Treasury Report on Regulatory Reform: Key Recommendations and Initial Regulatory Responses on Capital, Stress Testing and Liquidity

July 14, 2017

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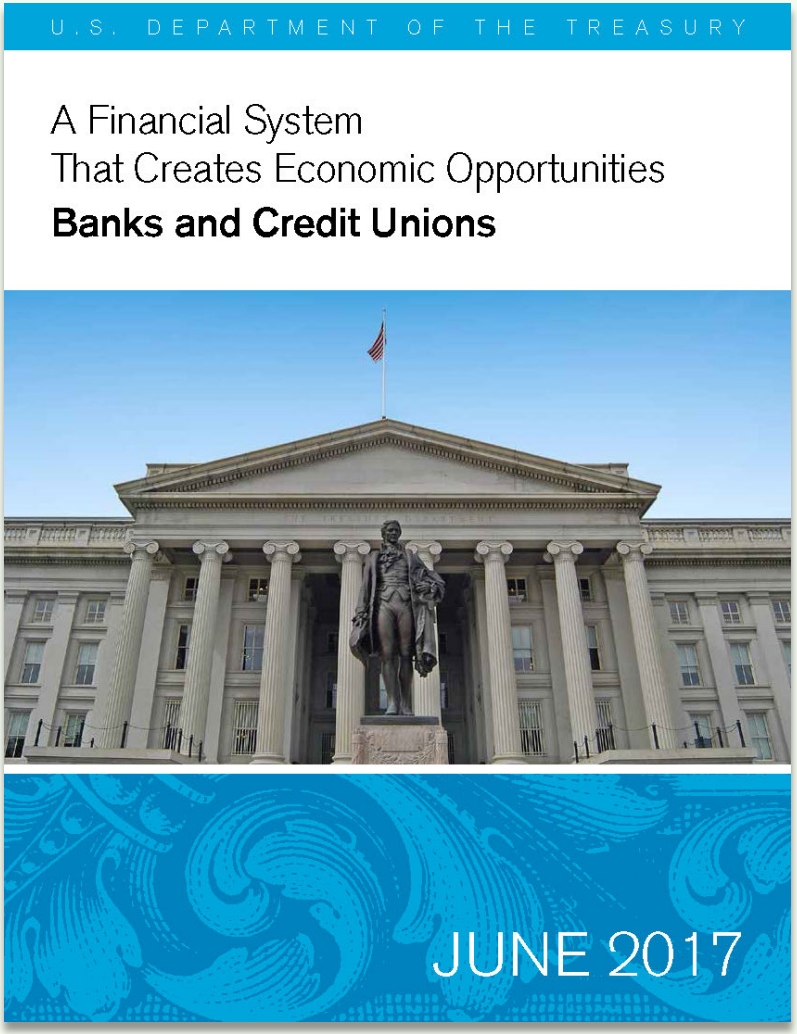
Introduction

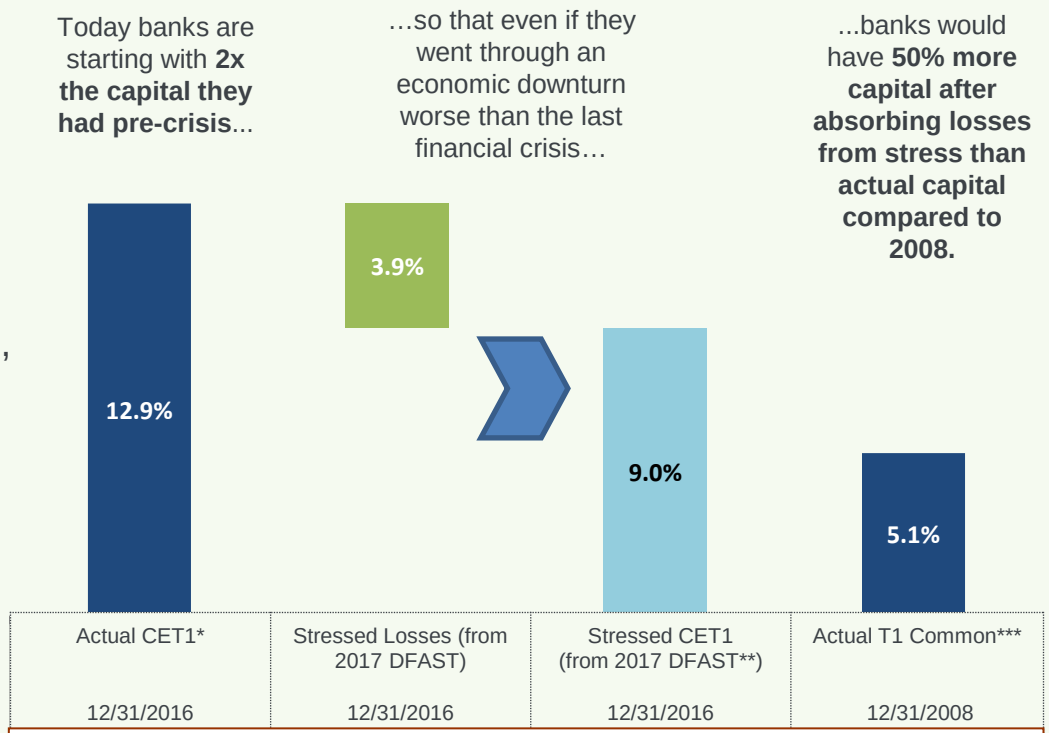
- On June 12, 2017, the U.S. Department of the Treasury ("**U.S. Treasury**") published "A Financial System that Creates Economic Opportunities: Banks and Credit Unions" (the "**Report**"), the first of what will be several U.S. Treasury reports in accordance with President Trump's February 3 Executive Order on Core Principles for Regulating the U.S. Financial System.
- The Report focuses on the U.S. depository system and covers many potential banking regulation reforms, making several recommendations related to capital, stress testing and liquidity requirements.
- This visual memorandum summarizes the U.S. Treasury's recommendations with respect to capital, stress testing and liquidity reforms and provides additional analysis and context.
  - Our analysis includes consideration of subsequent public statements of principals of the U.S. banking agencies, including the July 12-13, 2017 Congressional testimony of Federal Reserve Chair Janet Yellen and the June 22, 2017 Senate Banking Committee testimony of Federal Reserve Governor Jerome H. Powell, Acting Comptroller of the OCC Keith Noreika, FDIC Chairman Martin J. Gruenberg, Acting Chairman of the NCUA J. Mark McWatters and Texas Department of Banking Commissioner and member of the Conference of State Bank Supervisors Charles G. Cooper.



Introduction

- The Report recommends many important changes to U.S. capital, stress testing and liquidity requirements based on the Core Principles.
- The Report recognizes the importance of capital and liquidity requirements in maintaining the safety and soundness of the U.S. financial system and preventing taxpayer-funded bailouts.
- The capital and liquidity recommendations are not designed to weaken the quantitative requirements applicable to the largest U.S. banking organizations, which are among most well-capitalized and liquid banking organizations in the world.
- Rather, the Report stresses that capital, stress-testing and liquidity requirements should be appropriately tailored, appropriately calibrated and simplified in order to ensure that they avoid unnecessary duplication and, in concert with resolution planning and other enhanced prudential standards, further enhance the stability and resilience of the U.S. financial system.

U.S. G-SIBs have higher risk-based capital ratios today in a stressed environment than actual risk-based capital ratios in 2008.



* **CET1** = Common Equity Tier 1 capital, a measurement of a bank's core equity capital, as defined by and subject to adjustments and deductions under U.S. Basel III

** **DFAST** = Dodd-Frank Act Stress Testing

*** **T1 Common** = Tier 1 common, includes common stock and related surplus + retained earnings + qualifying minority interests +/- adjustments and deductions

Source: SNL Financial, Regulatory Filings, 2017 DFAST Results

Table of Contents

Guide to Reading

This Visual Memo assumes a basic knowledge of the current capital and liquidity regime in the United States. For further background information, please see our resources on usbasel3.com, including:

- U.S. Basel III Final Rule Visual Memo
- U.S. Basel lll Supplementary Leverage Ratio Visual Memo
- U.S. Basel lll Liquidity Coverage Ratio Visual Memo
- Final TLAC Rule Visual Memo
- U.S. Intermediate Holding Company Visual Memo
- 2017 CCAR Results Visual Summary

Glossary

- The Report uses its own terminology to refer to certain categories of banking organizations, which this memorandum adopts.

Term*	Definition (as Used in the Report)	Scope
G-SIBs	U.S. Global Systemically Important Bank Holding Companies	Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street, Wells Fargo
Internationally active banks (IABs)**	Banking organizations with $250 billion or more in total consolidated assets or more than $10 billion of on-balance sheet foreign exposures, other than G-SIBs	e.g., Capital One, HSBC North America Holdings, PNC, TD Group US Holdings, U.S. Bancorp
Regional Banks	Banking organizations with $50 billion or more, but less than $250 billion, in total consolidated assets, other than G-SIBs	e.g., Ally, BB&T, Citizens, Comerica, Discover, Huntington, M&T Regions, Suntrust, Zions
Mid-Sized Banks	Banking organizations with $10 billion or more, but less than $50 billion, in total consolidated assets	e.g., New York Community Bancorp, Provident Bank
Community Banks (or Small BHCs and Small SLHCs)	Banking organizations with $10 billion or less in total consolidated assets	e.g., First Sleepy Eye Bancorporation, Prophetstown Banking Co.
FBO IHCs***	Foreign Banking Organization Intermediate Holding Companies required to be established pursuant to the Federal Reserve's Regulation YY (enhanced prudential standards)	e.g., BMO Financial, Deutsche Bank Trust Corporation, Santander Holdings USA, TD Group US Holdings

* When a recommendation applies only to a category of institution that is not listed above (e.g., credit unions), that category is specifically noted in these slides.

** For ease-of-use of these slides, this category includes U.S. banking organizations that have opted into the advanced approaches.

