitive ones. These new requirements, referred to as the "expanded risk-based approach," would apply to all banks with over $100 billion in total assets (that is, banking organizations subject to Category I, II, III, or IV capital standards). The updated market risk requirements would also extend to other banking organizations with trading assets plus trading liabilities of $5 billion or more, or where these trading assets plus liabilities surpass 10% of total assets.
- Extend capital standards for larger banks to a wider range of banking institutions. The Proposed Rule would mandate consistent regulatory capital calculation for all banks with $100 billion or more in total assets, including factoring unrealized gains or losses on available-for-sale securities in regulatory capital. The Proposed Rule would also enforce supplementary leverage ratio compliance and countercyclical capital buffer application, if activated, for banks with $100 billion or more in total assets.
- Uphold more stringent regulations for the largest and most systemically important banks. The Proposed Rule would retain risk-based capital surcharges for GSIBs and maintain the enhanced supplementary leverage ratio requirement for Category I banking organizations.

[3] In March 2023, three small- to mid-size U.S. banks failed: Silvergate Bank, Silicon Valley Bank, and Signature Bank.
[4] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation, "Interagency Overview of the Notice of Proposed Rulemaking for Amendments to the Regulatory Capital Rule" (July 27, 2023).

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- Enhance transparency of capital requirements for large banks. The Proposed Rule's use of standardized approaches and improved public disclosures would boost comparability and transparency of capital requirements among large banking organizations' capital requirements. Additionally, the Proposed Rule would align Federal Reserve reporting requirements with capital requirement changes. The Agencies plan to propose adjustments to Federal Financial Institutions Examination Council (FFIEC) reporting forms for large banks and those with significant trading activity, aligning with the capital rule revisions.
- Retain dual methodologies for risk-based requirements. The Proposed Rule would mandate large banks to calculate risk-weighted assets (RWAs) using both the current standardized approach and the expanded risk-based approach. The higher of these two risk-weighted asset amounts is used to meet minimum capital requirements. This approach would ensure that capital requirements for large banking organizations remain as stringent as those for smaller banks (see Figure 1 below, illustrating the standardized approach and expanded risk-based approach, as published by the Agencies).
- Introduce a transition period for adjustment. The Proposed Rule includes provisions that phase in the new requirements over three years, with full implementation starting in the fourth year after the Proposed Rule's effective date, allowing banking organizations ample time to adapt.

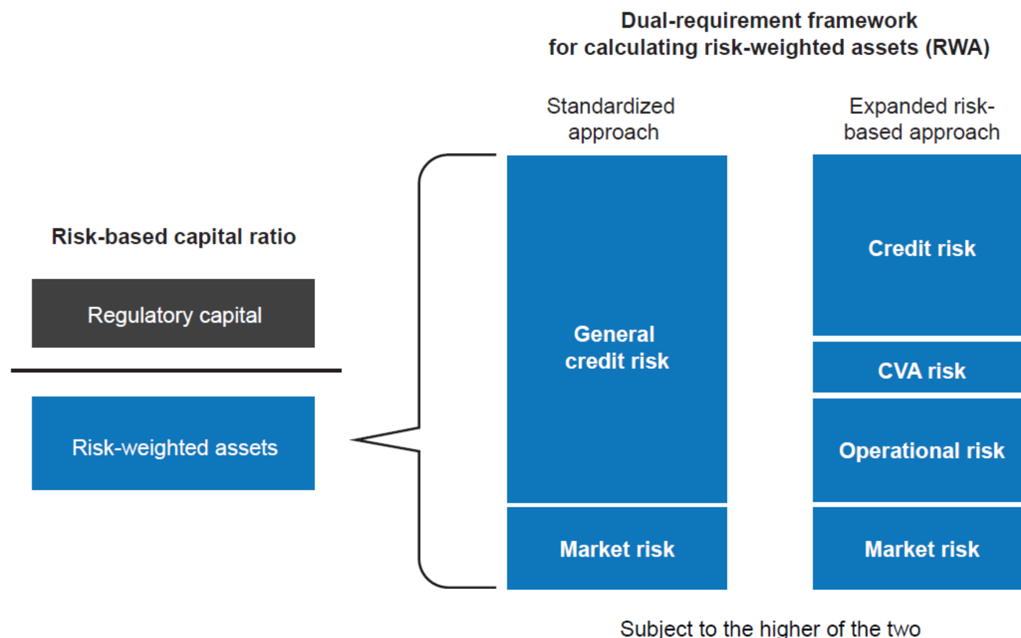

Figure 1: Standardized Approach and Expanded Risk-Based Approach

Major Elements

As noted above, the Proposed Rule would revise the regulatory capital requirements for large banking organizations with total assets of $100 billion or more, and implement the final components of the Basel III agreement, also known as the Basel III endgame. Following the banking failures in March 2023, the Proposed Rule applies a broader set of capital requirements to more large banks in an attempt to address emerging issues, identify underlying risks, and increase the transparency and consistency of the regulatory capital framework. The Proposed Rule would also apply supplementary leverage ratio and countercyclical capital buffer requirements, if activated, to all large banking organizations, rather than only to banking organizations subject to Category I, II, or III capital standards.

