April 8, 2014

MEMORANDUM TO: Board of Directors

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

SUBJECT: *Notice of Proposed Rulemaking to Implement Basel Committee Revisions to the Denominator Measure for the Supplementary Leverage Ratio*

Summary: In August 2013, the FDIC Board of Directors (Board) adopted an interim final rule that comprehensively revised the general risk-based and leverage capital rules for state nonmember banks and state savings associations (FDIC-supervised institutions). The interim final rule is consistent with the international capital standards adopted by the Basel Committee on Banking Supervision (BCBS) in 2010, as set forth in *Basel III: A global regulatory framework for more resilient banks and banking systems* (Basel III), as well as subsequent changes to the Basel III framework and recent BCBS consultative papers. Importantly, the interim final rule introduced a supplementary leverage ratio requirement for FDIC-supervised institutions subject to the advanced internal-ratings based approaches (advanced approaches), consistent with the international leverage ratio for large, internationally active banking organizations under Basel III. In contrast to the longstanding U.S. leverage ratio that was retained under the interim final rule, the supplementary leverage ratio includes certain off-balance sheet items in the denominator measure, total leverage exposure.

Concurrent with the adoption of the interim final rule, the Board approved a joint notice of proposed rulemaking to apply enhanced supplementary leverage ratio requirements to

Concur:

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domestic global systemically important banks (enhanced supplementary leverage ratio standards NPR). Specifically, the enhanced supplementary leverage ratio standards NPR would require certain "covered" bank holding companies (BHCs) to maintain a supplementary leverage ratio capital buffer of 2 percent (in addition to the 3 percent minimum supplementary leverage ratio requirement under the interim final rule and the substantively identical joint final rule adopted by the Board of Governors of the Federal Reserve System and Office of the Comptroller of the Currency (together, with the FDIC, the agencies)). In addition, an insured depository institution (IDI) subsidiary of a covered BHC would be required to maintain a 6 percent supplementary leverage ratio to be considered well capitalized for purposes of the prompt corrective action (PCA) framework.

In January 2014, the Basel Committee on Banking Supervision (BCBS) released various revisions to the denominator measure for the Basel III leverage ratio, in a publication entitled, *Basel III leverage ratio framework and disclosure requirements* (BCBS 2014 revisions). If it is approved, the attached notice of proposed rulemaking (NPR, proposed rule, or proposal) would revise the denominator measure for the supplementary leverage ratio in a manner consistent with the BCBS 2014 revisions and introduce related public disclosure requirements. The revisions set forth in the proposal would apply to all advanced approaches banking organizations, including those that would be subject to the enhanced supplementary leverage ratio standards NPR.[1]

Recommendation: That the Board issue the attached proposed rule and authorize its publication in the *Federal Register* with a public comment period of 60 days following the date of publication.

Discussion:

Background

In 2013, the agencies comprehensively revised and strengthened their respective regulatory capital frameworks (2013 revised capital rule).[2] Among other provisions, the 2013

[1] Today, staff also is seeking the Board's approval to adopt as final the enhanced supplementary leverage ratio standards NPR and the interim final rule.

[2] The Board and the OCC issued a joint final rule on October 11, 2013 (78 FR 62018) and the FDIC issued a substantially identical interim final rule on September 10, 2013 (78 FR 55340). Today, staff will also seek the Board's approval to adopt as final the interim final rule.

revised capital rule introduced a supplementary leverage ratio, defined as the ratio of tier 1 capital to total leverage exposure. In contrast to the generally applicable leverage ratio that has long applied to U.S. IDIs, the supplementary leverage ratio includes certain off-balance sheet exposures in the denominator measure. The 2013 revised capital rule applies the supplementary leverage ratio to IDIs and bank and savings and loan holding companies that are subject to the advanced approaches risk-based capital rules (advanced approaches banking organizations), and establishes a minimum supplementary leverage ratio requirement of 3 percent. Although the supplementary leverage ratio was generally consistent with the Basel III leverage ratio when the 2013 revised capital rule was adopted, the agencies indicated in the preambles to the 2013 revised capital rule and the enhanced supplementary leverage ratio standards NPR that they would consider whether subsequent BCBS revisions to the Basel III leverage ratio are appropriate for implementation in the United States, as revisions to the supplementary leverage ratio (through notice and comment rulemaking).