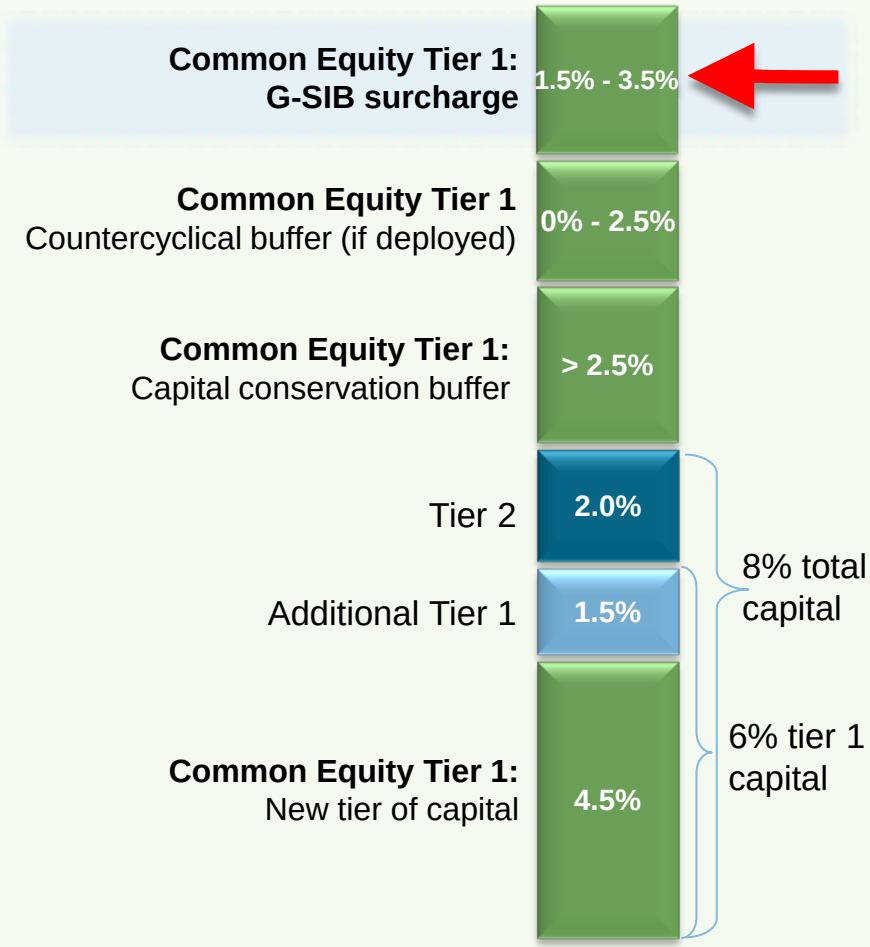
*** This report also refers to three sub-categories of FBO IHCs: (1) Advanced Approaches FBO IHCs (which have opted into the advanced approaches); (2) Large FBO IHCs (which have not opted into the advanced approaches but which meet the $250 billion total assets or $10 billion foreign exposure thresholds); and (3) Standardized Approach FBO IHCs (which have not opted into the advanced approaches and are below these quantitative thresholds).

U.S. Basel III Risk-Based Capital Requirements

Buffers and Minimum Requirements

Recalibration of G-SIB Surcharge

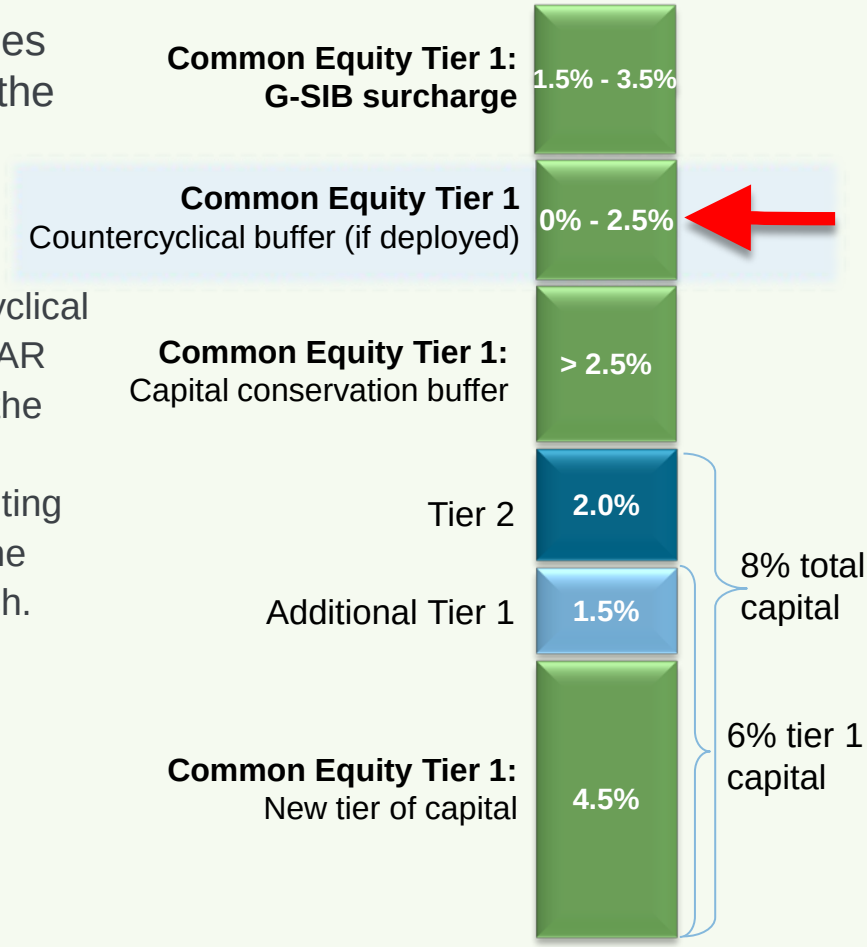
- **Treasury Recommendation:** The Federal Reserve should recalibrate the G-SIB surcharge, including with respect to its focus on the use of short-term wholesale funding, to avoid exceeding international Basel III standards.
  - This recommendation appears to take aim at the Method 2 component of the Federal Reserve's capital rules' G-SIB surcharge provisions, which unlike Method 1 incorporates the use of short-term wholesale funding.
- **Applies to:** G-SIBs



Buffers and Minimum Requirements

Elimination of CCyB

- **Treasury Recommendation:** The U.S. banking agencies should eliminate the countercyclical capital buffer from the capital rules and instead implement any countercyclical capital requirements through the CCAR and DFAST processes.
  - It is unclear if Treasury is recommending that the countercyclical buffer, if deployed, should be incorporated solely in the CCAR and DFAST post-stress minimum requirements (but not in the capital rules themselves) or, alternatively, that CCAR and DFAST themselves should be viewed as already implementing a form of countercyclical capital requirement. We believe the former is more likely the Treasury's recommended approach.
  - The Federal Reserve issued guidance in September 2016 regarding its framework for implementing the U.S. Basel III Countercyclical Capital Buffer.
- **Applies to:** G-SIBs | IABs | Advanced Approaches FBO IHCs | Large FBO IHCs



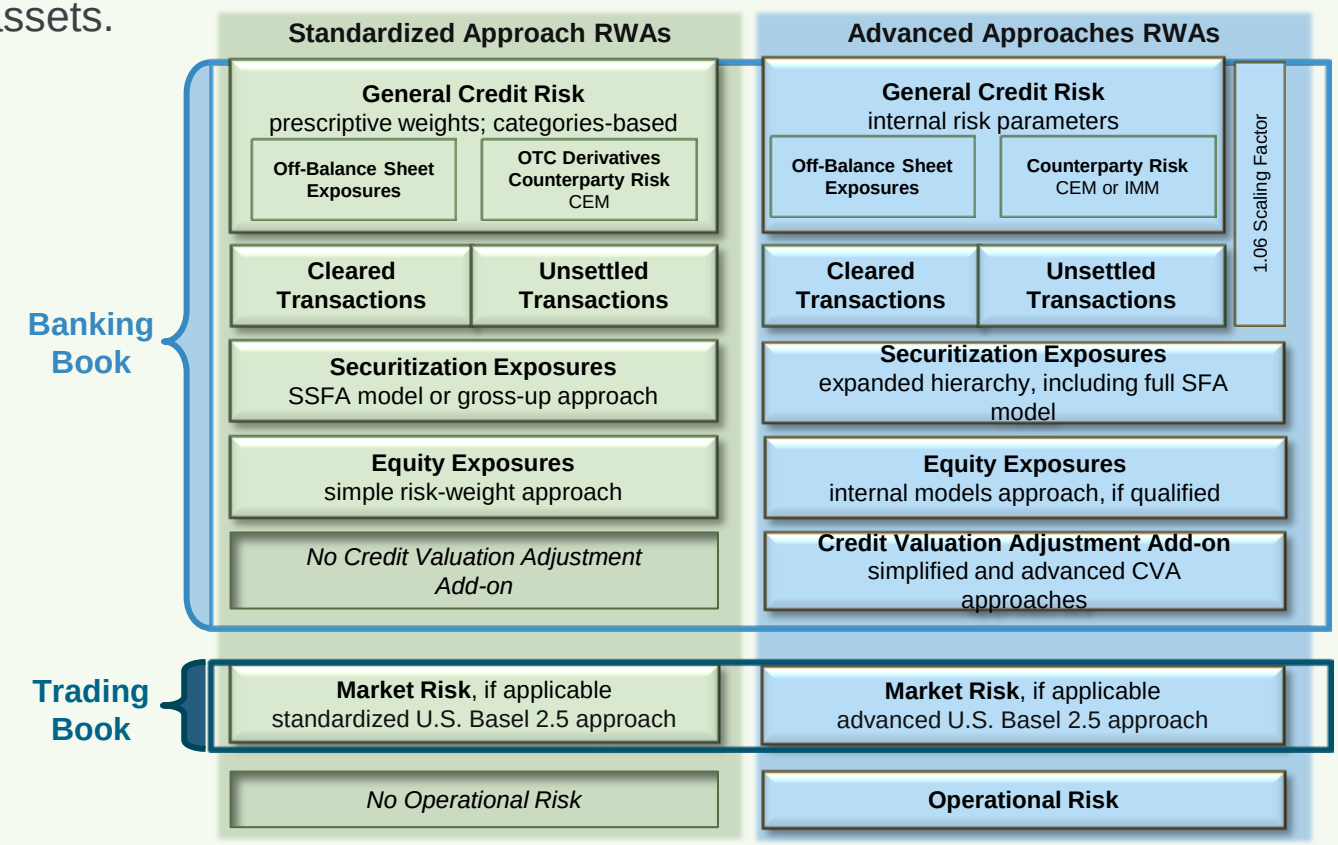
Risk-weighted Assets

Reduced Reliance on Advanced Approaches

- **Treasury Recommendation:** As a means of simplifying the U.S. capital framework over time, the U.S. banking agencies should keep the standardized approach and reduce reliance on the advanced approaches for risk-weighted assets.

