Supplementary Leverage Ratio Standards: An Update

April 22, 2014

On April 8, 2014, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency approved standards for the supplementary leverage ratio ("SLR"), consisting of three parts:

- Final rules on the enhanced SLR for the largest U.S. top-tier bank holding companies and their insured depository institution subsidiaries;
- Proposed rules modifying the definition of "total leverage exposure" (the denominator of the SLR) for all advanced approaches banking organizations;[1] and
- Proposed rules revising the definition of "eligible guarantee" for the mitigation of credit risk exposure under the advanced approaches risk-based capital rules.

These standards supplement and revise the banking agencies' final rules from July 2013 implementing capital standards under Basel III and the Dodd-Frank Act.[2]

A. THE ENHANCED SLR FOR THE EIGHT U.S. GLOBALLY SYSTEMICALLY IMPORTANT BANKS

The final rules implement an "enhanced" SLR for any U.S. top-tier bank holding company with more than $700 billion in total consolidated assets (as reported on its most recent FR Y-9C filing) or more than $10 trillion in assets under custody (as reported on its most recent FR Y-15 filing) and its insured depository institution subsidiaries. Under these criteria, there are currently eight U.S. bank holding companies covered by the final rules, all of which have been designated as globally systemically important banks based on methodology endorsed by the Basel Committee on Banking Supervision.[3]

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[1] Advanced approaches banking organizations are generally bank holding companies, savings and loan holding companies, and insured depository institutions with consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion. They also include banking organizations that, while not meeting such thresholds, have elected to use the advanced approaches methodology to calculate their risk-weighted assets or are subsidiaries of advanced approaches banking organizations.

[2] For a summary of the July 2013 capital rules, please see our memorandum titled, "Federal Reserve Adopts Final U.S. Bank Capital Standards Under Basel III," dated July 8, 2013, *available at* http://www.stblaw.com/about-us/news/details?id=55abe6b4-d81a-4e3c-9cb4-7fd02835c9eb.

[3] The eight U.S. covered institutions are Bank of America, The Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo. *See* Financial Stability Board, *2013 Update of Group of Global Systemically Important Banks (G-SIBs)* (Nov. 11, 2013), *available at* http://www.financialstabilityboard.org/publications/r_131111.pdf.

The enhanced SLR is intended to address U.S. concerns, including those expressed by Federal Reserve Board Governor Daniel K. Tarullo last year,[4] over the adequacy of the 3% minimum SLR for global institutions under the international Basel III accord. In general, the final rules require that a covered bank holding company must have an enhanced SLR *exceeding* 5%—comprised of the 3% minimum SLR applicable to all advanced approaches banking organizations and an additional 2% leverage buffer—to avoid limitations on capital distributions and discretionary bonus payments.[5] Restrictions on distributions or bonus payments are based on a sliding scale depending on the institution's SLR calculated as of the last day of the previous calendar quarter:

Leverage Buffer Above 3% Minimum SLR	Maximum Leverage Payout Ratio
> 2.0%	No limitation
2.0% ≥ X > 1.5%	60%
1.5% ≥ X > 1.0%	40%
1.0% ≥ X > 0.5%	20%
≤ 0.5%	0%

The maximum leverage payout ratio is the percentage of eligible retained income[6] that a covered bank holding company may pay out, or create an obligation to pay out, in capital distributions and discretionary bonus payments for the current quarter.

Additionally, any insured depository institution subsidiary of a covered bank holding company must have an SLR of at least 6% to be "well capitalized" under the banking agencies' prompt corrective action framework. Under the July 2013 capital rules, all insured depository institutions subject to the advanced approaches risk-based capital rules must have an SLR of at least 3% to be "adequately capitalized."

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4 Daniel K. Tarullo, *Evaluating Progress in Regulatory Reforms to Promote Financial Stability* (May 3, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20130503a.htm; *Opening Statement at Open Board Meeting* (July 2, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/tarullo20130702a.htm.

5 The SLR is calculated by dividing a banking organization's Tier 1 capital by its total leverage exposure. The term "total leverage exposure" incorporates, among other things, the notional amount of certain off-balance sheet exposures (such as 10% of the notional amount of unconditionally cancellable commitments made by the banking organization and the potential future exposure amount for derivative contracts) in addition to on-balance sheet assets.

