Davis Polk

Brown-Vitter Bill

Commentary and Analysis

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Introduction

The bill announced by Senators Sherrod Brown (D-Ohio) and David Vitter (R-La.) is the latest volley in the ongoing debate about whether financial reform has gone far enough in ending the risk that some banks are too big to fail.[1] Although it is highly unlikely that the Brown-Vitter bill, in its current form, will become law, its erroneous assumptions and assertions, as well as the policy measures proposed by the bill, could resurface, either in other bills or as pressure on regulators to transform the financial regulatory landscape.[2]

The Brown-Vitter bill's core political game of punishing the larger banks while offering the false prospect of protections to smaller banks follows a traditional playbook in American financial legislation. The problem is that the bill would end up hurting banks of all sizes and could inflict serious harm to the U.S. economy. There must be a way to exempt community banks from the most burdensome aspects of Basel III without imposing on the entire U.S. banking sector a risk-insensitive and excessive leverage capital requirement, curtailing the Federal Reserve's lender-of-last-resort powers or causing our modern financial system to regress back to the instability of the 19th century. The bargain being offered to community banks is a Faustian one.

This commentary on the Brown-Vitter bill consists of a policy discussion of the bill in Part I and an analysis of the bill's key provisions in Part II. Part II also includes a visual overview of capital requirements in the Brown-Vitter bill and a chart comparing the bill's equity capital ratio with the U.S. leverage ratio and the proposed Basel III supplementary leverage ratio.

I. Policy Discussion

A. Executive Summary

- The Brown-Vitter leverage ratio is too blunt an instrument for prudential financial regulation because it is not capable of distinguishing between risky and non-risky assets, and could result in two banks with vastly different risk profiles holding exactly the same amount of capital.
- Even assuming, for the sake of argument, that a leverage ratio is appropriate as the exclusive capital adequacy metric, the minimum levels set by the Brown-Vitter bill have no rational basis. Among other things, they fail to take into account the significant increase in the largest U.S. banks' **common equity** levels in recent years. For example, the results of the Federal Reserve's 2013 Dodd-Frank and CCAR stress tests show that the largest U.S. bank holding companies have enough common equity to absorb all of their projected losses under the Federal Reserve's severely adverse stress scenario and still have enough common equity left to exceed the minimum risk-based and leverage capital requirements.
- The inappropriate calibration and design of the Brown-Vitter leverage ratio reveals the dangers of prescribing technical capital standards through legislation.

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[1] The text of the Brown-Vitter bill is available **here**.

[2] *See e.g.*, Rob Blackwell, *Why the Brown-Vitter Bill Matters — Even if It Doesn't Pass*, American Banker (Apr. 26, 2013), available **here**.

- By imposing excessive capital requirements on all banking groups with assets of more than $50 billion, the Brown-Vitter bill could precipitate a dangerous contraction in the supply of credit in the U.S. similar to what occurred in the Great Depression. Many banking groups would have difficulty raising the massive amount of common equity required by the bill in the public markets because the negative impact on expected returns and the dilution of existing shareholders. As a result, banking groups would be forced to reduce their assets, including by reducing lending to consumers and businesses. According to one study, lending in the banking sector could shrink by as much as $3.8 trillion, or 25% of today's level, as a result of the Brown-Vitter bill. This contraction could cause a credit crisis and drag the U.S. economy back into a recession.
- The type of recession that could result from the Brown-Vitter bill would adversely affect banks of all sizes,[3] impair U.S. financial stability, and harm households and businesses across America.
- Another fundamental flaw of the Brown-Vitter bill is its failure to take into account the new legal tools and requirements added by the Dodd-Frank Act, including the Orderly Liquidation Authority in Title II and the comprehensive set of enhanced prudential standards for systemically important financial institutions ("**SIFIs**") mandated by Title I.
- If the bill had taken into account these new legal tools and requirements, it would not have proposed a new risk-insensitive super leverage ratio that will undermine the global competitiveness of U.S. banks, adversely affect banks of all sizes, and inflict immense harm on the real economy.
- There is still much debate as to whether the largest U.S. banking groups enjoy a funding advantage or whether any such funding advantage is actually caused by a reasonable belief that such institutions would be bailed out. Unless and until it is proven that the largest U.S. banking groups in fact enjoy a significant funding advantage and that the advantage arises because of a reasonable perception in the credit markets that such institutions will be bailed out, it would be irresponsible to base public policy on the assumption that they do, especially since the Dodd-Frank Act prohibits such bailouts and the U.S. government has said it now has the legal tools necessary to impose all losses on the shareholders and creditors of such institutions without destabilizing the system.
- The Brown-Vitter bill falsely assumes that large, diversified banking groups are less safe and more prone to failure than small institutions that concentrate on a particular line of business or geographic region. U.S. banking history indicates otherwise.
- The Brown-Vitter bill's rose-colored glasses view of the U.S. banking sector before the advent of the federal safety net is contradicted by the facts. Before the establishment of the Federal Reserve System and deposit insurance, the U.S. banking system was plagued by an epidemic of regular financial panics and regular waves of bank failures that were a drag on economic growth and destabilizing for the financial system.
- The Brown-Vitter bill has some good news for small banks: it would not set a minimum leverage ratio for banking groups with $50 billion or less in total assets; it would stop U.S. implementation of Basel III; and it would amend a number of existing laws to alleviate the regulatory burden on community banks. However, nothing in the bill prohibits the U.S. banking agencies from exercising their discretion to impose minimum leverage ratios on regional, mid-size and community banks in the order of 8% or even 15% on the theory that what is good for the goose is