- **Applies to:**

G-SIBs | IABs | Advanced Approaches FBO IHCs



Risk-weighted Assets

Increased Risk Sensitivity of Standardized Approach

- **Treasury Recommendation:** The U.S. banking agencies should introduce additional risk sensitivity into the standardized approach, such as in the calculation of derivatives (a reference to the capital rules' Current Exposure Method for OTC derivatives) and securities lending exposures.
  - Although the Report refers to securities lending exposures, it would be logical to assume it means "repo-style transactions," since the capital rules treat repo and reverse repo transactions similarly to securities lending and borrowing transactions.
  - The reference to both derivatives and (likely) repo-style transactions suggests that the Treasury's recommendations are intended to address the standardized approach rules for collateralized transactions more generally.
- **Applies to:** G-SIBs | IABs | Regional Banks | Mid-sized Banks | Community Banks* | Advanced Approaches FBO IHCs | Large FBO IHCs | Standardized Approach FBO IHCs

  + other entities to the extent they are subject to affected rules under the standardized approach

  ***** to the extent they are subject to U.S. Basel III

Exposure Amount for a Single OTC Derivative Transaction under the CEM

Exposure Amount = Current credit exposure + Potential future exposure

- Current credit exposure = max(mark-to-fair value of the OTC derivative, 0)
- Potential future exposure (PFE) is calculated by multiplying effective notional principal amount of contract by appropriate conversion factor below:

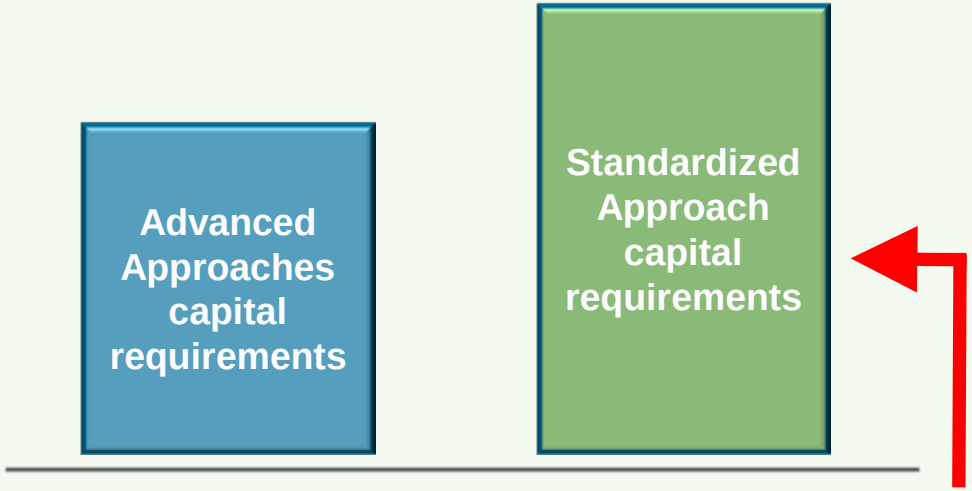
Remaining maturity	Interest rate	Foreign exchange rate and gold	Credit (investment grade reference asset)	Credit (non-investment grade reference asset)	Equity	Precious metals (except gold)	Other
1 year or less	0.00	0.01	0.05	0.10	0.06	0.07	0.10
Over 1 to 5 years	0.005	0.05	0.05	0.10	0.08	0.07	0.12
Over 5 years	0.015	0.075	0.05	0.10	0.10	0.08	0.15

Risk-weighted Assets

Reduced Redundancy in RWA Calculations

- **Treasury Recommendation:** Congress should be tasked with "reducing redundant calculation approaches," a clear reference to the statutory requirement, known as the Collins Amendment, that entities eligible for the advanced approaches must also calculate their required capital under the standardized approach, and meet the higher of the two requirements.
- **Applies to:** G-SIBs | IABs | Advanced Approaches FBO IHCs

Collins Amendment Capital Floor:
The Collins Amendment, introduced by the Dodd Frank Act, requires advanced approaches banking organizations to use the **lower** of each capital ratio (higher RWAs) calculated under the two approaches to determine compliance.



Capital requirement = max(standardized approach, advanced approaches)

Risk-weighted Assets

Revised Capital Treatment of Securitization Exposures

- **Treasury Recommendation:** The U.S. banking agencies should review the calculation of risk-weighted assets for securitization exposures, in particular private label securitizations.
  - Treasury takes particular aim at the calibration of risk weights that could result in firms holding more capital against securitization exposures than the firm's maximum economic loss on the exposure, a result exacerbated in CCAR and DFAST.*

* Under international Basel III, capital is capped at the capital requirement that would have been assessed against the underlying exposures had they not been securitized.

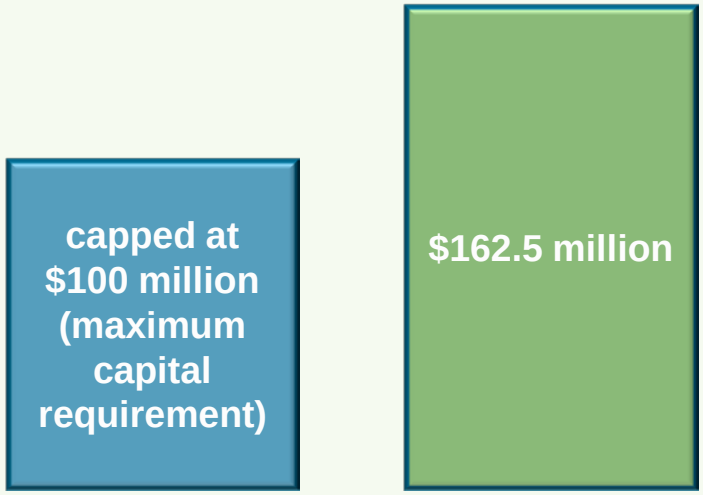
- **Applies to:**

G-SIBs	IABs	Regional Banks	Mid-sized Banks
Community Banks †	Advanced Approaches FBO IHCs	Large FBO IHCs	Standardized Approach FBO IHCs

+ other entities to the extent they are subject to affected rules under the standardized approach

† to the extent they are subject to U.S. Basel III

Example of risk-based capital requirements for a $100 million securitization exposure**



International Basel III
(assuming managing to a 13% total risk-based capital ratio)

U.S. Basel III
(assuming managing to a 13% total risk-based capital ratio)

** Assuming for simplicity that the exposure represents a complete securitization of the underlying exposures.

Risk-weighted Assets

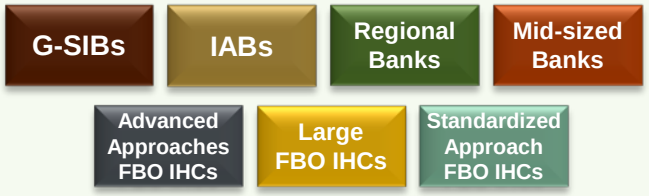
Changes to Operational Risk RWA Methodology

- **Treasury Recommendation:** The U.S. banking agencies should make the capital requirements for operational risk under the advanced approaches more transparent and rules-based, especially in view of the impact of supervisory actions under the current approach to operational risk RWAs.
  - In light of Treasury's recommendation to reduce reliance on the advanced approaches over time, and since currently there is no operational risk charge under the standardized approach of the U.S. capital rules, it is unclear whether this recommendation is intended to be limited to the advanced approaches or to have potentially broader applicability.
  - The Basel Committee released a consultative document in March 2016 with proposed revisions to the standardized approach for calculating operational risk capital.
- **Applies to:** G-SIBs | IABs | Advanced Approaches FBO IHCs

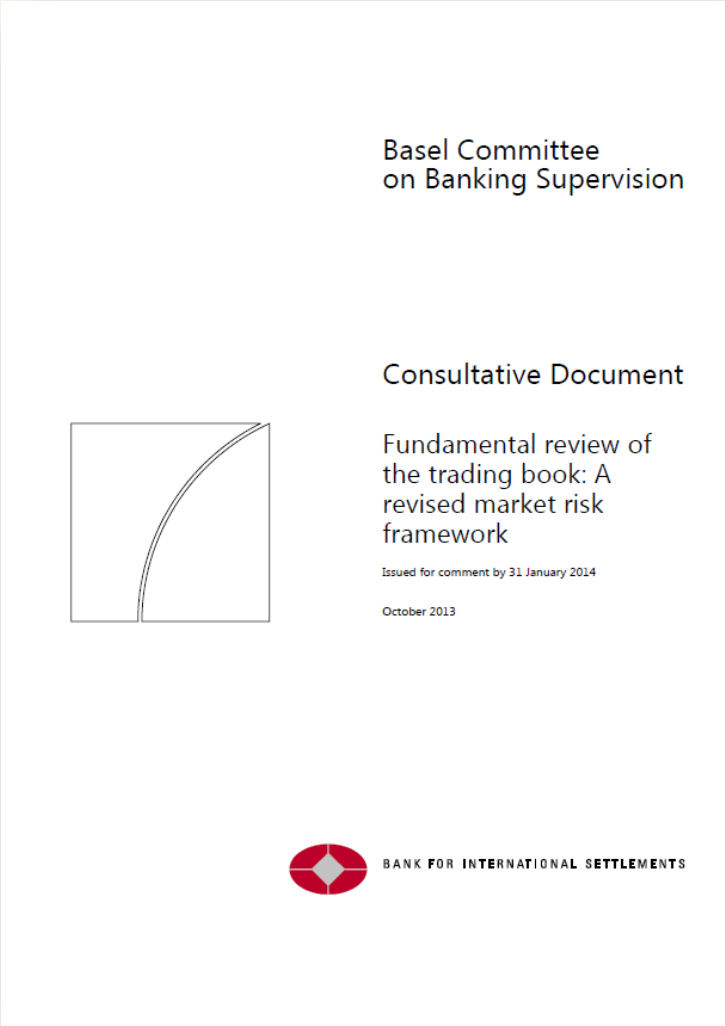
Implementation of Revised Capital Rules and Impact of Accounting Standards

