July 9, 2013

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Notice of Proposed Rulemaking – *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions*

Summary: Maintenance of a strong base of capital among the largest, most interconnected U.S. banking organizations is particularly important because capital shortfalls at these institutions have the potential to result in significant adverse economic effects and contribute to systemic distress on both a domestic and an international scale. In addition, higher capital standards for these institutions would place additional private capital at risk before the Federal deposit insurance fund and the Federal government's resolution mechanisms would be called upon, and reduce the likelihood of economic disruptions caused by problems at these institutions. FDIC staff believes that higher leverage capital standards, in particular, would reduce the likelihood of resolutions and allow regulators more time to tailor resolution efforts in the event they are required. By further constraining their use of leverage, higher leverage standards also would offset possible funding cost advantages that these institutions may enjoy as a result of real or perceived implicit Federal support.

Today, staff is seeking approval from the FDIC Board of Directors ("Board") to issue a notice of proposed rulemaking ("NPR" or "proposal") that would strengthen the supplementary leverage ratio requirements for the largest, most interconnected U.S. banking organizations with

Concur:

Richard J. Osterman, Jr.

Acting General Counsel

consolidated total assets of more than $700 billion or assets under custody of more than $10 trillion ("covered banking organizations"). Under this applicability threshold, the requirements set forth in the proposal would apply to the eight U.S. banking organizations designated as Global Systemically Important Banks ("U.S. G-SIBs") by the Financial Stability Board, as well as their insured depository institution subsidiaries. Going forward, as the G-SIB capital framework is implemented in the United States or otherwise modified, the agencies would consider the appropriateness of conforming changes to the scope of application of these requirements.

Under the proposal, insured depository institution ("IDI") subsidiaries that are part of a covered banking organization must satisfy a 6 percent supplementary leverage ratio requirement to be considered "well capitalized" for purposes of the prompt corrective action ("PCA") framework. In addition, to avoid restrictions on certain capital distributions and discretionary bonus payments, the top-tier bank holding company ("BHC") of a covered banking organization ("covered BHC") must maintain a leverage capital conservation buffer that exceeds 2 percent of the company's total leverage exposure. The leverage capital conservation buffer is operationally similar to the capital conservation buffer for the minimum risk-based capital ratios, as it would require covered BHCs to hold a minimum amount of additional tier 1 capital above the amount required (3 percent) for purposes of the minimum supplementary leverage ratio. If it is approved by the Board, the NPR would be published jointly in the *Federal Register* by the FDIC, Office of the Comptroller of the Currency ("OCC"), and Board of Governors of the Federal Reserve System ("Federal Reserve") (collectively, the "agencies") for a 60-day comment period.

As discussed in the attached *Federal Register* document, further analysis by the agencies suggests that a 3 percent minimum supplementary leverage ratio requirement would not have appreciably mitigated the growth in leverage among covered banking organizations in the years preceding the recent crisis. The proposed enhancements to the supplementary leverage ratio would materially strengthen leverage capital requirements among these organizations while offsetting potential weaknesses in the risk-based capital measures. Under this proposal, the proportional increase in leverage requirements for these organizations would be roughly similar to the proportional increase in their risk-based capital requirements, as adopted by the Board today under the Basel III Interim Final Rule.[1]

In contrast to the standard leverage ratio, the supplementary leverage ratio includes many off-balance sheet assets in the denominator measure ("total leverage exposure"). Accordingly, recent staff analysis has found that a 6 percent supplementary leverage ratio would require roughly the same amount of additional tier 1 capital as a standard leverage ratio of 8.6 percent. Although the conversion between the two ratios depends on the amount of off-balance sheet assets, which vary over time and across banks, staff believes it is important to note that the requirements set forth in the NPR would significantly enhance the existing leverage standards for covered banking organizations, and support the agencies' objectives to mitigate systemic risk and interconnectedness within the financial system as well as misperceptions among market participants that such institutions remain "too big to fail".

Recommendation: That the Board approve the issuance of the NPR set forth in the attached *Federal Register* document for a 60-day comment period.

Discussion:

Background

The recent financial crisis demonstrated that some financial companies had grown so large, leveraged, and interconnected that their failure could pose a threat to overall financial stability, as the sudden collapses or near-collapses of major financial companies were among the most destabilizing events of the crisis. As a result of the imprudent risk taking of major financial companies and the severe consequences to the financial system and the economy associated with their disorderly failure, the U.S. government (and many foreign governments in their home countries) intervened on an unprecedented scale to reduce the impact or prevent the failure of these companies and the attendant consequences for the broader financial system.

The residual post-crisis misperception among market participants that some companies remain "too big to fail" poses threats to the financial system. First, it reduces the incentives of

[1] *See*, *infra* note 3 and accompanying text.

shareholders, creditors and counterparties of these companies to discipline excessive risk-taking. Second, it produces competitive distortions because companies perceived as "too big to fail" can often obtain funding at a lower cost and on more favorable terms than other financial institutions. Such distortion creates an unfair economic environment for smaller companies that is damaging to competition and tends to artificially encourage further consolidation and concentration in the financial system.