[3] Jeff Plagge, President and CEO, Northwest Financial Corp, Chairman-Elect, American Bankers Association, *Small Banks Will Suffer from Big-Bank Breakups,* American Banker (Apr. 15, 2013), available here.

good for the gander as a matter of best practices. In fact, the bill would *require* regulators to impose on smaller banks leverage requirements that are "comparable" to existing capital standards, giving regulators discretion to determine what is "comparable" and thereby creating a best practices trickle-down risk. To borrow Jeff Plagge's three-strikes analogy: "For those of us in the community banking space, remember when we were told that Dodd-Frank would primarily impact large banks? Strike one. Remember when we were told that the Consumer Financial Protection Bureau would only impact those with more than $10 billion in assets? Strike two. Now there is this assumption that breaking up big banks will only impact big banks. How do you call this pitch? From my perspective it has a significant chance to be strike three for community banks, big banks and our industry as a whole."[4]

B. Brown-Vitter Leverage Ratio Fails to Take Into Account Different Levels of Risk

By making a leverage ratio the centerpiece of its capital framework, the Brown-Vitter bill represents a deliberate departure from the risk-based capital framework, notwithstanding the fact that the risk-based approach has been endorsed and adopted by all major economies around the world. While there may arguably be some merit to an *appropriately calibrated* leverage ratio to exist alongside a risk-based capital framework,[5] a leverage ratio on its own is too blunt an instrument for prudential financial regulation.

The inherent disadvantage of a leverage ratio such as the one in the Brown-Vitter bill is its inability to distinguish between risky and non-risky assets. Imagine two banks with exactly the same amount of tangible common equity and exactly the same amount of total assets. Bank A's assets primarily consist of U.S. Treasury bonds backed by the full faith and credit of the U.S. government. Bank B's assets primarily consist of the junior tranches of commercial real estate securitizations and equity exposures. The two banks would have exactly the same leverage ratio under the Brown-Vitter bill, notwithstanding their entirely different risk profiles. In contrast, under a risk-based capital framework, Bank B's risk-based capital ratio would be lower than Bank A's risk-based capital ratio, reflecting Bank B's riskier balance sheet. Further background on the risk-based capital framework can be found in Part II.

C. No Rational Basis for the Level of the Proposed Leverage Ratio

Even assuming that a stand-alone leverage ratio is appropriate, the minimum levels set by the Brown-Vitter bill have no rational basis. In deciding the appropriate amount of tangible common equity, the Brown-Vitter bill completely ignores the results of the Federal Reserve's annual supervisory stress tests.

1. U.S. Banks Already Hold Sufficient Common Equity to Withstand Severely Adverse Stress

The results of the Federal Reserve's 2013 Dodd-Frank and CCAR stress tests demonstrate that the largest U.S. bank holding companies had enough **common equity** to absorb all of their projected losses under the Federal Reserve's severely adverse stress scenario and still had enough common equity left to exceed the minimum risk-based and leverage capital requirements. Going forward, Basel III will place an even greater emphasis on common equity capital, will significantly increase minimum capital requirements (as illustrated by this **Davis Polk visual**) and will require all preferred stock and

[4] *Id.*

[5] Under both the existing U.S. bank capital framework and under Basel III, a leverage ratio exists alongside the risk-based capital framework.

subordinated debt capital instruments to be written off or converted to common equity at the point of "non-viability."

The severely adverse stress scenario used in the recent stress tests was deliberately designed to reflect, at a minimum, the economic and financial conditions typical of a severe post-World War II U.S. recession.[6] Among the assumptions made by the Federal Reserve under its severely adverse stress scenario was a drop in stock market equity prices of more than 50%, a decline in real GDP of 5%, an increase in the unemployment rate to 12%, a decline in house prices of more than 20%, recessions in Europe, the U.K. and Japan and below-trend growth in developing Asia.[7]

The Federal Reserve concluded that as a group, the largest bank holding companies have increased their common equity to more than twice the amount they had during the financial crisis of 2008. Specifically, the weighted tier 1 common equity ratio of the 18 bank holding companies, which is the ratio of common equity to risk-weighted assets, has more than doubled from 5.6% at the end of 2008 to 11.3% in the fourth quarter of 2012, reflecting an increase in common equity from $393 billion to $792 billion during the same period.[8] This means that the largest U.S. bank holding companies now have more than twice as much loss-absorbing capacity than they did a few years ago. As noted above, Basel III will further increase bank capital requirements — yet the Brown-Vitter bill would prohibit the implementation and application of Basel III to any banking organization.