6 Eligible retained income is a banking organization's net income (as reported in the banking organization's quarterly regulatory reports) for the four calendar quarters preceding the current calendar quarter, net of any capital distributions and associated tax effects not already reflected in net income.

Consistent with the minimum SLR under the July 2013 capital rules, the enhanced SLR will take effect beginning January 1, 2018.[7]

B. REVISED SLR STANDARDS FOR ADVANCED APPROACHES INSTITUTIONS

The banking agencies also issued proposed rules applicable to all advanced approaches institutions that revise the definition of "total leverage exposure" (the denominator of the SLR), and require disclosure of the SLR in a common format. The proposed rules would conform U.S. capital rules to revised Basel III leverage ratio standards that the Basel Committee finalized in January 2014,[8] subsequent to the banking agencies' release of the July 2013 capital rules.

Under the July 2013 capital rules, the SLR for a reporting quarter is calculated as the average of three month-end balances of the SLR. The proposed rules would change that methodology to calculate (i) Tier 1 capital as of the last day of each reporting quarter, which is consistent with the generally applicable leverage ratio, and (ii) total leverage exposure as the arithmetic mean of the total leverage exposure for each day of the reporting quarter. In the preamble to the proposed rules, the banking agencies noted that the move to a daily average of total leverage exposure is intended to limit the ability of banking organizations to artificially increase their SLR by temporarily inflating their balance sheet assets at the end of a reporting quarter by, for example, receiving a large inflow of deposits.

The proposed rules would also make a number of changes to the exposures included in total leverage exposure, including, among other changes:

- *Sold Credit Protection*—The notional principal amount of a sold credit derivative would be included in total leverage exposure, but may be reduced, subject to certain conditions, by any reduction in fair value recognized in common equity Tier 1 capital and by the notional amount of any purchased credit protection on the same reference name with an equal or greater maturity.

- *Credit Conversion Factors*—Standard risk-based capital credit conversion factors, rather than a uniform 100% credit conversion factor as under the July 2013 capital rules, would be applied to off-balance sheet items.

- *Cash Variation Margin*—The exposure amount of a derivative contract may only be reduced by the amount of cash collateral received from counterparties if the cash variation margin satisfies certain requirements. Under the July 2013 capital rules, the exposure amount of a derivative is the GAAP carrying value, which may reflect a more lenient netting of cash variation margin than the proposed rules.

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[7] Although SLR and enhanced SLR compliance does not commence until 2018, all advanced approaches banking organizations are required to calculate and report their ratios in the first quarter of 2015. As noted in Section B of this memorandum, SLR-related disclosure is expected to be made on a common template.

[8] Basel Committee, *Basel III Leverage Ratio Framework and Disclosure Requirements* (Jan. 2014), *available at* http://www.bis.org/publ/bcbs270.htm.

- *Repo-style Transactions*—The exposure amount of a repo-style transaction, defined as a repurchase or reverse repurchase transaction or a securities borrowing or securities lending transaction, which under the July 2013 capital rules was the GAAP balance sheet carrying value of such exposure (including all offsets to such exposure), may only reflect the GAAP option to offset certain gross accounting assets by the amount of payments due to a counterparty under certain specified circumstances. A securities lender would also be allowed to adjust its on-balance sheet assets in security-for-security transactions when it does not re-hypothecate or resell securities received as collateral. Additionally, total leverage exposure would include a measure of counterparty credit risk.

The proposed rules would require disclosure of the SLR beginning January 1, 2015, using a new common disclosure template adopted by the Basel Committee.

C. REVISED DEFINITION OF ELIGIBLE GUARANTEE

The banking agencies also adopted proposed rules that would revise the definition of "eligible guarantee" for purposes of the advanced approaches risk-based capital rules, which allow a banking organization to mitigate its credit risk exposure with an eligible guarantee. The proposed rules would remove the July 2013 capital rules' requirement that an eligible guarantee be provided by an eligible guarantor[9] for exposures that are not securitizations. Accordingly, the proposed rules would allow banking organizations to more easily mitigate credit risk exposures by obtaining guarantees from guarantors that do not qualify as eligible guarantors.

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[9] Eligible guarantors include sovereigns, certain international organizations, certain U.S. government-sponsored entities, banking organizations, qualifying central counterparties, and qualifying entities with investment grade unsecured debt outstanding.

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