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'Holistic' review yields potential significant changes to bank capital

Expected new requirements for banks above the $100B threshold

On July 10, 2023, the Federal Reserve Board of Governors' (FRB) Vice Chair for Supervision Michael Barr (Vice Chair Barr) previewed upcoming changes to the existing capital framework that are expected to be part of the long-awaited Basel III Endgame rules.[1] One of Vice Chair Barr's first initiatives after his confirmation was a "holistic review of capital" that served to inform several of the proposed Basel III reforms.[2] Vice Chair Barr continued to signal significant changes over the subsequent months.[3] While many of the changes that will be reflected in the Basel III reforms are not directly linked to the recent bank failures, these events have reinforced the need for regulatory capital reform and renewed thinking about systemic risk.

The enhanced capital rules will be proposed to be applicable at the $100 billion total asset threshold level and above, which will include a subset of large regional banks.[4] Based upon financial data as of Q1 2023, this group above $100 billion includes 27 banks.[5] The majority of newly applicable requirements would fall on Category III and Category IV banks (banks above the $100 billion Category IV threshold, but below the $700 billion Category II threshold).

Vice Chair Barr specifically mentioned two ways that capital requirements should be different for larger regional banks (>$100B): (1) changing the treatment of unrealized gains and losses on securities, which could require these gains/losses to be realized in advance of the sale of the security, and (2) the imposition of long-term debt requirements, which would serve to assist with loss absorption. These larger regional banks would also face new standardized risk-based approaches for operational risk, and increased standards for credit and trading risk, per the Vice Chair's remarks.

The proposed rulemaking is expected to be phased-in after a notice and comment period. Vice Chair Barr estimated that many banks already have enough capital to meet the new requirements, and for those that do not, it can be built up within two years, even while maintaining dividends.

Our initial takeaways for banks include the following:

- **Net new requirements:** These new requirements for Category III and IV banks would include a) a long-term debt requirement, b) operational risk-based capital requirements under a standardized approach, and c) no longer being able to opt out of accumulated other comprehensive income (AOCI).

- **Stress testing framework largely unchanged:** The FRB's stress testing framework "generally remains sound." The FRB will evaluate comments on the proposed risk-based capital adjustments and evaluate their treatment within the stress tests.

- **Scaling back reliance on internal models for regulatory capital:** As the Basel III Endgame moves from internal models to standardized models, it will be "less burdensome" for banks (especially smaller banks) to implement the standardized approach.

- **Changes in methodology:** In addition to standardized approaches for risk-based capital, the new framework would adopt small changes in methodology to stress testing, the globally systemically important bank (G-SIB) surcharge (for US G-SIBs).

Current capital requirements and potential impacts of proposals[6]

LEGEND: Currently applicable with no changes | Currently applicable with changes to methodology | Newly applicable

<table>
<tr><th colspan="2" rowspan="2">Capital regulations</th><th>Category I</th><th>Category II</th><th>Category III</th><th>Category IV</th><th>Other firms</th><th rowspan="2">Potential impacts</th></tr>
<tr><th>US G-SIBs</th><th>≥$700B total assets or ≥$75B cross jurisdictional activity</th><th>≥$250B total assets or ≥$75B in nonbank assets, wSTWF or OBS exposure</th><th>Other firms with $100B to $250B total assets</th><th>$50B to $100B total assets</th></tr>
<tr><td>Long-term debt</td><td>Long-term debt</td><td></td><td></td><td></td><td></td><td></td><td>The FRB is expected to introduce a long-term debt requirement for all large banks greater than $100B.</td></tr>
<tr><td rowspan="3">Stress testing</td><td>Stress testing: Company run (DFAST)</td><td colspan="2">(Annual)</td><td>(Every two years)</td><td></td><td></td><td rowspan="3">The FRB will review the global market shock and the stress tests’ approach to estimating operational risk. In addition, the board could use a range of exploratory scenarios to assess bank’s resilience to an evolving set of risks.</td></tr>
<tr><td>Stress testing: Supervisory</td><td colspan="3">(Annual)</td><td>(Every two years)</td><td></td></tr>
<tr><td>Stress capital buffer</td><td colspan="3">(Calculated annually)</td><td>(Calculated every two years)</td><td></td></tr>
<tr><td rowspan="6">Risk-based requirements</td><td>Credit risk</td><td></td><td></td><td></td><td></td><td></td><td rowspan="3">The FRB would update the principles used to calculate risk-weighted assets for banks above the $100B threshold, which would impact the total capital required.</td></tr>
<tr><td>Trading risk</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Operational risk</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>No opt-out of AOCI capital impact</td><td></td><td></td><td></td><td></td><td></td><td>The FRB is expected to require banks above the $100 billion threshold to account for unrealized losses and gains in available-for-sale (AFS) securities when calculating regulatory capital.</td></tr>
<tr><td>G-SIB surcharge</td><td></td><td></td><td></td><td></td><td></td><td>The FRB is expected to make minimal changes and technical adjustments to match a bank’s systemic footprint. First, the proposal would measure on an average basis over the full year the indicators that are currently measured only as of year-end. Second, it would reduce “cliff effects” in the G-SIB surcharge by measuring in 10-basis point increments (versus 50 bps currently). Third, it would make improvements to some systemic indicators to better align them with risk.</td></tr>
<tr><td>Countercyclical Buffer (CCyB)</td><td></td><td></td><td></td><td></td><td></td><td>The FRB is not planning changes to the CCyB and will call for activation if necessary (including lowering as in COVID-19 crisis).</td></tr>
<tr><td>Leverage capital</td><td>Supplementary leverage ratio</td><td>(Enhanced)</td><td></td><td></td><td></td><td></td><td>The FRB is expected to not change the calibration of the enhanced supplementary leverage atio (eSLR) at this time. Proposed changes in the capital framework will not act as a binding constraint at the holding company level, where Treasury intermediation occurs.</td></tr>
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* wSTWF: Weighted short-term wholesale funding; OBS: Off-balance sheet