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What follows is a discussion of the Proposed Rule's revisions to the fundamental components of capital adequacy.

Disclosure Requirements

The Proposed Rule would revise certain existing qualitative disclosure requirements and introduce new and enhanced qualitative disclosure requirements related to the proposed revisions described below. Specifically, the proposal introduces a comprehensive overhaul of qualitative disclosure requirements, revising existing ones and introducing new ones. This overhaul includes the removal of most qualitative disclosures from the disclosure tables, which will be transitioned into regulatory reporting forms. As a result, revisions are expected to be proposed separately for the Consolidated Reports of Condition and Income, the Regulatory Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework (FFIEC 101), and the Market Risk Regulatory Report for Institutions Subject to the Market Risk Capital Rule (FFIEC 102).

Similar corresponding revisions are anticipated from the Board for the Consolidated Financial Statements for Holding Companies (FR Y–9C), the Capital Assessments and Stress Testing (FR Y–14A and FR Y–14Q), and the Systemic Risk Report (FR Y-15) to accommodate changes required under the Proposed Rule. Notably, the proposal also entails the removal of disclosures associated with internal ratings-based systems and internal models to align with the broader objectives of the proposal. Banking organizations adhering to Category I or II capital standards experience heightened public disclosure and reporting demands compared to those under Category III or IV standards. The proposal seeks to extend enhanced public disclosure requirements to all large banking organizations. This move aims to standardize disclosure and reporting obligations across large banking entities, fostering transparency for market participants. In line with the current capital rule, top-tier entities, including applicable depository institutions, would be subject to both qualitative and quantitative enhanced disclosure and reporting obligations. Notably, the current capital rule does not impose qualitative disclosure requirements on certain entities, such as banking organizations consolidated under bank holding companies or non-U.S. banking organizations subject to comparable public disclosure requirements in their respective jurisdictions. The proposal maintains the existing requirements on public disclosure policy and attestation, the frequency of disclosures, the location of disclosures, and the handling of proprietary information.

Definition of Capital

Under the Proposed Rule, large banking organizations' method of calculating regulatory capital would remain essentially unchanged, retaining common stock and retained earnings as eligible capital instruments. However, the proposal introduces some critical modifications.

When calculating regulatory capital, the first change would require banking organizations with $100 billion or more in total assets to account for unrealized gains and losses in available-for-sale securities. This requirement would eliminate the option for Category III and IV organizations to opt out of including certain components of accumulated other comprehensive income (AOCI) in their common equity tier 1 (CET1) capital. For affected organizations, AOCI could represent a substantial portion of CET1 capital.

Additionally, the proposal would require Category III and IV institutions to adhere to a standard previously applicable only to Category I and II institutions. This standard includes recognizing most elements of AOCI in regulatory capital, particularly unrealized gains and losses on available-for-sale securities. The criteria for minority interest inclusion in capital would also be affected, as well as more

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stringent requirements concerning capital deductions for investments in unconsolidated financial institutions, mortgage servicing assets, and certain deferred tax assets.

Credit Risk

The Proposed Rule aims to enhance the calculation of credit risk within the banking sector and possibly eliminate internal credit risk models. Thus, it introduces a new expanded risk-based approach for calculating credit-RWAs.

Under the proposed changes, certain institutions would no longer have the option to elect the current exposure methodology. Specifically, impacted institutions, such as intermediate holding companies with assets exceeding $5 billion or Category IV institutions, would be affected. However, the new risk-based approach would retain some familiar elements, including risk-based treatment for certain forms of real estate, such as pre-sold construction loans, multifamily mortgages, and high-volatility commercial real estate.

The proposed changes offer a more risk-sensitive approach to credit risk calculation compared to the current framework. These changes would allow for greater segmentation of credit risk across exposure categories and provide the flexibility to apply a broader range of risk weights. For example, the proposal suggests using loan-to-value (LTV) ratios to determine risk weights for regulatory residential or commercial real estate exposures, where higher LTV ratios would generally result in higher risk weightings.