Delay in Fundamental Review of Trading Book (FRTB)

- **Treasury Recommendation:** The U.S. banking agencies should delay the U.S. implementation of the Basel Committee's FRTB rules, i.e., the revisions to the market risk rules, until they can be appropriately assessed and calibrated.
  - Treasury's concern is that the FRTB rules would lead to requirements that are excessive and duplicative.
- **Applies to:***



* in each case to the extent that they are subject to the market risk capital rule



Basel Committee
on Banking Supervision

Consultative Document

Fundamental review of the trading book: A revised market risk framework

Issued for comment by 31 January 2014

October 2013

BANK FOR INTERNATIONAL SETTLEMENTS

Implementation of Revised Capital Rules and Impact of Accounting Standards

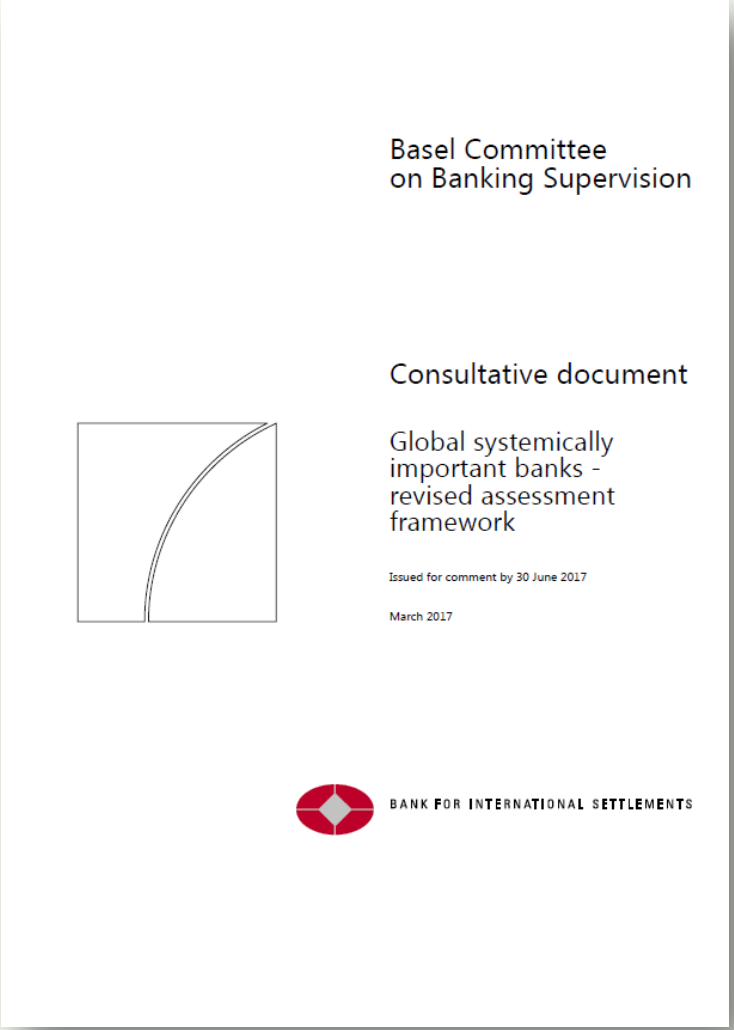
Revisions to Standardized Approach (a.k.a. Basel IV)

- **Treasury Recommendation:** The U.S. banking agencies should carefully consider the effects of implementing the revised standardized approach to credit risk under Basel III in the U.S., and should clarify how the adoption of any new Basel committee standard would affect U.S. firms' capital requirements and RWA calculations.
- **Applies to:**

G-SIBs	IABs	Regional Banks	Mid-sized Banks
Community Banks*	Advanced Approaches FBO IHCs	Large FBO IHCs	Standardized Approach FBO IHCs

+ other entities to the extent they are subject to affected rules under the standardized approach

* to the extent they are subject to U.S. Basel III


Basel Committee
on Banking Supervision

Consultative document

Global systemically important banks - revised assessment framework

Issued for comment by 30 June 2017

March 2017

BANK FOR INTERNATIONAL SETTLEMENTS

Implementation of Revised Capital Rules and Impact of Accounting Standards

Establishment of International Standard on Capital Floors

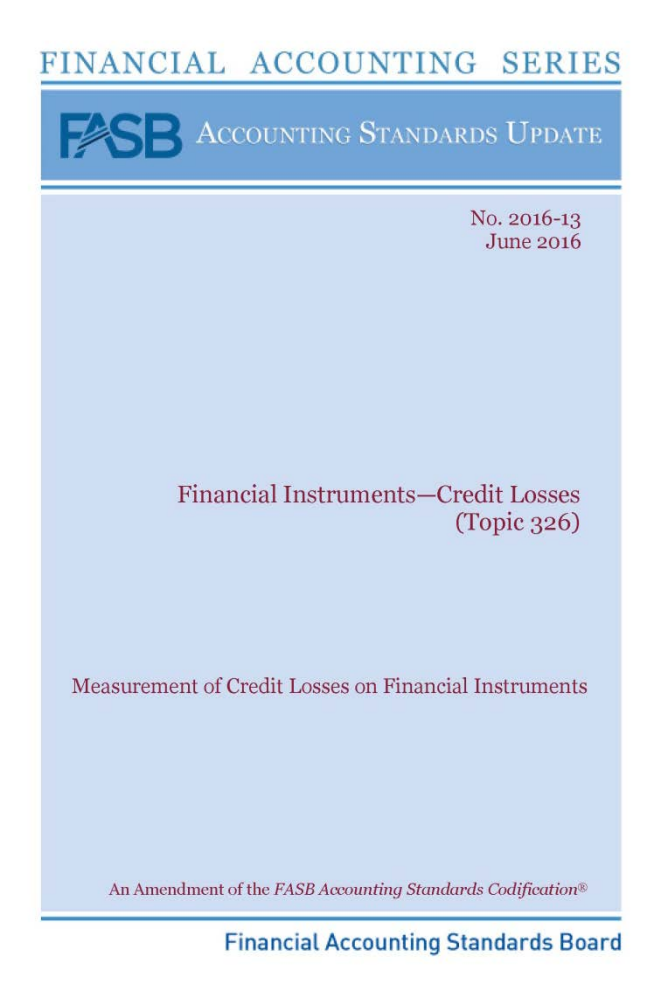
- **Treasury Recommendation:** An interagency group should establish a global standard for risk-based capital floors, among other efforts by the Basel Committee to finalize the international capital standards, in order to promote a level playing field for more highly-capitalized U.S. firms.
  - The Basel Committee has not yet reached agreement on the calibration of a capital floor.
  - In the U.S., the Collins Amendment serves as a capital floor.
  - The Report's reference to a "level playing field" implies that any global standard would be implemented in the U.S., potentially requiring an amendment to the Collins Amendment.
- **Applies to:** G-SIBs | IABs | Advanced Approaches FBO IHCs
- **Initial Agency Response:** *In her Congressional testimony, Chair Yellen responded to a question about global risk-based capital floors by stating her support for other countries putting in place appropriate capital regulation to ensure a level playing field.*

Implementation of Revised Capital Rules and Impact of Accounting Standards

Application of Current Expected Credit Losses (CECL) Accounting Standard

- **Treasury Recommendation:** The U.S. banking agencies should review the impact of the FASB's new CECL standard for loan loss reserves on U.S. firms' capital levels and formulate recommendations to harmonize the application of this new GAAP standard with U.S. supervisory efforts.
- **Applies to:**

G-SIBs	IABs	Regional Banks	Mid-sized Banks
Community Banks	Advanced Approaches FBO IHCs	Large FBO IHCs	Standardized Approach FBO IHCs


FINANCIAL ACCOUNTING SERIES

FASB ACCOUNTING STANDARDS UPDATE

No. 2016-13
June 2016

Financial Instruments—Credit Losses
(Topic 326)

Measurement of Credit Losses on Financial Instruments

An Amendment of the *FASB Accounting Standards Codification®*

Financial Accounting Standards Board

Tailoring of Capital Rules

Exemption from U.S. Basel III for Community Banks

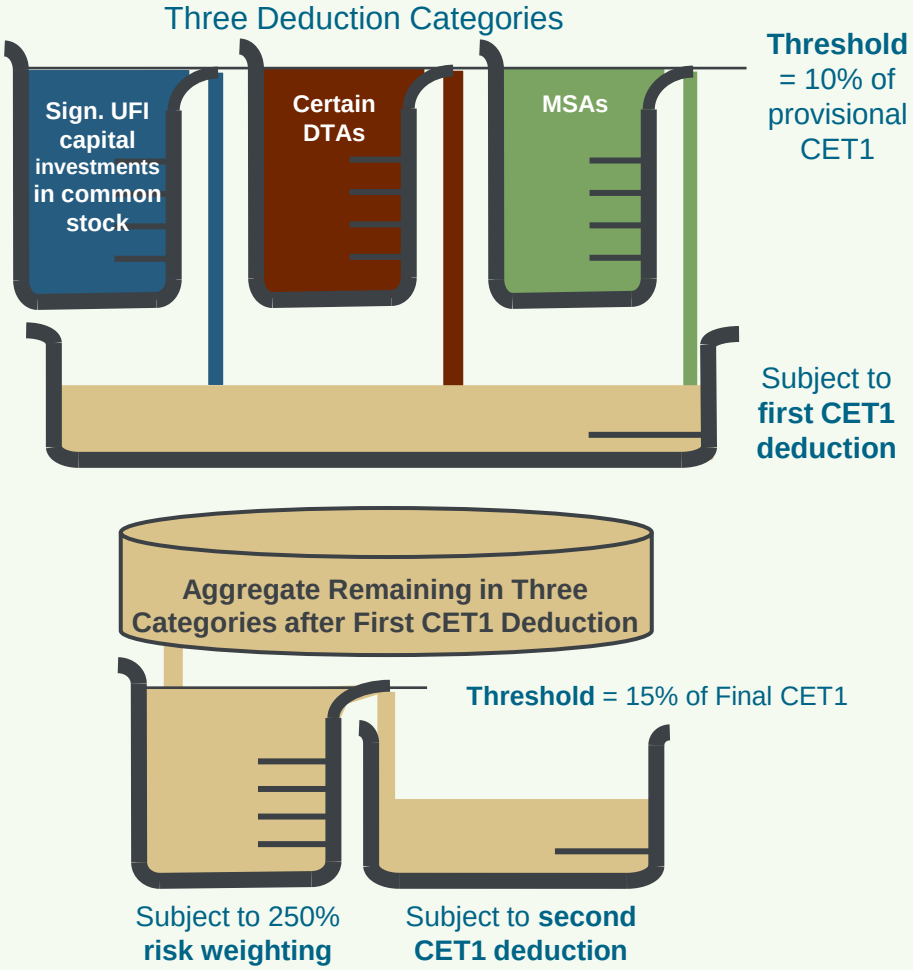
- **Treasury Recommendation:** The U.S. banking agencies should consider an exemption from the U.S. Basel III capital rules for community banks, while retaining the greater emphasis on common equity represented by the Basel III CET1 standard. If necessary to facilitate such an exemption, Congress should amend the Collins Amendment.
- **Applies to:** Community Banks
- **Initial Agency Response:** *In their Senate testimony, Chair Yellen, Gov. Powell, Acting Comptroller Noreika, Chairman Gruenberg and Commissioner Cooper each stated support for simplifying the capital rules for community banks. They stopped short, however, of endorsing the Report's recommended outright exemption for community banks from U.S. Basel III. Instead, they each expressed support for some or all of the recommendations in the Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA") Report regarding the simplification of the capital rules applicable to community banking organizations (discussed on page 20).*