Besides a significant increase in levels of loss-absorbing capital, U.S. banks have also substantially improved their liquidity profiles. For example, U.S. banks' holdings of cash and high-quality liquid securities have more than doubled since the end of 2007 and now total more than $2.5 trillion.[9]

2. Dangers of Prescribing Technical Capital Metrics Through Legislation

Had the authors of the Brown-Vitter bill taken into account the Federal Reserve's Dodd-Frank and CCAR stress test results, they would, at the very least, have recalibrated the levels of their proposed minimum leverage ratios. The recalibrated ratios would not have been nearly as high in view of the strong capital positions already maintained by the largest U.S. banks. Instead, they would have been more in line with the existing U.S. leverage ratio.

Moreover, by nearly doubling the minimum leverage ratio from 8% to 15% when a banking group crosses an arbitrary $500 billion total assets threshold, the bill would impose a *de facto* cap on growth for banking groups that are currently below the threshold. As the president of the New York Fed stated: "With respect to size limitations, it is important to recognize that a new and much reduced size threshold could sacrifice socially useful economies of scale and scope benefits. And it could do this without actually solving the problem of system risk externalities that aren't related to balance sheet size."[10]

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[6] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *Stress Testing Banks: What Have We Learned?* (Apr. 8, 2013), available **here**.

[7] Federal Reserve, *2013 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule* (Nov. 15, 2012), available **here**.

[8] Federal Reserve, *Press Release - Federal Reserve Announces Results of Comprehensive Capital Analysis and Review (CCAR)* (Mar. 14, 2013), available **here**.

[9] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *Stress Testing Banks: What Have We Learned?* (Apr. 8, 2013), available **here**.

[10] William C. Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, *Solving the Too Big to Fail Problem* (Nov. 15, 2012), available **here.**

The approach taken in the Brown-Vitter bill demonstrates the dangers of setting numerical capital requirements through the legislative process, rather than providing experienced regulators with the authority to establish appropriate capital standards that properly align regulatory capital requirements with actual risks and foster a financial regulatory environment that is conducive to the level of credit availability to support a strong economic recovery and long-term economic growth. As Senator Mike Crapo (R-Idaho), ranking minority member of the Senate Banking Committee, stated in response to the Brown-Vitter bill: setting capital standards is a job for regulators, not legislators.[11]

D. Brown-Vitter Could Cause a Dangerous Contraction in the Supply of Credit

The kind of capital levels mandated by the Brown-Vitter bill create a substantial risk of causing a dangerous contraction in the supply of credit similar to the Great Contraction of money and credit caused by the Federal Reserve during the Great Depression. As discussed below, Nobel Prize-winning economist Milton Friedman showed that the Great Depression was deepened and prolonged because of what he called the Great Contraction of money and credit caused by the Federal Reserve's reluctance to use its lender-of-last-resort authority aggressively enough.

The Brown-Vitter bill could precipitate a similarly dangerous contraction in the supply of credit in the United States by imposing excessive tangible common equity leverage requirements on U.S. banks and their parent holding companies. According to an S&P report, banking groups would need to raise as much as $1.2 trillion in additional equity to meet the capital levels required by the Brown-Vitter bill.[12] According to S&P, the equity markets simply would not be able to meet the "massive level of common equity the bill requires." As a result, banking groups would be forced to reduce their assets, including by reducing lending to customers and businesses. For U.S. banking groups with cross-border activities, having to comply with leverage ratios that are much higher than in any other jurisdiction in the world would severely undermine their international competitiveness.

One group of economists estimated that the Brown-Vitter capital requirements could reduce lending capacity by $3.8 trillion, or 25% of today's level.[13] S&P similarly stated that the Brown-Vitter requirements could cause a credit crisis and drag the U.S. economy back into a recession.[14] To top it off, the bill would require banks to do all this within five years, and at a time when the U.S. economy is only beginning to recover from a deep economic recession.

The type of recession that could result from the Brown-Vitter bill would adversely affect banks of all sizes, impair U.S. financial stability, and harm households and businesses across America.

Some academics, led by Anat Admati, Martin Hellwig[15] and Simon Johnson,[16] have argued that increased common equity requirements would have no impact on the total cost of debt and equity capital raised by banking groups, or the supply of money and credit provided by these banking groups, based on a theoretical economic model developed by Franco Modigliani and Merton Miller (the "**MM model**").

[11] Cheyenne Hopkins, *Crapo Says He Opposes Setting Capital Standards With Legislation*, Bloomberg (Apr. 9, 2013), available **here**.

[12] S&P, *Brown-Vitter Bill: Game-Changing Regulation For U.S. Banks* (Apr. 25, 2013).

[13] Goldman Sachs Equity Research, *Brown-Vitter Bill: The Impact of Potential New Capital Rules* (Apr. 10, 2013).

[14] S&P, *Brown-Vitter Bill: Game-Changing Regulation For U.S. Banks* (Apr. 25, 2013).

[15] Anat Admati & Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It* (2013).

[16] Simon Johnson, *Higher Bank Equity Is in the Public Interest,* Bloomberg (Mar. 3, 2013), available **here**.