In January 2014, the BCBS adopted the BCBS 2014 revisions,[3] which are intended to better capture a banking organization's economic exposure to its off-balance sheet activities. For example, under the BCBS 2014 revisions, a banking organization that provides credit protection in the form of a derivative or other similar instrument must include in the denominator a measure of its exposure to the underlying reference entity. For repo-style transactions, the BCBS 2014 revisions strengthen the criteria for recognizing the offsetting effects of multiple repo-style transactions with a single counterparty. Similarly, with respect to derivative contracts, the BCBS 2014 revisions clarify the treatment of cash variation margin exchanged between counterparties, and permit a banking organization to reduce the exposure measure for derivative contracts only where certain requirements are satisfied. Such requirements are generally consistent with the requirements under U.S. generally accepted accounting principles (GAAP) for the recognition of cash collateral in determining the mark-to-market value of a derivative contract.

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[3] See BCBS, "Basel III leverage ratio framework and disclosure requirements" (January 2014), available at http://www.bis.org/publ/bcbs270.htm. See also BCBS, "Revised Basel III leverage ratio framework and disclosure requirements - consultative document" (June 2013), available at http://www.bis.org/publ/bcbs251.htm.

Other aspects of the BCBS 2014 revisions may offset increases in leverage capital requirements resulting from the provisions described above. For example, the revisions would permit a banking organization to measure the notional amount of its off-balance sheet exposures (not including exposures arising from repo-style transactions and derivatives) using the credit conversion factors (CCFs) set forth in the standardized approach for risk-weighted assets, subject to a minimum CCF of 10 percent.[4] In addition, the revisions would clarify the exposure calculation for a clearing member banking organization with regard to cleared derivative contracts that are intermediated on behalf of a client with a central counterparty, to ensure that the banking organization is not required to hold leverage capital for the portion of the transaction to which it has no economic exposure.

The BCBS 2014 revisions also set forth public disclosure requirements for the Basel III leverage ratio. Specifically, a banking organization must publicly disclose any differences between its total assets under the U.S. GAAP (or the accounting standards relevant to the banking organization) and its denominator measure under the Basel III leverage ratio, as well as additional information regarding the components of the denominator measure. The public disclosures are intended to improve transparency and market discipline by ensuring that information regarding a banking organization's Basel III leverage ratio is provided in a comparable and consistent manner.

Proposed Rule

Summary of the proposed requirements:

The attached NPR would seek public comment on proposed revisions to the denominator for the supplementary leverage ratio that are generally consistent with the BCBS 2014 revisions, related public disclosure requirements, as well as revisions to the methodology for calculating total leverage exposure. Staff believes the proposed revisions would require banking organizations to more appropriately capture the economic exposure of their off-balance sheet activities for purposes of the supplementary leverage ratio. Moreover, the proposed rule would

[4] The Basel III leverage ratio previously required banking organizations to assign a 100 percent CCF to the notional amount of all off-balance sheet items.

ensure consistency across internationally active banking organizations, in keeping with the objectives of the BCBS 2014 revisions, and respond to certain comments raised during the public comment period for the enhanced supplementary leverage ratio standards NPR.

Specifically, under the proposed rule and consistent with the 2013 revised capital rule, total leverage exposure would continue to include the following items:

- The balance sheet carrying value of all of a banking organization's on-balance sheet assets, less amounts deducted from tier 1 capital;
- The off-balance sheet amount of a banking organization's derivative contracts, as determined under the standardized approach for risk-weighted assets in the 2013 revised capital rule, without regard to any collateral that may be recognized under the 2013 revised capital rule to reduce the exposure amount for such derivatives; and
- 10 percent of the notional amount of any unconditionally cancellable commitment of the banking organization.