Tailoring of Capital Rules

Revisions to Capital Requirements for Community Banks

- **Treasury Recommendation:** The agencies should revise the capital treatment for community banks of various asset classes, such as mortgage servicing assets (MSAs) currently subject to potential partial or full deduction from CET1 capital under the U.S. capital rules, and certain commercial real estate exposures.
  - Specifically, Treasury recommends that the definition of High Volatility Commercial Real Estate (HVCRE) loans be simplified and clarified to avoid the application of higher risk weights, currently 150% under the U.S. capital rules, in cases where the higher risk weights are "unnecessary."
- **Applies to:** Community Banks

10% / 15% Threshold Deduction Approach



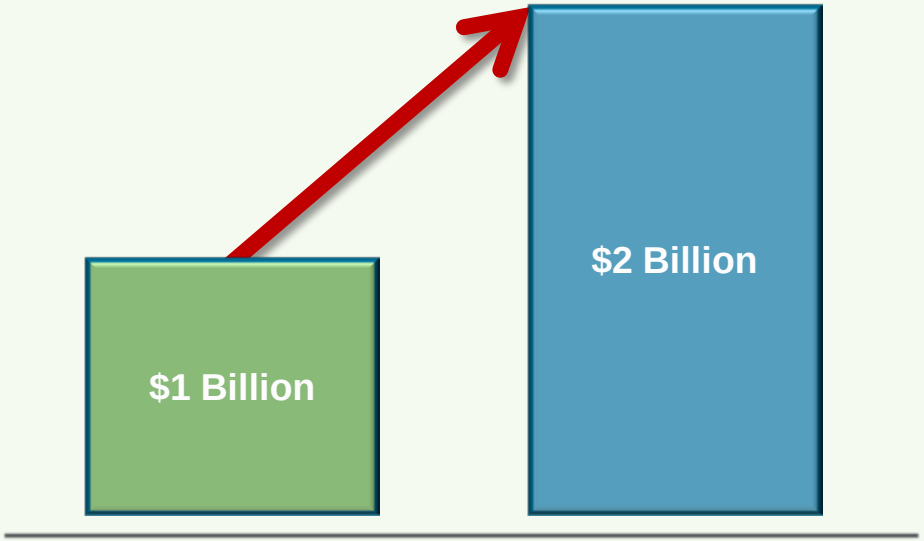
Tailoring of Capital Rules

- **Initial Agency Response:**
  - *Chair Yellen, Gov. Powell, Acting Comptroller Noreika, Chairman Gruenberg and Commissioner Cooper have expressed support for simplifying capital rules for community banks, including endorsement of some or all of the recommendations in the EGRPRA Report regarding the simplification of the capital rules applicable to community banking organizations.*
  - *In the EGRPRA Report, the U.S. banking agencies stated that they are developing a proposal to simplify the following capital requirements applicable to community banking organizations:*
    - *Risk weights for HVCRE exposures;*
    - *Capital deductions for certain MSAs, deferred tax assets (DTAs) and investments in the capital of unconsolidated financial institutions (UFI investments); and*
    - *Recognition in capital of minority interests.*

Tailoring of Capital Rules

Higher Threshold for Small BHC and SLHC Policy Statement

- **Treasury Recommendation:** Congress should raise the threshold for the Federal Reserve's Small Bank Holding Company and Savings and Loan Holding Company Policy Statement, which applies greatly simplified capital requirements to small BHCs and small SHLCs, from $1 billion in total consolidated assets to $2 billion in total consolidated assets.
- **Applies to:** Community Banks



Threshold for Policy Statement (Total Consolidated Assets)

Tailoring of Capital Rules

Recalibrated Capital Requirements for Credit Unions

- **Treasury Recommendation:** The NCUA should review and recalibrate the NCUA's capital and stress-testing requirements. The Report specifically recommends:
  - Exempting credit unions with $10 billion or less in total assets from the NCUA's risk-based capital requirements or eliminating these requirements for credit unions satisfying 10% simple leverage or net worth test.
  - Credit unions to which the risk-based capital requirements would continue to apply should be allowed to issue supplemental capital instruments to meet a portion of their requirements, such as non-cumulative perpetual preferred stock (similar to Alternative Tier 1 capital) or subordinated debt with long maturity and no early acceleration features (similar to Tier 2 capital).
  - Raising the threshold for the application of the NCUA's stress testing requirements from $10 billion in total assets to $50 billion in total assets.
- **Applies to:** Credit Unions

Tailoring of Capital Rules

Recalibrated Capital Requirements for Credit Unions

- **Initial Agency Response:** *Acting Chairman McWatters has stated that the NCUA is exploring ways for more supplemental capital instruments, such as subordinated debt, to be counted as capital for risk-based capital requirements for credit unions. Furthermore, the NCUA intends to review its risk-based capital rule in its entirety to determine if significant revision or repeal is warranted. The NCUA is making similar legislative recommendations to Congress in regard to supplemental capital, in an effort to allow new layers of capital to absorb losses at credit unions.*
- *McWatters also stated that while currently only credit unions having a low-income designation are allowed to issue secondary capital instruments that count against their mandatory leverage ratios, the NCUA is exploring ways for supplemental capital instruments, such as subordinated debt, to be counted as capital for credit unions' risk-based capital requirements.*

Tailoring of Capital Rules

Additional Capital Instruments for CDFIs and MDIs

- **Treasury Recommendation:** Community Development Financial Institutions (CDFIs) and Minority Depository Institutions (MDIs) should be granted the flexibility to use alternative forms of capital, such as subordinated debt or capital borrowed by the holding company and injected into the bank. This capital may include program-related investments from foundations or impact investors.
- **Applies to:** CDFIs and MDIs

Tailoring of Capital Rules

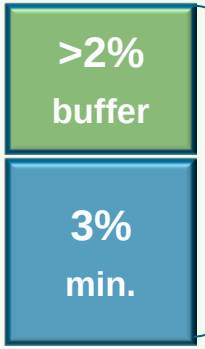
Review of De Novo Bank Capital Requirements

- **Treasury Recommendation:** The FDIC should review capital requirements applicable to de novo banks.
  - This is a reference to the fact that the U.S. banking agencies and state banking regulators often impose significantly higher capital requirements on newly-chartered banks for at least the first five years of their operations.
- **Applies to:** De novo banks
- **Initial Agency Response:** *In keeping with this recommendation, Chairman Gruenberg highlighted before the Senate the fact that the FDIC has loosened the regulatory and capital requirements on de novo banks over the past year by freeing them from the previous requirement that they maintain a Tier 1 leverage ratio of not less than 8 percent for the first seven years of operation; this requirement now only applies for the first three years.*

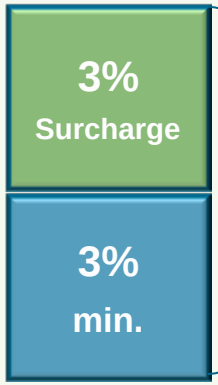
Supplementary Leverage Ratio (SLR)

Supplementary Leverage Ratio (SLR)

- The Report took particular aim at the SLR and its potential impact on market liquidity and certain intermediation activities that the U.S. Treasury described as "critical banking functions."
- The U.S. Treasury expressed concern that the current interaction between the SLR (particularly the enhanced SLR, or eSLR, applicable to G-SIBs) and other rules such as the LCR makes it difficult to accept "safe-haven" deposits from customers (e.g., custody-related deposits), to provide customer access to centrally-cleared derivatives (because initial cash margin posted on behalf of clients is included in the SLR's total leverage exposure) and to provide secured repo financing.
- The Report also expressed concern that making a risk-insensitive measure the primary binding capital constraint could have the unintended consequence of encouraging risk-taking.



A U.S. G-SIB must maintain a **>5%** SLR, on a consolidated basis, to avoid restrictions on capital distributions and discretionary bonus payments to executive officers



Each IDI subsidiary must maintain a **6%** SLR to be considered well-capitalized

The eSLR applies to a U.S. top-tier BHC with at least $700 billion in total consolidated assets **or** at least $10 trillion in assets under custody and its IDI subsidiaries – this threshold captures the 8 U.S. G-SIBs and their IDI subsidiaries.