Other economists contend that the MM model is based on idealistic assumptions that do not apply in the real world and may not apply to banks and other financial institutions that (1) are engaged in the maturity transformation process; (2) provide money and money-like instruments to the market; and (3) allow payments to be made more efficiently by electronic transfer than by physical deliveries of cash.[17] These economists argue that the MM model is not an appropriate tool for developing sound equity capital requirements for the banking system in the real world.[18] They also argue that when a more realistic model is applied to banks and other financial institutions, the cost of these higher equity requirements is a contraction in the supply of credit provided by these institutions. As noted above, one group of economists has estimated that the Brown-Vitter bill would result in a $3.8 trillion reduction in available credit in the U.S. banking system, or 25% of today's levels.

If this second group of economists is right that there is a trade-off between increased capital requirements and the supply of money and credit, the Brown-Vitter bill could indeed trigger a dangerous contraction in the supply of credit similar to the Great Contraction during the Great Depression. It will be too late to turn back the clock once the harm is done. Common sense dictates that we should not base real-world government policy in the world's largest economy on a theoretical model like the MM model unless we are sure that its implications are valid in the real world.

E. A Fundamental Flaw: The Failure of Brown-Vitter to Take Into Account New Legal Tools Added by the Dodd-Frank Act

A fundamental flaw of the Brown-Vitter bill is its failure to take into account the new legal tools and requirements added by the Dodd-Frank Act.

1. Title II of the Dodd-Frank Act

Title II of the Dodd-Frank Act gives regulators the power to impose losses on the entire range of capital structure liabilities of SIFIs without destabilizing or risking a collapse of the financial system and, importantly, without the need for a government bailout. In fact, Title II expressly mandates that "**taxpayers shall bear no losses** from the exercise of any authority under this title."[19]

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[17] For example, Harry DeAngelo, Kenneth King Stonier Chair at the Marshall School of Business, University of Southern California, and René M. Stulz, Everett D. Reese Chair of Banking and Monetary Economics at Ohio State University, describe the idealistic assumptions of the MM model as follows: "There are no taxes, agency costs, or any other types of frictions. The capital market is complete, with costless access for all households, operating firms, and banks. Intermediation is redundant because all operating firms and households can directly access capital markets at zero cost." This is clearly not an appropriate description of any real-world economy. *See* Harry DeAngelo & René M. Stulz, *Why High Leverage is Optimal for Banks* (Apr. 12, 2013), available **here**.

[18] *See, e.g.*, Douglas Gale, Silver Professor and Professor of Economics, New York University, *Capital Ratios May Be Too High, Not Too Low*, Lunch Speech, Conference on Resolution Authority and Structural Reform, NYU Stern School of Business (Apr. 11, 2013); Douglas Elliott, *Higher Bank Capital Requirements Would Come at a Price*, Brookings Institution Working Paper (Feb. 20, 2013), available **here**.

See also Harry DeAngelo & René M. Stulz, *Why High Leverage is Optimal for Banks* (Apr. 12, 2013), available **here** ("Bank leverage and liquidity production are connected in a fundamentally inseparable way so that it is inappropriate to use MM's debt-equity neutrality principle for judgments that bank leverage is excessive. When liquidity is valuable, regulations mandating significant bank-leverage reductions are not free to society, as they would be if the MM theorem were applicable.").

[19] *See* Dodd-Frank Act § 214(c) (emphasis added); Sheila C. Bair, former FDIC Chairman, *Statement on the Changing Role of the FDIC before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs; Committee on Oversight and Government Reform, U.S. House Of Representatives* (Jun. 22, 2011), available **here** ("The [Dodd-Frank Act] create[d] an Orderly Liquidation Authority (OLA) that gives the FDIC receivership-like powers over bank holding companies and non-bank SIFIs if they cannot be resolved in an orderly manner through bankruptcy. . . . **The OLA strictly prohibits bailouts**.")(emphasis added).

The FDIC and our bankruptcy courts now have the power to impose losses on preferred stock, long-term unsecured debt and any other capital structure liabilities. This means that common equity is no longer the only capital structure liability that is truly loss-absorbing. Other capital structure liabilities can be made to absorb losses, after all the common equity has been wiped out, in accordance with the contractual priority of their claims.

Even under the Basel III framework, the U.S. implementation of which the Brown-Vitter bill would prohibit, all non-common equity capital instruments issued by banking organizations, such as perpetual preferred stock and subordinated debt, must include terms for their write-off or conversion to common equity at the point of "non-viability."[20] In proposing rules to implement Basel III in the United States, the U.S. banking agencies specifically noted that "U.S. law generally is consistent with the Basel non-viability standard," citing Title II of the Dodd-Frank Act, Section 11 of the Federal Deposit Insurance Act ("**FDIA**") (for insured depository institutions) and U.S. bankruptcy law.[21]

This new power is illustrated by the FDIC's new single-point-of-entry ("**SPOE**") recapitalization approach, which is designed to resolve even the largest, most complex and most global financial institutions by imposing all losses on their capital structure liabilities rather than on taxpayers. The FDIC's approach is authorized under Title II of the Dodd-Frank Act.