In addition to the abovementioned changes, the proposal would require banking organizations to disclose certain additional information regarding their risk management policies and objectives for credit risk. Specifically, the proposal would require a banking organization to enhance its existing disclosures by describing how its business model translates into the components of the banking organization's credit risk profile and how it defines its credit risk management policy and sets credit limits. Banking organizations would be required to disclose the organizational structure of their credit risk management and control functions as well as interactions with other functions. A banking organization would also be required to disclose information on its policies related to reporting of credit risk exposure and the credit risk management function that are provided to the banking organization's leadership.

Finally, the Proposed Rule addresses credit risk in equity exposures, securitizations, and risk mitigation. For equity exposures, the proposal suggests increasing risk weightings under the simple risk-weight approach and adjusting various risk factors applicable to investment firms. It would also enhance the risk sensitivity of the look-through approaches for equity exposures to investment funds.

Regarding securitizations, as further described below, the proposal introduces a new standardized approach with minor adjustments to account for delinquencies, level of subordination, and inherent risks compared to direct credit exposures. This proposed formula is largely similar to the existing method.

Changes to the application of credit risk mitigants involve replacing certain methodologies with standardized approaches. Notably, the proposal revises the collateral haircut approach by increasing netting and diversification benefits within netting sets. The changes would also adjust market price volatility and haircuts and introduce floors. As a result, institutions may be required to increase collateral associated with repo-style transactions, notably if conducted with unregulated entities like hedge funds and private equity firms.

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Operational Risk

The proposal would require all banks subject to Category I-IV capital standards to calculate operational RWA, extending the current requirements beyond Category I and II institutions.

The proposal also suggests replacing internal models with a new standardized approach for operational RWA, which would be determined by the institution's business indicator component and internal loss multiplier. The business indicator component considers various factors, such as business volume, lending and investment activities, fee and commission-based activities, trading activities, and other associated assets and liabilities. The internal loss multiplier is based on a historical ratio of operational losses to the business indicator component, with a minimum value of 1. Consequently, an institution's operational risk capital requirement would rise with increasing historical operating losses.

Like the existing capital rule, operational RWA would be multiplied by a factor of 12.5. These changes aim to provide a standardized and more inclusive framework for operational risk calculation.

Market Risk

The Proposed Rule would also make significant changes to market risk requirements. These changes follow the fundamental review of the trading book (FRTB) standards, widely discussed after the 2008 financial crisis. Key changes would include:

- Replacing the current VaR (Value at Risk)-based measure with an expected shortfall-based measure.
- Introducing liquidity horizons aligned with underlying risk factors.
- Implementing a standardized methodology for calculating market risk.
- Enhancing transparency through improved disclosures.

The new models-based methodology aims to enhance risk sensitivity by introducing the concept of a trading desk and requiring approval for each desk before using internal models. The new model would also require desk-level backsetting or profit and loss attribution testing. If these requirements are not met, the standardized approach would be applied, potentially increasing RWAs.

All institutions, regardless of model approval, would be required to calculate market risk capital requirements under the standardized method, which comprises three main components:

- A sensitivities-based method
- A standardized default risk requirement
- A residual risk capital requirement

Additionally, specific positions may trigger three additional components:

- A fallback capital requirement
- A capital add-on for re-designations
- Any further requirements set by the primary supervisor

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Securitization Framework

The proposal entails a comprehensive overhaul of the current securitization framework, encompassing several crucial aspects.

First, the Proposed Rule introduces new operational requirements for synthetic securitizations and alters the re-securitization approach. This approach involves the extension of early amortization provisions to synthetic securitizations and the imposition of consistent credit risk mitigation thresholds.

Second, the Proposed Rule introduces a fundamental shift by replacing the current supervisory formula approaches with the securitization standardized approach (SEC-SA). This replacement involves recalibrated definitions, risk-weight parameters, and floors for securitization exposures to foster a more precise risk assessment.

The Proposed Rule would also restrict the acknowledgment of risk-mitigating benefits for nth-to-default credit derivatives and present revised treatments for overlapping exposures. These changes seek to establish a better alignment between applicable risk-based requisites.

The proposal also outlines a new mechanism for senior securitization exposures, allowing institutions to cap risk weights using a look-through approach. However, this approach also includes a minimum total risk-based capital requirement floor.

Third, the proposal introduces a new framework for non-performing loan (NPL) securitizations, proposing a 100% risk weight for NPL securitization exposure when specific criteria are satisfied. Non-compliant exposures would face alternative risk weights.

Credit Valuation Adjustment Risk

The proposal introduces modifications to Credit Valuation Adjustment (CVA) capital requirements without impacting the scope of institutions. It offers a new standardized approach that would allow banks to recognize hedges for the expected exposure component of CVA risk. Alternatively, the basic approach is similar to the current rule's simple CVA approach and is also provided as an option.