Supplementary Leverage Ratio (SLR)

Deductions from SLR Denominator

- **Treasury Recommendation:** Treasury recommended "significant adjustments" to the SLR but did not elaborate beyond calling for three specific deductions from Total Leverage Exposure for cash on deposit with central banks, U.S. Treasury securities and initial margin for centrally cleared derivatives.
- **Applies to:** G-SIBs | IABs | Advanced Approaches FBO IHCs | Large FBO IHCs

$$\textbf{Supplementary Leverage Ratio (\%)} = \frac{\textbf{Tier 1 Capital}}{\textbf{Total Leverage Exposure}}$$

Total Leverage Exposure =

1. On-balance Sheet Assets
2. Derivative Exposures
3. Repo-Style Transaction Exposures
4. Other Off-Balance Sheet Exposures

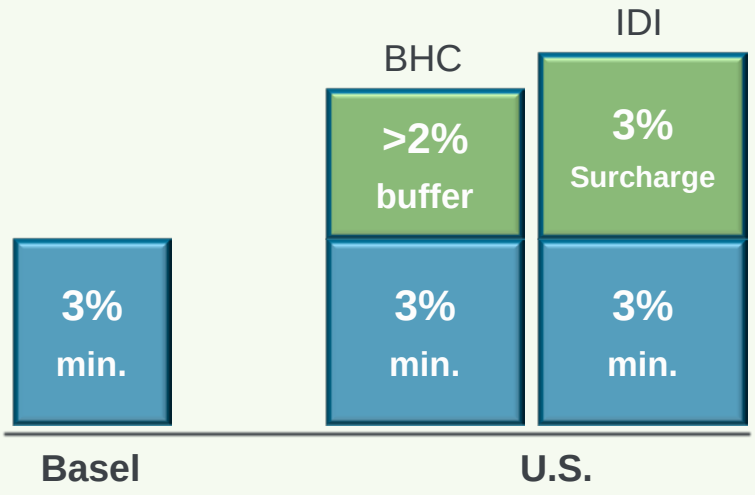
Proposed deductions for central bank deposits, U.S. Treasuries, and initial margin for centrally cleared derivatives

Supplementary Leverage Ratio (SLR)

Recalibrated eSLR

- **Treasury Recommendation:** The eSLR should be recalibrated to avoid exceeding international standards.
  - The international Basel III standard is 3% rather than 5% for U.S. G-SIB BHCs (consisting of a 2% capital buffer on top of the 3% minimum requirements) and 6% for IDI subsidiaries of U.S. G-SIBs to be well-capitalized.
- **Applies to:** G-SIBs
- **Initial Agency Response:**
  - *Chair Yellen has stated that the calibration of the eSLR is under review to ensure that risk-based capital ratios are the binding capital constraint.*
  - *Gov. Powell has stated that the eSLR should be recalibrated and changed to address concerns of custody banks regarding disproportionate impact on their business models.*
  - *Chairman Gruenberg is opposed to any changes to SLR/eSLR. We note that the FDIC's SLR rules would not actually apply to any of the G-SIBs or advanced approaches banks because they are all national or state member banks.*

Comparison of Basel SLR and U.S. SLR/eSLR



Supplementary Leverage Ratio (SLR)

Revisions for Off-balance Sheet Lines of Credit to SMEs

- **Treasury Recommendation:** Interagency group should consider the recalibration of the SLR for the unfunded portion (i.e., off-balance sheet portion) of lines of credit to SMEs, in order to help banks provide additional access to working capital lines for small businesses.
- **Applies to:** G-SIBs, IABs, Advanced Approaches FBO IHCs, Large FBO IHCs

$$\textbf{Supplementary Leverage Ratio (\%)} = \frac{\textbf{Tier 1 Capital}}{\textbf{Total Leverage Exposure}}$$

Total Leverage Exposure =

1. On-balance Sheet Assets
2. + Derivative Exposures
3. + Repo-Style Transaction Exposures
4. + Other Off-Balance Sheet Exposures

Proposed recalibration of treatment for unfunded lines of credit to SMEs

Stress Testing and Capital Planning

Comprehensive Capital Adequacy and Review (CCAR)

CCAR – Scope

- Treasury referred to CCAR as the binding capital regime (meaning the one that requires the highest amount of capital) for the majority of large banking organizations subject to CCAR.
- **Treasury Recommendation:** The Federal Reserve should make a number of changes to the scope of CCAR, including:
  - **Increased CCAR Threshold.** Revise the threshold for the application of CCAR to match the revised threshold for the application of the enhanced prudential standards.
  - **Elimination of Qualitative CCAR Assessment as Sole Basis for Objection.** The Federal Reserve should limit its ability to object to CCAR planning for large and complex BHCs solely on qualitative grounds. Instead, the Federal Reserve should conduct its qualitative assessment of all firms' capital planning processes through the same supervisory horizontal capital review process announced by the Federal Reserve for large and noncomplex firms starting from Q3 2017.
- **Applies to:** G-SIBs | IABs | Regional Banks | Advanced Approaches FBO IHCs | Large FBO IHCs | Standardized Approach FBO IHCs
- **Initial Agency Response:** *Gov. Powell has stated that if progress continues, it may be appropriate for the Federal Reserve to remove the qualitative assessment. In the 2017 CCAR cycle, all 34 BHCs received a non-objection (or, in one case, a conditional non-objection) from the Federal Reserve to their 2017 capital plans.*

Davis Polk materials on the 2017 CCAR results are available here and here.

Comprehensive Capital Adequacy and Review (CCAR)

CCAR – Procedural

- **Treasury Recommendation:** The Federal Reserve should make a number of changes to the CCAR process, including:
  - **Reduced CCAR Frequency.** Considering a two-year CCAR cycle, with the option for off-cycle reviews to allow revisions to capital plans for extraordinary events.
  - **Greater Transparency.** Subjecting its CCAR and DFAST review framework, including its models, scenarios and other material parameters and methodologies, to public notice and comment.
  - **More Predictable Post-Stress Capital Requirements.** The Federal Reserve should either (a) change the CCAR sequence so that firms are able to consider projected CCAR results as part of their capital planning process or (b) integrate CCAR into the risk-based capital regime in a way that does not increase post-stress capital requirements.
    - For the second alternative, Treasury cited by former governor Dan Tarullo's September 2016 speech proposing the introduction of a Stressed Capital Buffer.
- **Applies to:** G-SIBs | IABs | Regional Banks | Advanced Approaches FBO IHCs | Large FBO IHCs | Standardized Approach FBO IHCs
- **Initial Agency Response:** *Gov. Powell has noted that there should be enhanced disclosure of CCAR results, indicative loss rates and more information disclosed regarding qualitative assessment.*

Comprehensive Capital Adequacy and Review (CCAR)

CCAR – Assumptions & Models

- **Treasury Recommendation:** The Federal Reserve should make a number of changes to the assumptions and models of CCAR, including:
  - **Reassessment of CCAR Assumptions.** The CCAR assumptions should be reassessed, including the assumptions that firms' balance sheets will continue to grow and that firms will make planned capital distributions, even under a severely adverse scenario.
    - In addition, in the context of discussing capital requirements for securitization exposures related to investments in private-label mortgage-backed securities, Treasury stated that the treatment of such exposures under CCAR and DFAST can sometimes result "in scenarios where a bank is required to hold more capital against [an] asset than the maximum economic loss on that asset." Treasury recommended that regulators "calibrate standards to resolve this type of counterintuitive result."
  - **More Tailored CCAR Supervisory Models.** Supervisory models used in CCAR "should be improved by better recognizing firms' unique risk profiles."
- **Applies to:** G-SIBs | IABs | Regional Banks | Advanced Approaches FBO IHCs | Large FBO IHCs | Standardized Approach FBO IHCs
- **Initial Agency Response:** *Gov. Powell has stated that CCAR assumptions should be adjusted in conjunction with integrating stress tests into a firm's regulatory capital requirements, which is likely a reference to the Stress Capital Buffer approach announced by former governor Tarullo in 2016. Chair Yellen has stated that the Federal Reserve is seeking to include G-SIB surcharges, make other adjustments and integrate stress test requirements into the "normal capital regime."*

Dodd-Frank Act Stress Testing (DFAST)

DFAST

- **Treasury Recommendation:** The Federal Reserve and Congress should make a number of changes to the DFAST process, including:
  - **Increased Company-run DFAST Threshold.** The threshold for company-run DFAST requirements should be increased from $10 billion to $50 billion, with authority to revise upwards based on risk and complexity of institution.
  - **Reduced Frequency.** The mid-year company-run DFAST requirement should be eliminated, reducing the frequency of DFAST to once per year.
  - **Fewer DFAST Supervisory Scenarios.** The adverse supervisory scenario should be eliminated, leaving the baseline and severely adverse supervisory scenarios.
  - **Increased DFAST Reliance on Company Modeling.** Banks should be granted leeway to determine the appropriate number of models based on the scale and complexity of each organization.
  - **Increased Stress-Testing Threshold for Credit Unions.** Raising the threshold for required stress testing for federally-insured credit unions from $10 billion to $50 billion.
- **Applies to:** G-SIBs | IABs | Regional Banks | Mid-sized Banks | Credit Unions | Advanced Approaches FBO IHCs | Large FBO IHCs | Standardized Approach FBO IHCs

Dodd-Frank Act Stress Testing (DFAST)

DFAST

- **Initial Agency Response:**
  - *Gov. Powell has stated his support for increasing the EPS and DFAST thresholds.*
  - *Acting Comptroller Noreika stated that DFAST applicability should be made fully flexible, without regard to asset threshold, based on regulatory judgment.*
  - *Chairman Gruenberg has supported a Congressional amendment raising the DFAST threshold to $50 billion from $10 billion, with a reservation of authority to require stress testing for banks below that threshold if warranted by the bank's risk profile or condition.*