FDIC Chairman Martin Gruenberg and Bank of England Deputy Governor Paul Tucker wrote an article in the *Financial Times* arguing that their jointly developed SPOE approach will work during a financial crisis as long as an institution has sufficient capital structure liabilities and access to a temporary secured liquidity facility provided by the private or public sectors.[22]

The SPOE approach has also been endorsed with varying degrees of confidence by former FDIC Chairman Sheila Bair,[23] current Federal Reserve Chairman Ben Bernanke[24] and Federal Reserve Governors Daniel Tarullo,[25] Jeremy Stein[26] and Jerome Powell.[27] It has also been endorsed by the Bank of England[28] and the Financial Stability Board.[29]

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[20] Basel Committee, *Final Elements of the Reforms to Raise the Quality of Regulatory Capital* (Jan. 2011), available **here**.

[21] *See* Federal Reserve, OCC & FDIC, *Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 Fed. Reg. 52,792, 52,815 (Aug. 30, 2012).

[22] Martin Gruenberg and Paul Tucker, *When Global Banks Fail, Resolve Them Globally*, Financial Times (Dec. 10, 2012), available **here**. *See also* Martin Gruenberg, FDIC Chairman, *Remarks at the FDIC to the Federal Reserve Bank of Chicago Bank Structure Conference* (May 10, 2012), available **here** ("The new [Dodd-Frank Title II] resolution authority does **not** provide insurance or credit protection for creditors and counterparties, and creditors will always be subject to potential losses. This is a central feature of the new resolution authority and is designed to ensure that there is market accountability. . . . In all likelihood the firm's equity holders will be wiped out and their claims will likely have little or no value. . . . [T]he FDIC expects that it will have to look to subordinated debt or even senior unsecured debt claims as the immediate source of capital. These debt holders can thus expect that their claims will be written down . . . .").

[23] Sheila C. Bair, former FDIC Chairman, *Why Taxpayers May Now Be Off the Hook When a Big Bank Fails*, Fortune Magazine (Apr. 11, 2013), available **here**.

[24] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *Semiannual Monetary Policy Report to the Congress Before the Senate Committee on Banking, Housing, and Urban Affairs* (Feb. 26, 2013) ("We didn't have the tools [during the crisis], now we have the tools . . . . Some of these rules take time to develop. The orderly liquidation authority . . . we've made a lot of progress on that. . . . There's a three-part plan under Dodd-Frank. . . . Number two is the orderly liquidation authority, which we're working closely with the FDIC and with our foreign counterparts to figure out how we would take down a large institution without bringing down the system . . . . Even though U.S. banks are stronger financially than European banks, frequently U.S. banks have wider credit default swap spreads, indicating a higher probability of actual failure because the differences between U.S. and Europe in terms of government proceeds government support.").

[25] Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, *Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs* (Feb. 14, 2013), available **here** ("Since the passage of the Dodd-Frank Act, the FDIC has been developing a single-point-of-entry strategy for resolving systemic financial firms under the OLA. As explained by the FDIC, this (*cont.*)

The SPOE approach has been stress-tested in simulations conducted by U.S. financial regulatory officials under the direction of the Financial Stability Oversight Council and by the private sector in a simulation sponsored by The Clearing House Association.[30]

The SPOE approach can also be successfully used under existing Chapter 11 of the Bankruptcy Code, at least under certain economic conditions. It could be successfully used under the Bankruptcy Code even under the most severely adverse economic conditions if a new Chapter 14 (with certain modifications to the current proposal) were added to the Bankruptcy Code to govern the liquidation and reorganization of financial institutions. To be effective under the most severely adverse economic scenarios, the new Chapter 14 would need to include a lender-of-last-resort facility that could provide temporary secured liquidity to any newly recapitalized bridge institutions created under Section 363 of the Bankruptcy Code and to their fully recapitalized subsidiaries, while ensuring that all of the group's losses would be borne by the holders of the group's capital structure liabilities.

2. Title I of the Dodd-Frank Act

In addition to the new tools under Title II of the Dodd-Frank Act, Title I of the Dodd-Frank Act requires the Federal Reserve to impose higher risk-based and leverage capital requirements, heightened liquidity standards, single counterparty credit limits, heightened risk management standards, annual capital stress testing requirements and a whole host of other enhanced prudential standards on SIFIs. Title I also requires each SIFI to submit a credible resolution plan, or "living will," to demonstrate how it would be resolved in a rapid and orderly manner in the event of the company's material financial distress or failure. Furthermore, the Federal Reserve is required to establish a framework for the early remediation of any financial weaknesses experienced by SIFIs. All of these heightened standards are designed to minimize the possibility that a SIFI will become insolvent as well as to minimize the impact such insolvency would have on the financial stability of the United States.

Brown-Vitter: If the Brown-Vitter bill had taken into account these new legal tools and requirements, it would not have proposed a new risk-insensitive super leverage ratio that will undermine the global competitiveness of U.S. banks, adversely affect banks of all sizes, and inflict immense harm on the real economy. At the very least, in light of the new powers under Title II of the Dodd-Frank Act, the bill would

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(*cont.*)

strategy is intended to effect a creditor-funded holding company recapitalization of the failed financial firm, in which the critical operations of the firm continue, but shareholders and unsecured creditors absorb the losses, culpable management is removed, and taxpayers are protected.").

