Simpson Thacher

Memorandum

Federal Banking Agencies Issue Proposed Rules to Increase Bank Capital Requirements

July 28, 2023

On Thursday, July 27, 2023, the federal banking agencies (the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation) issued long-anticipated proposed changes to the regulatory capital requirements for banks and bank holding companies. The proposed rulemaking is the culmination of a "holistic review" of U.S. capital standards initiated by Federal Reserve Vice Chair Barr shortly after his Senate confirmation, as well as months of public speeches and testimony from Vice Chair Barr, Michael Hsu, Acting Comptroller of the Currency, and Martin Gruenberg, Chairman of the FDIC, stating their support for stronger capital and liquidity requirements and implementation of the changes adopted by the Basel Committee on Banking Supervision in 2017.

At over 1,000 pages, the proposed rules will take some time to fully digest, but there are a few things we can immediately highlight:

- Basel III: As signaled by Vice Chair Barr in his July 10th speech (see our previous memo), the proposed rules would largely implement "Basel III endgame" standards to more fully reflect credit, trading and operational risk in the calculation of minimum regulatory capital ratios. This includes risk weightings for various asset classes (particularly real estate) with higher degrees of granularity and risk sensitivity. The proposal also eliminates the use of most internal modeling and third-party ratings by banking organizations. As a result, the proposed rules are dense, complicated and dependent on formulas developed by agency staff that have not been applied in practice by any banking organization.
- Expanded Application:
    - The proposed rules would apply an "expanded" risk-based approach to risk-weighted asset calculations to all banking organizations with total assets of $100 billion or more. This would represent a significant expansion of the applicability of the most risk-sensitive capital rules for Category III and IV banking organizations as compared to the current framework.
    - The proposed rules would eliminate the ability of all banking organizations with total assets of $100 billion or more to exclude accumulated other comprehensive income (AOCI) from regulatory capital.
    - The revised requirements for market risk would apply to all banking organizations (regardless of asset size) with $5 billion or more in trading assets plus trading liabilities or for which trading assets plus trading liabilities exceed 10% of total assets.

- The proposal would expand application of the supplementary leverage ratio and the countercyclical capital buffer to Category IV banking organizations.

As a result, the proposed rules would largely undo major parts of the "tailoring rules" adopted in 2019 in response to bipartisan legislation. The proposed rules do not cover requirements for enhanced loss-absorbing capital and long-term debt. The regulators have already signaled an intention to propose changes to those requirements in a separate rulemaking to come.

- Dual Stack: The proposed rules maintain the current dual stack system for calculating capital for the largest banking organizations and, as noted above, expand its application to all banking organizations with total assets of $100 billion or more. Similar to the current method (and based on the "Collins Amendment"), banking organizations would calculate their risk-based capital ratios based on the proposed expanded risk-based approach as well as the standardized approach, and use the lesser of the two for each ratio. Capital buffers would continue to apply regardless of which approach yields the lower risk-based capital ratio.
- Transition Periods: The proposed rules provides a lengthy transition period, which may or may not be adjusted depending on how long it takes the agencies to finalize the rules.
  - A banking organization's expanded total risk-weighted asset calculations would be subject to a phase-in period starting July 1, 2025, until June 30, 2028.
  - Category III and IV banking organizations would have a similar phase-in period for making the required AOCI adjustments.
  - Banking organizations not currently subject to Category I, II, III, or IV standards that become subject to Category I, II, III, or IV standards during the proposed transition period, would be eligible for the remaining time contemplated by the transition provisions. However, beginning January 1, 2028, the proposed rules provide no transition period for banking organizations that become subject to Category I, II, III, or IV standards.
- GSIB Surcharge and Systemic Risk Report (Y-15): The Federal Reserve separately approved a proposed rulemaking that would adjust the GSIB surcharge scoring methodology to measure systemic risk indicators on a full-year average basis (rather than only as of year-end) and modify the reporting methodology for several systemic risk factors. The proposal also would adjust method 2 surcharge calculations in 10-basis point increments instead of the current 50-basis point increments (to reduce "cliff effect" changes in an organization's surcharge). The Federal Reserve also requested comments on some possible scenarios that would adjust the time for an increase in a banking organization's GSIB surcharge to take effect following the calculation date. The proposed rule also makes a variety of changes to what is included in each systemic indicator category for the Systemic Risk Report (Y-15).
- Comment Period: The proposed rules will be open for public comment until November 30, 2023.

Federal Reserve Governors Michelle Bowman and Christopher Waller did not support issuing the proposed rulemaking on risk-based capital. Travis Hill, Vice Chairman of the FDIC, and Jonathan McKernan, Director of

the FDIC, also opposed issuance of the proposed capital rules. In their public statements, both Governors Bowman and Waller heavily criticized the content and purpose served by rulemaking, suggesting that there is "insufficient evidence that the benefits produced by this proposal would justify the costs." The Governors also pointed out that the current overall capital structure in the U.S. is "gold plated" and the proposed rules go even further beyond international standards. Governor Bowman specifically noted that overly focusing on standalone capital elements distracts from whether the aggregate amount of capital held by banking organizations is appropriate.

Even Federal Reserve Chair Powell, while supporting publication of the proposed rules, expressed interest in public comment on whether the higher costs from increased capital requirements would unduly increase the cost of, or reduce access to, credit as well as threaten a decline in critical market liquidity (and movement of these activities into the "shadow banking sector"). He also noted the need to "strike the right balance" on heightened regulation for $100-$250 billion institutions.

There will be substantial debate and comment volume related to this proposal. Members of Congress and a number of industry groups have been vocally opposed to a one-size-fits all approach to the supervision of banking organizations, including with respect to capital and liquidity requirements. Given the long public comment period, the number of requests for comments within the rules, the rules' complexity, as well as the proposed transition periods, we would not expect any final changes to regulatory capital requirements to take effect for several years. However, it is likely that some banking organizations will increase capital levels and/or modify aspects of their operations in anticipation of the full implementation of the rules. It is also possible that the proposed rules will spur a new wave of mid-sized bank mergers as banks seek greater scale to offset the additional capital, liquidity and compliance costs.

For further information regarding this memorandum, please contact any member of the Firm's Financial Institutions Group, including those listed below.

NEW YORK CITY

Lee A. Meyerson
+1-212-455-3675
lmeyerson@stblaw.com

Spencer A. Sloan
+1-212-455-7821
spencer.sloan@stblaw.com

WASHINGTON, D.C.

Amanda K. Allexon
+1-202-636-5977
amanda.allexon@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.