In addition, consistent with the BCBS 2014 revisions, the proposed rule would require a banking organization to <u>include</u> in total leverage exposure:

- Any cash collateral that is received from, or posted to, a counterparty to a derivative contract, except for cash variation margin that meets certain requirements that are consistent with the requirements under U.S. GAAP for the recognition of cash collateral in determining the mark-to-market value of a derivative contract;
- A measure of the banking organization's exposure to the reference entity for a credit derivative (or other similar instrument) under which the banking organization provides credit protection. The proposed rule would permit the banking organization to offset its exposure to the reference entity by protection purchased on the same underlying reference entity, provided that certain conditions are satisfied;

- The amount of any adjustment (under GAAP) to accounting assets for repo-style transactions that do not meet certain conditions designed to ensure that the adjustment is appropriate and reflective of the banking organization's economic exposure;
- A measure of counterparty credit risk for repo-style transactions; and
- The notional amount of all other off-balance sheet exposures (excluding securities lending, securities borrowing, reverse repurchase transactions, derivatives and unconditionally cancellable commitments) multiplied by the appropriate credit conversion factor under the standardized approach for risk-weighted assets, and as set forth in section 33 of the 2013 revised capital rule. However, for purposes of determining total leverage exposure, the minimum credit conversion factor that may be assigned to an off-balance sheet exposure is 10 percent.

Consistent with the BCBS 2014 revisions, the proposal would clarify the calculation of total leverage exposure for a clearing member bank with regard to cleared derivatives contracts that are intermediated on behalf of a client with a central counterparty (CCP). Specifically, where a clearing member banking organization does not guarantee the performance of the CCP, it would not be required to include in total leverage exposure the exposure amount of any derivatives transaction between the banking organization and the CCP. This treatment would recognize that, in such a situation, the clearing member banking organization has no payment obligation to the client in the event of a CCP default.

In response to comments received in connection with the enhanced supplementary leverage standards NPR, the proposed rule would also revise the calculation of the supplementary leverage ratio to address concerns regarding sudden substantial deposit inflows that some banking organization experience at the end of reporting periods or during times of financial stress. Specifically, under the proposal, a banking organization would calculate the total leverage exposure as the simple arithmetic mean of the total leverage exposure amount calculated each day of the reporting quarter.[5]

[5] Under the 2013 revised capital rule, a banking organization must calculate total leverage exposure as the simple arithmetic mean of the total leverage exposure amount calculated as of the last day of each month in the reporting quarter.

Capital impact of the proposal:

Supervisory estimates suggest that the proposed total leverage exposure measure would exceed the total leverage exposure measure under the 2013 revised capital rule by approximately 8 percent, on average, for the eight bank holding companies that would be subject to the enhanced supplementary leverage ratio standards. Therefore, if the NPR is adopted as a final rule, these institutions would need to raise an additional $47 billion in tier 1 capital to meet the 5 percent enhanced supplementary leverage ratio standard (relative to the amount of tier 1 capital that would be required to meet this standard in the absence of these proposed changes).

For other advanced approaches banking organizations that would not be subject to the enhanced supplementary leverage ratio standards, supervisory data suggests that the proposed total leverage exposure amount may decrease by approximately 8 percent compared to the total leverage exposure under the 2013 revised capital rule. This decrease is a result of reductions in the credit conversion factors associated with off-balance sheet items and the absence of significant exposure to credit derivatives. These advanced approaches banking organizations currently meet a 3 percent supplementary leverage ratio requirement calculated under both the 2013 revised capital rule's definition of total leverage exposure and under the definition proposed in this proposal.

<u>Conclusion</u>

FDIC staff recommends that the FDIC Board adopt the attached NPR and authorize its publication in the *Federal Register* for a 60-day comment period.

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