[26] Jeremy C. Stein, Governor, Board of Governors of the Federal Reserve System, *Regulating Large Financial Institutions* (Apr. 17, 2013), available **here** ("Higher and more robust capital requirements, new liquidity requirements, and stress testing all should help to materially reduce the probability of a SIFI finding itself at the point of failure. And, if, despite these measures, a SIFI does fail, the orderly liquidation authority (OLA) in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act now offers a mechanism for recapitalizing and restructuring the institution by imposing losses on shareholders and creditors. . . . [T]he Federal Deposit Insurance Corporation's (FDIC's) so-called "single point of entry" approach to resolution is a promising one. . . . I believe this approach gets the first-order economics right and ultimately has a good chance to be effective.").

[27] Jerome H. Powell, Governor, Board of Governors of the Federal Reserve System, *Ending "Too Big to Fail"* (Mar. 4, 2013), available **here** ("If the [SPOE] process can be fully worked out and understood by market participants, regulators, and the general public, it should work to resolve even the biggest institution without starting or accelerating a run, and without exposing taxpayers to loss.").

[28] Bank of England & FDIC, *Joint Paper on Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012), available **here**.

[29] Financial Stability Board, *Recovery and Resolution Planning: Making the Key Attributes Requirements Operational* (*Consultative Document)* (Nov. 2012), available **here**.

[30] *See* The Clearing House Association, *Report on the Orderly Liquidation Authority Resolution Symposium and Simulation* (Jan. 2013), available **here**.

have included all common and preferred stock, long-term unsecured debt and all other loss-absorbing capital structure liabilities in the numerator of its leverage requirement, instead of just tangible common equity.

F. Brown-Vitter's Unproven Premise About an Implicit Subsidy

In their *New York Times* op-ed article, Senators Brown and Vitter claim that the largest U.S. banking groups enjoy an implicit annual subsidy of $83 billion in the form of lower borrowing costs because the market assumes that they will be bailed out by the government if they fail.[31]

Their assertion is based on studies that are subject to dispute over their methodologies and conclusions. For example, the $83 billion number is extrapolated by journalists at Bloomberg[32] from an attempt by two researchers in a working paper to estimate the level of the implicit subsidy that certain large banking groups allegedly received.[33] The researchers' estimates are based on judgments made by a single credit rating agency. As the researchers themselves stated in their paper, "rating agencies have been known to make mistakes in their judgments."[34]

Most economists agree that the largest, most diversified banking groups enjoy lower funding costs than smaller, less diversified banks. This relationship should not be surprising because the same relationship exists between the funding costs of large, diversified commercial (*i.e.*, non-financial) groups and smaller, less diversified commercial companies.[35]

But economists do not agree on the size of the funding advantage of the largest U.S. banking groups. Some argue that the right figure is much lower by orders of magnitude, if it exists at all. They argue that many of the higher estimates are based on historical data from narrow periods that are not representative of the full range of relevant time periods. They also argue that many of the higher estimates are based solely on a comparison of the relative cost of deposit funding at subsidiary bank levels, and do not take into account the higher cost of funding for the largest banking groups at the bank holding company levels. This is important because the largest U.S. banking groups raise a significant amount of their funding at the holding company level.[36]

The most important point of dispute is whether any of the studies that allege a funding advantage have actually proven that there is a cause-and-effect relationship between the funding advantage and any perception by the market that the largest banking groups would be bailed out by the government if they fail. The studies that allege a funding advantage appear simply to assume rather than to prove that any

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[31] Sherrod Brown & David Vitter, *Make Wall Street Choose: Go Small or Go Home*, New York Times (Apr. 24, 2013), available **here**.

[32] Bloomberg Editors, *Why Should Taxpayers Give Big Banks $83 Billion a Year?* (Feb. 20, 2013), available **here**. The journalists at Bloomberg took a percentage point estimate made in the working paper and multiplied it by the total liabilities of the 10 largest U.S. banks by assets to derive at the $83 billion figure. As noted further below, the working paper's estimates are based on judgments made by a single credit rating agency before the passage of the Dodd-Frank Act and well before the regulatory implementation phase of the statute's key provisions, which is currently underway.

[33] Kenichi Ueda & Beatrice Weder di Mauro, *Quantifying Structural Subsidy Values for Systemically Important Financial Institutions*, IMF Working Paper (May 2012), available **here**.

[34] *Id.* at 4.

[35] *See* Francesca Franco, Oktay Urcan & Florin P. Vasvari, *Debt Market Benefits of Corporate Diversification and Segment Disclosures* (Jan. 31, 2013), available **here**; Michel Araten & Christopher Turner, *Understanding the Funding Cost Differences Between Global Systemically Important Banks (G-SIBs) and Non-G-SIBs in the United States* (Mar. 11, 2012), available **here**.