CVA risk refers to potential losses due to changes in counterparty credit spreads and market risk factors affecting derivative and securities financing transactions. The proposal separates the CVA risk capital requirement from credit risk provisions. It mandates that banking organizations with $100 billion or more in total assets maintain capital for CVA-risk-covered positions. A CVA-risk-covered position is a derivative contract that is not cleared. Moreover, banking organizations can exclude eligible credit derivatives with recognized credit risk mitigation benefits from the CVA risk calculation.

Under the Proposed Rule, banks would also need to implement identification, documentation, and operational controls to comply with these CVA capital requirements. Increased costs may result in consolidation within derivatives dealing and a potential reduction in dealers offering certain products.

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Other Changes

Technical Amendments to the Capital Rule: The proposal would make certain technical corrections and clarifications to several provisions of the capital rule. These changes mainly involve updates to align terminology and address errors. The proposal also removes transition provisions that have expired or are no longer applicable.

Specific changes include the introduction of a new standardized approach (SA-CVA) for CVA capital requirements, allowing recognition of hedges for the expected exposure component of CVA risk. The proposal also corrects the definition of qualifying master netting agreement to include inadvertently deleted criteria.

Additionally, the proposal clarifies the treatment of total leverage exposure, aligning it with adjustments for credit loss allowances. It requires Category III or IV institutions to use SA-CCR for calculating total leverage exposure for derivatives, removing the option to use the current exposure method.

The proposal addresses various transitional provisions, updates terminology, and removes sections that are no applicable.

Enhanced Supplementary Leverage Ratio: In addition to the technical amendments, the OCC proposes revising the methodology it uses to identify which national banks and federal savings associations are subject to the enhanced supplementary leverage ratio (eSLR) standard to ensure the standard applies only to those national banks and federal savings associations that are subsidiaries of a Board-identified GSIB.

Previously, the eSLR standard applied to U.S. top-tier bank holding companies with specific asset thresholds. The Proposed Rule aims to align the OCC's regulations with the Board's approach for identifying U.S. GSIBs and measuring the eSLR standard for holding companies and their subsidiary depository institutions.

Timeline and Transition Period

The Proposed Rule offers transition provisions for large banks to adapt to the new requirements after the Agencies' final rule adoption, while also minimizing potential impacts on their lending capacity.

- The revised expanded total RWAs would be phased in over three years starting July 1, 2025, until June 30, 2028. In year one, banks would need to acknowledge 80% of changed RWAs, rising to 85% in year two, 90% in year three, and 100% thereafter.
- For banking organizations subject to Category III or IV standards, the requirement to reflect in regulatory capital AOCI, which includes unrealized gains or losses on available-for-sale securities, would also be phased in over three years starting July 1, 2025, until June 30, 2028. In the initial year, banks could acknowledge 75% of the AOCI adjustment (i.e., exclude 75% of AOCI from CET1 capital), decreasing to 50% in year two, 25% in year three, and 0% thereafter.
- All other elements of the calculation of regulatory capital would apply upon the effective date of the Proposed Rule.

According to this timeline, the Proposed Rule's requirements would be fully phased in **July 1, 2028.**

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Takeaways

The Proposed Rule was put forward on a 4-2 vote by the Federal Reserve Board. The FDIC had similar dissent. The industry has been critical of the Proposed Rule as have several members of Congress. The comment process is expected to be active and contentious, and finalization may extend into 2024. However, based on the current version of the Proposed Rule, we offer the following takeaways.

- **Increased Regulatory Requirements**: The Proposed Rule may lead to higher capital and resource expenses for banks to ensure compliance. Banks, in turn, may pass these costs on to consumers through increased charges on core banking products and services like lending, potentially causing such business to move to non-bank financial services companies.
- **Reversal of Tailoring Rules**: The Proposed Rule would reverse much of the tailoring rules in the current capital framework, shifting toward a more asset-size-based system rather than risk-based principles. This could impact institutions differently based on size rather than actual risk profiles.
- **Impact on AOCI Opt-Out**: The Proposed Rule's elimination of the AOCI opt-out could affect how banks calculate common equity tier 1 capital. While aimed at preventing bank failures, this change, if implemented previously, might not have prevented the March 2023 failures. It might incentivize banks to limit flexibility and increase risk in their investment portfolios by restricting larger portions of their investment portfolios and impairing access to liquidity through securities sales.
- **Unintended Consequences for Market Risk**: The market risk provisions in the Proposed Rule might inadvertently affect regional banks with minor trading activities, requiring them to invest heavily in infrastructure and personnel to meet the full scope of market risk requirements.

Conclusion

As the Agencies propose significant changes to capital rule requirements, financial institutions and market stakeholders should closely monitor the developments and assess the potential impact on their operations.

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