Accordingly, a major thrust of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 "(Dodd-Frank Act") is to mitigate the threat to financial stability posed by systemically important financial companies.[2] The Dodd-Frank Act addresses this problem with a multi-pronged approach: a new orderly liquidation authority for financial companies (other than banks and insurance companies); the establishment of the Financial Stability Oversight Council empowered with the authority to designate nonbank financial companies for Federal Reserve oversight; stronger regulation of major bank holding companies and designated nonbank financial companies; and enhanced regulation of over-the-counter derivatives, other core financial markets, and financial market utilities. The new regulatory framework established under the Dodd-Frank Act augments and complements the agencies' existing authorities to require banking organizations to maintain capital above the minimum leverage and risk-based capital requirements.

Supplementary Leverage Ratio

In June, 2012, the Board approved for publication in the *Federal Register* three joint interagency notices of proposed rulemaking (the "2012 NPRs") that collectively proposed to strengthen the existing risk-based and leverage capital requirements applicable to all banking organizations in a manner consistent with enhancements to the international capital framework adopted by the Basel Committee on Banking Supervision ("BCBS"), and certain provisions of the Dodd-Frank Act: *Implementation of Basel III, Minimum Regulatory Capital Ratios and Transition Provisions* (the "Basel III NPR"); *Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements* (the "Standardized Approach NPR"); and *Advanced*

[2] Pub. L. 111-203, 124 Stat. 1376 (2010).

Approaches Risk-Based Capital Rules; Market Risk Capital Rules (the "Advanced Approaches NPR"). In addition to the minimum leverage ratio requirement of 4 percent applicable to all banking organizations, the Basel III NPR proposed a minimum requirement of 3 percent of tier 1 capital to total leverage exposure (supplementary leverage ratio) applicable to banking organizations subject to the advanced approaches rule. The supplementary leverage ratio is consistent with the minimum leverage ratio requirement adopted by the BCBS.

In response to the Basel III NPR, the agencies received a number of comments regarding the proposed supplementary leverage ratio. Some commenters encouraged the agencies to increase the minimum supplementary leverage ratio requirement to as high as 8 percent and others supported increases as high as 20-25 percent. Commenters favoring a higher supplementary leverage ratio requirement expressed significant concerns regarding the risk-based capital measures, including their opacity and the potential for error and manipulation, as well as the lack of market confidence in risk-based measures during stress events.

Following the close of the comment period for the 2012 NPRs, the agencies' staffs conducted further analysis regarding the minimum supplementary leverage ratio requirement. This analysis found that an estimated half of the covered banking organizations that were BHCs in 2006 would have met or exceeded a 3 percent minimum supplementary leverage ratio at the end of 2006, and the other half were quite close to the minimum. This suggests that the minimum supplementary leverage ratio requirement would not have placed a significant constraint on the pre-crisis buildup of leverage at the largest banking organizations. Based on their experience during the financial crisis, staff believes that there could be benefits to financial stability and reduced costs to the deposit insurance fund by requiring these banking organizations to meet a well-capitalized standard or capital buffer in addition to the 3 percent minimum supplementary leverage ratio requirement.[3]

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[3] In addition to this NPR, today staff is also seeking the Board's approval to adopt the 2012 NPRs as an interim final rule (the "Basel III Interim Final Rule") that is substantively identical to the final rules being issued by the Federal Reserve and the OCC. Adopting the 2012 NPRs as an interim final rule would allow the FDIC to proceed with the revised implementation of the 2012 NPRs on a unified, expedited basis with the other agencies, pending consideration of this proposal to strengthen the supplementary leverage ratio for covered BHCs and their IDI subsidiaries, as described in the attached *Federal Register* document.

Proposed Rule

Under the attached NPR, covered banking organizations would be subject to enhanced supplementary leverage ratio requirements that apply in addition to the 3 percent minimum supplementary leverage ratio requirement established in the Basel III Interim Final Rule. Specifically, IDI subsidiaries that are part of a covered BHC must satisfy a 6 percent supplementary leverage ratio to be considered well capitalized for purposes of the agencies' PCA regulations. An IDI subsidiary of a covered BHC that fails to satisfy a 6 percent supplementary leverage ratio would not be permitted to accept brokered deposits without a waiver from the FDIC pursuant to section 303.243 of the FDIC's regulations, and could be subject to additional restrictions by its primary Federal supervisor.

In addition, covered BHCs would need to maintain a supplementary leverage ratio of at least 5 percent to avoid conservation buffer limitations on capital distributions and discretionary bonus payments. The proposed leverage capital conservation buffer for the supplementary leverage ratio would follow the general mechanics and structure of the capital conservation buffer for the minimum risk-based capital ratios set forth in the Basel III Interim Final Rule. Therefore, the leverage buffer constraints on capital distributions and discretionary bonus payments would be independent of any constraints imposed by the capital conservation buffer or other supervisory or regulatory measures.

Consistent with the transition provisions set forth in subpart G of the Basel III Interim Final Rule, staff is proposing to require covered banking organizations to comply with the requirements of this NPR beginning on January 1, 2018.

Staff Contacts:

RMS		Legal	
George French	ext. 8-3929	Mark Handzlik	ext. 8-3990
Bobby Bean	ext. 8-6705	Michael Phillips	ext. 8-3581
Ryan Billingsley	ext. 8-3797		
Karl Reitz	ext. 8-6775		