[36] *See* Michel Araten & Christopher Turner, *Understanding the Funding Cost Differences Between Global Systemically Important Banks (G-SIBs) and Non-G-SIBs in the United States* (Mar. 11, 2012), available **here**. *See also* Thomas Brown, *The Myth of the Too-Big-To-Fail Subsidy* (Apr. 25, 2013), available **here**.

alleged funding advantage is caused by the market's belief that the largest U.S. banking groups will be bailed out by the government if they fail. Under Secretary of the Treasury for Domestic Finance Mary John Miller recently argued that no such connection has been proven.[37]

These studies also do not reflect the new legal tools created by the Dodd-Frank Act that allow both the banking regulators and our bankruptcy courts to impose losses on the holders of common equity, preferred stock, long-term unsecured debt and other capital structure liabilities without the need for a government bailout and without destabilizing or risking a collapse of the financial system. Nor do these studies reflect the publicly announced commitment of the federal government, the U.S. banking agencies or the bankruptcy courts to impose such losses in this manner.[38] These studies also do not take into account the explicit congressional mandate in Title II of the Dodd-Frank Act that "taxpayers shall bear no losses from the exercise of any authority under this title." For example, the research paper from which the $83 billion number was extrapolated attempts to estimate the alleged subsidy as of end-2007 and end-2009 — before the passage of the Dodd-Frank Act and well before the regulatory implementation phase of the statute's key provisions, which is currently underway.

Under Secretary Miller argued that because of these new legal tools and commitments, it would be unreasonable for the market to assume that large U.S. banking groups will be bailed out by the government if they fail. She also pointed out that since the financial crisis, the largest banking groups' borrowing costs have not only increased at a rate greater than those of certain regional bank competitors, but have also increased to higher absolute levels.[39]

To the extent all U.S. banks enjoy lower deposit funding costs than they would otherwise enjoy because of FDIC deposit insurance, they pay for that benefit by paying deposit insurance premiums based on the amount of their assets and the riskiness of their activities. This is not corporate welfare. This is the same benefit that any purchaser of insurance receives in return for paying insurance premiums. In fact, the FDIC's Deposit Insurance Fund is funded entirely by assessments paid by insured depository institutions. It is not taxpayer funded.

G. Brown-Vitter's Invalid Assumption that Big is Bad

The Invalid Assumption: The Brown-Vitter bill and statements in support of the bill falsely assume that large, diversified banking groups are less safe and more prone to failure than small institutions that concentrate on a particular line of business or geographic region. This invalid assumption is perhaps best captured by the title of the *New York Times* op-ed article written by Senators Brown and Vitter: *Go Small or Go Home*. The flawed reasoning infects nearly all aspects of the Brown-Vitter bill: from the much higher leverage ratios imposed on larger banks to the ban on all Section 23A "covered transactions" between large insured depository institutions and their affiliates.

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[37] *See* Mary John Miller, Under Secretary of the Treasury for Domestic Finance, *Remarks at the Hyman P. Minsky Conference* (Apr. 18, 2013), available **here**.

[38] *See* Mary John Miller, Under Secretary of the Treasury for Domestic Finance, *Remarks at the Hyman P. Minsky Conference* (Apr. 18, 2013), available **here** ("[N]o financial institution, regardless of its size, will be bailed out by taxpayers again. Shareholders of failed companies will be wiped out; creditors will absorb losses; culpable management will not be retained and may have their compensation clawed back; and any remaining costs associated with liquidating the company must be recovered from disposition of the company's assets and, if necessary, from assessments on the financial sector, not taxpayers.").

[39] *Id.* *See also* Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *Semiannual Monetary Policy Report to the Congress Before the Senate Committee on Banking, Housing, and Urban Affairs* (Feb. 26, 2013) ("[E]ven though U.S. banks are stronger financially than European banks, frequently U.S. banks have wider credit default swap spreads, indicating a higher probability of actual failure because of the differences between the U.S. and Europe in terms of perceived government support.").

As further discussed in Part II, the bill's prohibition on covered transactions is tantamount to a *de facto* reinstatement of the Glass-Steagall Act, which prohibited combinations of commercial and investment banking. However, top U.S. regulators have warned that reinstating Glass-Steagall type prohibitions would not reduce systemic risk,[40] and would instead have a number of undesirable consequences.[41]

The Facts: Statistics on banking demonstrate the falsity of the "big is bad" assumption. For example, according to the U.S. Government Accountability Office, between January 2008 and December 2011, 414 insured U.S. banks failed. Of these, 85%, or 353, had less than $1 billion in assets.[42] As former Treasury Secretary Larry Summers explained: "[smaller] banks would be less diversified and, therefore, at greater risk of failing, because they wouldn't have profits in one area to turn to when a different area got in trouble. And most observers believe that dealing with the simultaneous failure of many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment."[43]

H. Brown-Vitter's False Premise About the Good Old Days

The False Premise: A fundamental premise of the Brown-Vitter bill is that if we just turned back the clock to the "good old days" of the 19th century before the Federal Reserve and deposit insurance existed, and if commercial banks and their holding company parents were all required to maintain common equity ratios similar to what most banks allegedly had in the 19th century, we would have a more resilient financial system without the sort of financial crises that occurred in 2008.