Expected upcoming changes to risk-based requirements for applicable institutions

An important aspect of the expected proposed reforms will be for banks to implement the changes to the risk-based capital requirements, which are intended to ensure that banks hold adequate capital against their risk-taking.

Credit risk: The proposed rules would end the practice of using internal models and estimates in favor of a standardized approach.

Applicability: Categories I-IV (all banks above the $100 billion threshold).

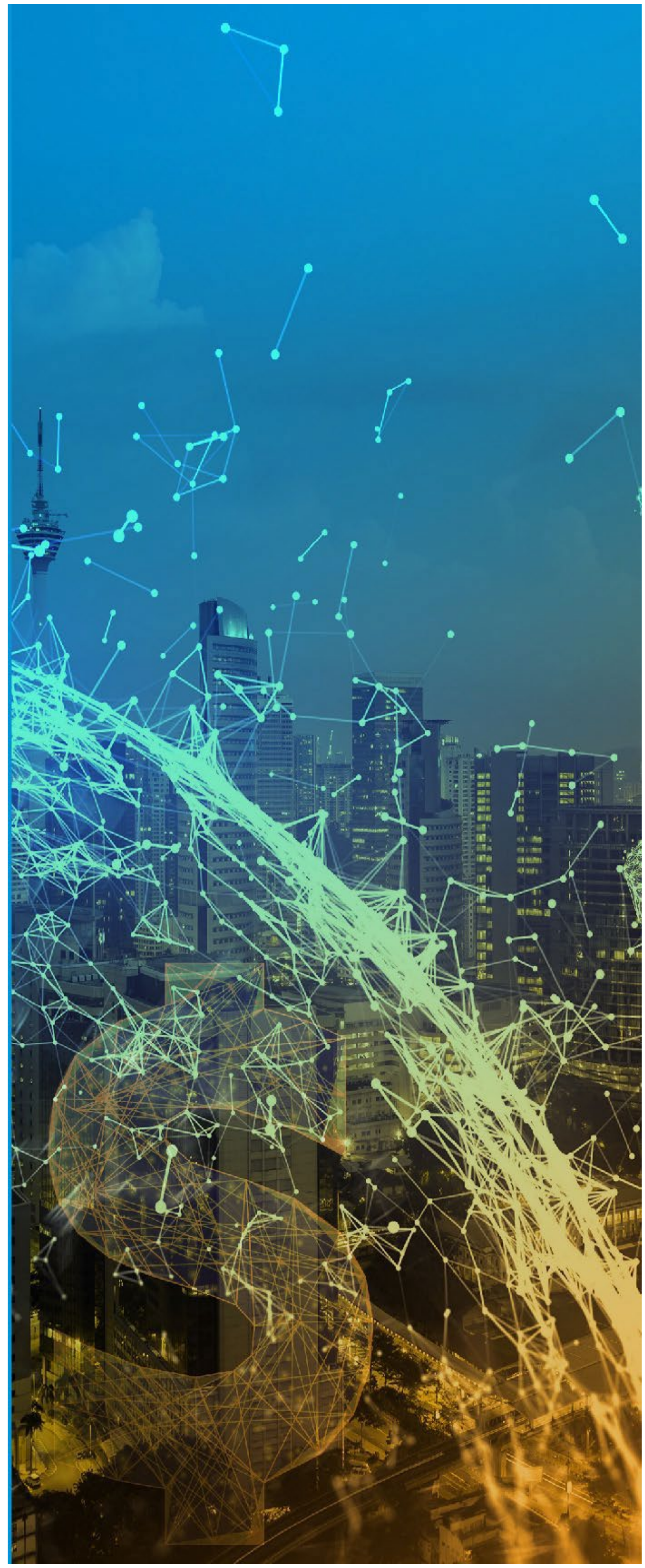
Trading risk: The proposed rules would adjust the way a firm measures market risk (interest rate, equity price, foreign exchange, and commodities risk). The changes would align market risk capital requirements with market risk exposure, permit firms to use internal models for most risks (but not all, especially risks that are hard to model), raise model quality standards, require firms to model risk at the trading desks of particular asset classes (instead of the firm level), and introduce a standardized approach.