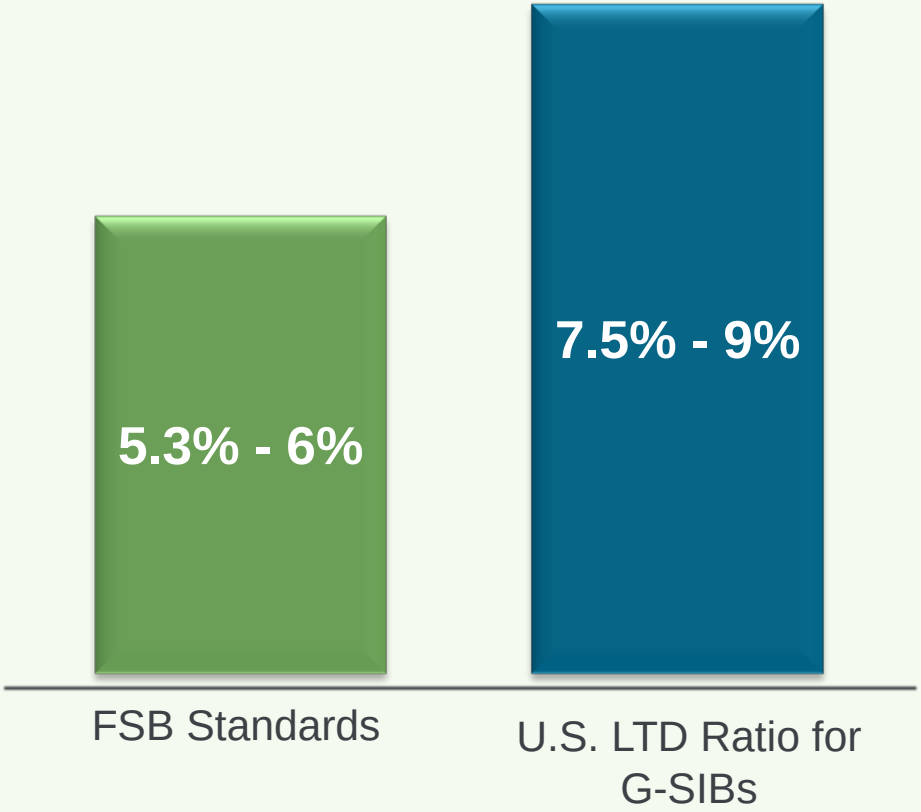
TLAC and LTD Requirements

TLAC and LTD Requirements

Recalibration of LTD Ratio for U.S. G-SIBS

- **Treasury Recommendation:** The Federal Reserve should consider recalculating the Federal Reserve's minimum LTD ratios in its final TLAC rule to avoid exceeding international standards.
- **Applies to:** G-SIBs

Comparison of FSB Standard and U.S. LTD Ratios for G-SIBs

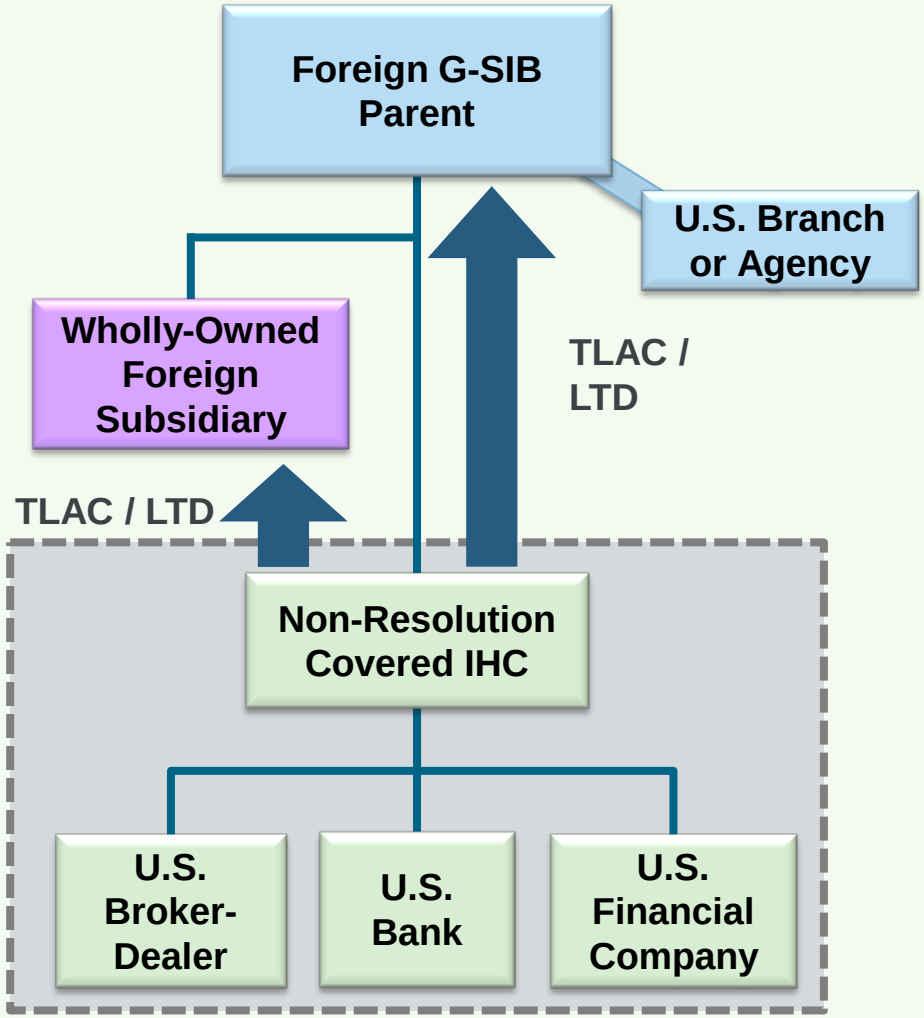


TLAC and LTD Requirements

Recalibration of Internal TLAC Requirement for FBO IHCs

- **Treasury Recommendation:** Although Treasury supports maintaining the internal TLAC requirement for the FBO IHCs of foreign G-SIBs as a means of improving their resolvability, it recommends that the Federal Reserve should recalibrate the requirement to take into account the foreign parent's ability to provide capital and liquidity to the IHC, provided that, among other factors, arrangements are made with home country supervisors for deploying unallocated TLAC to the IHC from the parent.
- **Applies to:*** Advanced Approaches FBO IHCs | Large FBO IHCs | Standardized Approach FBO IHCs

* **Only** FBO IHCs with a top-tier parent that is a non-U.S. G-SIB



Off-Ramp

CHOICE Act Off-Ramp

Regulatory Off-Ramp for Highly-Capitalized Entities

- **Treasury Recommendation:**
  - Although Treasury did express "support" for an off-ramp exemption from all capital and liquidity requirements, CCAR, DFAST, "nearly all" EPS and the Volcker Rule, it did not unequivocally endorse the CHOICE Act off-ramp approach, stating that it is "an alternative approach" that "should be considered."
    - It is likely that Treasury would view any off-ramp approach as existing alongside, as an optional alternative to, the regulatory reform recommendations in the Report.
  - Treasury cites a 10% "non-risk weighted leverage ratio" as an example of a "sufficiently high level of capital" under this approach, which is consistent with (though less specific than) the CHOICE Act approach.
- **Applies to:** G-SIBs | IABs | Regional Banks | Mid-sized Banks | Community Banks | Advanced Approaches FBO IHCs | Large FBO IHCs | Standardized Approach FBO IHCs

CHOICE Act Off-Ramp

- **Initial Agency Response:** *Chair Yellen has stated that a simple leverage ratio can result in more risk-taking by banks, a risk-based capital framework should be the most important form of capital regulation, and a leverage ratio should be a "backup catch-all."*

Liquidity Coverage Ratio (LCR)

Liquidity Coverage Ratio (LCR)

Scope of Applicability

- **Treasury Recommendation:** The U.S. banking agencies should narrow the scope of banking organizations that are subject to the LCR to G-SIBs, while a "less stringent standard" should be applied to IABs.
  - This recommendation would significantly limit the scope of the LCR, which currently applies in full (i.e., 100% LCR requirement) to any U.S. advanced approaches banking organization, any such organization's consolidated U.S. IDI subsidiaries with ≥ $10 billion in total consolidated assets, and any other banking organization that becomes subject to the LCR because its primary federal banking supervisor determines it is appropriate based on a variety of factors.
  - It is unclear whether the reference to a "less stringent standard" refers to the current modified LCR (i.e., 70% LCR requirement), which applies to U.S. BHCs and SLHCs with ≥ $50 billion in total consolidated assets, subject to certain exceptions, but does not apply to the U.S. IDI subsidiaries of these BHCs and SLHCs.
  - The Report does not specifically address the scope of applicability of the LCR or a "less stringent standard" to IDIs.
  - The Report notes that the costs of the LCR (requiring firms to invest in HQLAs that have lower yields relative to other assets) are felt more acutely by smaller regional BHCs that rely more heavily on net interest income than fee income for their earnings.
- **Applies to:** G-SIBs | IABs | Regional Banks

$$\frac{\text{High-Quality Liquid Assets}}{\text{Total Net Cash Outflows}} \geq 100\%$$

High Quality Liquid Assets (HQLAs)

Inclusion of "High-grade Municipal Bonds" as Level 2B HQLAs

- **Treasury Recommendation:** The U.S. banking agencies should expand the treatment of certain qualifying instruments as HQLAs, including classifying "high-grade municipal bonds" as Level 2B HQLAs.
  - It is unclear whether the Report intends the reference to "high-grade" to be the only requirement for recognition of municipal bonds as Level 2B assets or whether the other requirements currently applicable to Level 2B assets (including, for corporate debt, whether they are liquid and readily marketable, are investment grade and have a proven record as a reliable source of liquidity in stressed market conditions based on market price and market haircuts) would also apply.
  - In contrast, Senate Bill S.828 would require municipal securities to be liquid and readily marketable and investment grade to qualify as Level 2B HQLAs.
  - Additionally, the Federal Reserve finalized a rule on April 1, 2016 that would allow general obligation municipal securities insured by a bond insurer to count as Level 2B assets as long as the underlying municipal security would otherwise qualify as a HQLA without the insurance.
  - Under the current LCR rule, Level 2B assets are capped at 15% of a firm's total HQLAs and are subject to a haircut of 50% of their fair value.
- **Applies to:** G-SIBs | IABs | Regional Banks

HQLA Amount

=

Level 1 asset amount

+

Level 2A asset amount

+

Level 2B asset amount

−

the <u>greater</u> of:

{ *unadjusted* excess HQLA amount

and

adjusted excess HQLA amount }

High Quality Liquid Assets (HQLAs)

Evaluation of Impact on Private Label Securitizations

- **Treasury Recommendation:** The U.S. banking agencies should consider the impact that liquidity rules implementing Basel III standards (i.e., currently the LCR) would have on secondary market activity of private label securitizations.
  - The Report notes that non-agency mortgage-backed securities (MBS) do not qualify as HQLAs, regardless of their credit rating, implying that the U.S. banking agencies should consider qualifying them as HQLAs to some extent.
- **Applies to:** G-SIBs | IABs | Regional Banks

HQLA Amount

=

Level 1 asset amount

+

Level 2A asset amount

+

Level 2B asset amount

−

the greater of:

unadjusted excess HQLA amount

and

adjusted excess HQLA amount

Net Cash Outflow

Adjustment of Cash Flow Methodologies

- **Treasury Recommendation:** The U.S. banking agencies should adjust the degree of conservatism in the methodologies for calculating cash flows and other (unspecified) aspects of the LCR rule, including by allowing a greater reliance by banking organizations on their own historical experience.
  - The scope of this recommendation is unclear, but it likely covers the U.S. LCR rule's use of a "peak day" approach plus a maturity mismatch add-on in calculating net cash outflow, whereas the Basel Committee's version of the LCR uses the total cumulative amount of net cash outflow at the end of the 30-day stress period and does not include a maturity mismatch add-on, instead identifying a similar metric—a firm's contractual maturity mismatch profile—as an additional monitoring tool (apart from the LCR) that can aid supervisors in assessing liquidity risks.
  - The recommendation appears to suggest aligning the LCR's cash inflow and outflow calculations more closely with the liquidity stress testing requirements under the Federal Reserve's enhanced prudential standards, which do not require the use of standardized, prescribed cash inflow and outflow rates and instead require banking organizations to use their own internal liquidity models and assumptions for run-off rates and haircuts.
- **Applies to:** G-SIBs | IABs | Regional Banks

Total Net Cash Outflow Amount = **Cumulative Cash Outflows** − **Capped Cumulative Cash Inflows** + **Maturity Mismatch Add-on**

(Net Cumulative Peak Day Maturity Outflow − Net Day 30 Cumulative Maturity Outflow)

Liquidity Requirements under Enhanced Prudential Standards (EPS)

Enhanced Prudential Standards (EPS)

Recalibration of Liquidity Requirements Applicable to U.S. IHCs of FBOs

- **Treasury Recommendation:** The Federal Reserve should recalibrate the liquidity requirements applicable to U.S. IHCs.
  - These requirements include a U.S. liquidity buffer requirement based on the results of internal liquidity stress testing.
  - The Report recommends placing greater emphasis on the degree to which an FBO's home country regulations are comparable to the regulations applied to similar U.S. BHCs.
  - The Report states that where regulations are sufficiently comparable, FBOs should be allowed to meet U.S. requirements through substituted compliance with home country regulations.
  - This recommendation is consistent with its recommendations for the application of the Federal Reserve's internal TLAC requirement to U.S. IHCs.
- **Applies to:** Advanced Approaches FBO IHCs | Large FBO IHCs | Standardized Approach FBO IHCs

Resolution Planning Liquidity Requirements

Resolution Planning Liquidity Requirements

Recalibration of Resolution Liquidity Execution Need (RLEN) and Resolution Liquidity Adequacy and Positioning (RLAP)

- **Treasury Recommendation**: The Federal Reserve and FDIC should minimize their use of any resolution planning guidance that effectively acts as a regulatory requirement, and all such guidance should be subject to notice and public comment before becoming effective.
  - In particular, the Report recommends that RLEN and RLAP standards, which effectively require the prefunding and/or prepositioning of liquidity needs of material entity subsidiaries of banking organizations adopting a single point of entry (SPOE) resolution strategy, should be calibrated to avoid unnecessarily trapping liquidity and capital in subsidiaries.
- **Applies to:** Banking organizations subject to RLEN and RLAP resolution planning guidance (currently U.S. G-SIBs plus Barclays, Credit Suisse, Deutsche Bank and UBS)

Proposed Net Stable Funding Ratio (NSFR)

Proposed NSFR

Delay and reassessment of proposed NSFR rule

- **Treasury Recommendation:** U.S. banking agencies should delay the implementation of the proposed NSFR rule until it can be appropriately reassessed and calibrated.
  - The Treasury is concerned that, depending on its calibration, the NSFR rule could be duplicative of other liquidity requirements.
- **Applies to:** G-SIBs | IABs | Regional Banks

$$\frac{\text{Available Stable Funding (ASF)}}{\text{Required Stable Funding (RSF)}} \geq 1.0$$

Initial Agency Response to Liquidity Recommendations

Initial Agency Response to Liquidity Recommendations

- *Chair Yellen has stated that the Federal Reserve is supportive of expanded treatment of certain qualifying instruments as HQLAs, including "high-grade municipal bonds," as Level 2B HQLAs.*
- *With this exception, to date none of the principals of the U.S. banking agencies have specifically addressed the Treasury's recommendations on liquidity requirements in any testimony or speeches.*
  - *Nor does the EGRPRA report make any reference to liquidity requirements.*

Treasury Recommendations	U.S. Banking Organizations					FBO IHCs		
	G-SIBs	IABs ($250b+ or $10b+ foreign exposures)	Regional Banks ($50n-250b)	Mid-sized Banks ($10b-50b)	Community Banks (<$10b)	Advanced Approaches FBO IHCs	Large FBO IHCs ($250b+ or $10b+ foreign exposures)	Standardized Approach FBO IHCs (<$250b)
U.S. Basel III Risk-Based Capital Requirements								
Buffers and Minimum Requirements								
Recalibration of G-SIB Surcharge	✓							
Elimination of the countercyclical capital buffer	✓	✓				✓	✓	
Risk-weighted Assets								
Reduced Reliance on Advanced Approaches	✓	✓				✓		
Increased Risk Sensitivity of Standardized Approach	✓	✓	✓	✓	✓	✓	✓	✓
Reduced Redundancy in RWA Calculations	✓	✓				✓		
Revised Capital Treatment of Securitization Exposures	✓	✓	✓	✓	✓	✓	✓	✓
Changes to Operational Risk RWA Methodology	✓	✓				✓		
Implementation of Revised Capital Rules and Impact of Accounting Standards								
Delay in Fundamental Review of Trading Book (FRTB)	✓*	✓*	✓*	✓*		✓*	✓*	✓*
Revisions to Standardized Approach (a.k.a. Basel IV)	✓	✓	✓	✓	✓**	✓	✓	✓
Establishment of International Standard on Capital Floors	✓	✓				✓		
Application of Current Expected Credit Losses (CECL) Accounting Standard	✓	✓	✓	✓	✓	✓	✓	✓

* Applies to the extent that they are subject to the market risk capital rule

** Applies to the extent that they are subjected to affected rules under the standardized approach

Treasury Recommendations	U.S. Banking Organizations					FBO IHCs		
	G-SIBs	IABs ($250b+ or $10b+ foreign exposures)	Regional Banks ($50n-250b)	Mid-sized Banks ($10b-50b)	Community Banks (<$10b)	Advanced Approaches FBO IHCs	Large FBO IHCs ($250b+ or $10b+ foreign exposures)	Standardized Approach FBO IHCs (<$250b)
TAILORING OF CAPITAL RULES								
Exemption from U.S. Basel III for Community Banks					✓			
Revisions to Capital Requirements for Community Banks					✓			
Higher Threshold for Small BHC and SLHC Policy Statement					✓			
Recalibrated Capital Requirements for Credit Unions		Applies to Credit Unions						
Additional Capital Instruments for CDFIs and MDIs		Applies to CDFIs and MDIs						
Review of De Novo Bank Capital Requirements		Applies to De Novo Banks						
SUPPLEMENTARY LEVERAGE RATIO (SLR)								
Deductions from SLR Denominator	✓	✓				✓	✓	
Recalibrated eSLR	✓							
Revisions for Off-balance Sheet Lines of Credit to SMEs	✓	✓				✓	✓	
STRESS TESTING AND CAPITAL PLANNING								
COMPREHENSIVE CAPITAL ADEQUACY AND REVIEW (CCAR)								
CCAR – Scope	✓	✓	✓			✓	✓	✓
CCAR – Procedures	✓	✓	✓			✓	✓	✓
CCAR – Assumptions & Models	✓	✓	✓			✓	✓	✓

Treasury Recommendations	U.S. Banking Organizations					FBO IHCs		
	G-SIBs	IABs ($250b+ or $10b+ foreign exposures)	Regional Banks ($50n-250b)	Mid-sized Banks ($10b-50b)	Community Banks (<$10b)	Advanced Approaches FBO IHCs	Large FBO IHCs ($250b+ or $10b+ foreign exposures)	Standardized Approach FBO IHCs (<$250b)
DODD-FRANK ACT STRESS TESTING (DFAST)								
DFAST	✓	✓	✓*	✓*		✓	✓	✓
TLAC AND LTD REQUIREMENTS								
Recalibration of LTD Ratio for U.S. G-SIBS	✓							
Recalibration of Internal TLAC Requirement for FBO IHCs						✓**	✓**	✓**
CHOICE ACT OFF-RAMP								
Regulatory Off-Ramp for Highly-Capitalized Entities	✓	✓	✓	✓	✓	✓	✓	✓
LIQUIDITY COVERAGE RATIO (LCR)								
Scope of Applicability	✓	✓	✓					
Inclusion of "High-grade Municipal Bonds" as Level 2B HQLAs	✓	✓	✓					
Evaluation of Impact on Private Label Securitizations	✓	✓	✓					
Adjustment of Cash Flow Methodologies	✓	✓	✓					

* Also applies to credit unions
** Applies only to FBO IHCs that have a top-tier parent that is a non-U.S. G-SIB

Treasury Recommendations	U.S. Banking Organizations					FBO IHCs		
	G-SIBs	IABs ($250b+ or $10b+ foreign exposures)	Regional Banks ($50n-250b)	Mid-sized Banks ($10b-50b)	Community Banks (<$10b)	Advanced Approaches FBO IHCs	Large FBO IHCs ($250b+ or $10b+ foreign exposures)	Standardized Approach FBO IHCs (<$250b)
LIQUIDITY REQUIREMENTS UNDER ENHANCED PRUDENTIAL STANDARDS (EPS)								
Recalibration of Liquidity Requirements Applicable to U.S. IHCs of FBOs						✓	✓	✓
RESOLUTION PLANNING LIQUIDITY REQUIREMENTS								
Recalibration of Resolution Liquidity Execution Need (RLEN) and Resolution Liquidity Adequacy and Positioning (RLAP)	✓					Resolution Plan First-Wave Filer FBOs		
PROPOSED NET STABLE FUNDING RATIO (NSFR)								
Delay and reassessment of proposed NSFR rule	✓	✓	✓					

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Related Resources: Davis Polk's memoranda, visuals, interactive tools and webcasts on bank capital and other prudential standards are available at USBasel3.com