Applicability: Categories I-IV (based on trading book size).

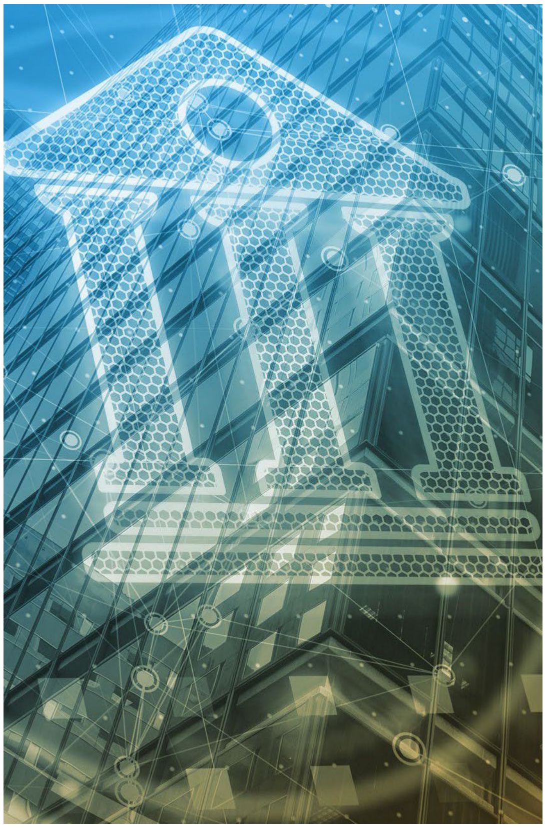
Operational risk: The proposed rules would replace the internal modeled operational risk requirement with a standardized measure, approximating the charge based on the firm's activities, and adjust upward based on historical operational losses to add sensitivity and provide an incentive to mitigate their operational risk.

Applicability: Currently only applicable to Categories I-II, and will be newly applicable to Categories III-IV.

Per Vice Chair Barr's remarks, these changes are expected to increase capital requirements overall, but would most impact the largest, most complex banks.[7] The increase will be equivalent to requiring the largest banks holding an additional two percentage points of capital, or an additional $2 of capital for every $100 of risk-weighted assets.



Final changes to be phased in



Consistent with prior statements from the other federal prudential banking regulators, Vice Chair Barr noted that any final changes will come with a sufficient implementation runway or transition period. However, discussion amongst industry stakeholders following Vice Chair Barr's remarks revealed concerns about the regulators having significant flexibility before the final changes are set forth. One suggestion was to issue an advanced notice of proposed rulemaking (ANPR) of the Basel III Endgame proposal along with a full quantitative impact study, similar to the approach taken for the issuance of Basel II.

In addition, the FRB was encouraged to issue the results of its holistic capital review for public comment. This would seemingly allow the public to draw linkages between the outcomes of the review and the proposed changes set forth in Basel III reforms.

Discover our latest perspectives on what recent developments could mean and what measures can be taken to gain a competitive advantage, drive growth, and increase profitability while also protecting the organization's assets from potential losses and risks.

Endnotes

1. Board of Governors of the Federal Reserve System (FRB), "Holistic capital review," speech by Vice Chair Barr, July 10, 2023.
2. FRB, "Making the financial system safer and fairer," speech by Vice Chair Barr, September 7, 2022.
3. FRB, "Why bank capital matters," speech by Vice Chair Barr, September 7, 2022.
4. Deloitte, "Federal Reserve Board finalizes tailoring prudential standards for large banking institutions," October 21, 2019; Deloitte, "Federal Reserve Board finalized tailoring prudential standards for foreign banking organizations," October 21, 2019.
5. Federal Financial Institutions Examination Council (FFIEC), "Large holding companies," March 31, 2023.
6. Deloitte, "Federal Reserve Board finalizes tailoring prudential standards for large banking institutions," October 21, 2019; Deloitte, "Federal Reserve Board finalized tailoring prudential standards for foreign banking organizations," October 21, 2019.
7. FRB, "Holistic capital review," speech by Vice Chair Barr, July 10, 2023.

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