This false premise is reflected in Senator Brown and Senator Vitter's recent op-ed article in the *New York Times*, in which they favorably claim that banks had common equity leverage ratios of 15% to 20% before the creation of the Federal Reserve's lender-of-last-resort authority in 1913 and the advent of deposit insurance in 1933, which they refer to as the federal safety net. This false premise is also reflected in the bill's requirement of a study of the historic capital ratios of large depository institutions before the advent

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[40] *See e.g.*, Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *Semiannual Monetary Policy Report to the Congress Before the Senate Committee on Banking, Housing, and Urban Affairs* (Feb. 26, 2013) ("I don't think that that Glass-Steagall by itself really would be all that helpful, because after all, in the crisis, some of the firms that fail were straight investment banks and some of the firms that were in trouble were straight commercial banks.").

See also William C. Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, *Solving the Too Big to Fail Problem* (Nov. 15, 2012), available **here** ("In my opinion, there are shortcomings to reimposing Glass-Steagall-type activity restrictions or strict size limits. With respect to Glass-Steagall, it is not obvious to me that the pairing of securities and banking businesses was an important causal element behind the crisis. In fact, independent investment banks were much more vulnerable during 2008 than the universal banking firms which conducted both banking and securities activities.").

[41] *See e.g.*, Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, *Industry Structure and Systemic Risk Regulation* (Dec. 4, 2012), available **here** ("The reinstatement of Glass-Steagall would mean that bank clients could no longer retain one financial firm that would have the capacity to offer the whole range of financing options--from lines of credit to public equity offerings--depending on a client's needs and market conditions.").

[42] U.S. Government Accountability Office, *Causes and Consequences of Recent Bank Failures* (Jan. 2013), available **here**.

[43] Lawrence Summers, former Secretary of the Treasury, former Director of the National Economic Council, *PBS NewsHour with Jim Lehrer* (Apr. 22, 2010).

See also Louise C. Bennetts, Associate Director of Financial Regulation Studies, Cato Institute, *Brown-Vitter: More Hot Air* (Apr. 24, 2013), available **here** ("The first problem is the [Brown-Vitter bill's] implicit assumption that large size and diversity of operations are negative traits. In fact, diversity is the key to managing risk in banking. Part of the reason why US banking has had such a checkered history relative to many other countries is because of its historical lack of geographical and product diversity – a result of the long-standing prohibitions on inter-state banking and branch banking and limitations on combining investment and commercial banking activities. One of the single biggest causes of the banking crisis in the late 1920s was a lack of geographical diversity (and, as congressional records show, States that prohibited branch banking fared the worst).").

of the federal safety net. Finally, it is reflected in the bill's proposal to severely cut back on the Federal Reserve's lender-of-last-resort authority so that it would not be available during the next financial crisis for nonbank financial institutions that engage in the same maturity transformation process as commercial banks.[44] In fact, as a technical drafting matter, though almost certainly unintended, the Brown-Vitter bill would actually repeal the discount window for commercial banks as well, except in a receivership proceeding after failure.[45]

The Facts: The Brown-Vitter rose-colored glasses view of U.S. banking history in the 19th century is contradicted by the facts. As shown by Figures 1 and 2 below, which are taken from Federal Reserve Chairman Ben Bernanke's recent lectures on the 2008 financial crisis,[46] the U.S. banking system was plagued by an epidemic of regular financial panics and regular waves of bank failures every decade or less between 1873 and the Federal Reserve's more aggressive use of its lender-of-last-resort authority and the advent of deposit insurance after 1933.

Indeed, as Chairman Bernanke stressed in his lectures, the principal motivation for creating the Federal Reserve in 1913 was to have a central bank with lender-of-last-resort authority to stem the epidemic of financial panics that plagued the late 19th century and early 20th century.[47] Having a central bank to manage monetary policy was an afterthought.

As Chicago school economist and Nobel laureate Milton Friedman showed in his classic work on the monetary history of the United States from 1867 to 1960, the Great Depression was deepened and prolonged by the early Federal Reserve's reluctance to aggressively use its lender-of-last-resort authority.[48]

In addition, during the imagined "golden age of banking" in the late 19th century and early 20th century, the United States was plagued by decades of deflation because of shortages of money and credit in the U.S. banking system, as outlined in Chairman Bernanke's lectures. As Chairman Bernanke explained, the shortage of money and credit held back the country's economic growth despite its phenomenal increase in productivity, which resulted in persistent deflation that caused farmers and other Main Street businesses that financed themselves with fixed-rate borrowings to fail with unnecessary regularity. These shortages of money and credit occurred in part because banks had ***too much*** common equity and cash reserves due to the lack of any central bank lender-of-last-resort or deposit insurance.

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[44] Maturity transformation refers to the socially beneficial process by which banks, broker-dealers and other financial institutions create money and other money-like instruments and provide long-term credit, by funding their operations with demand deposits and other overnight or short-term credit and using these funds to make long-term loans or to underwrite, deal or invest in long-term debt securities.

[45] This is because the bill's general prohibition on discount window access and other federal programs would apply to an "affiliate or subsidiary of a financial institution," which includes insured depository institution subsidiaries of bank holding companies.

[46] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *The Federal Reserve and the Financial Crisis* (Mar. 2012), available **here**.

[47] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *Lecture 1: Origins and Mission of the Federal Reserve* (Mar. 20, 2012), available **here** ("You can see in the very severe financial panic of 1893, more than 500 banks failed across the country. So that was a really big panic and it had significant consequences for the financial system and for the economy. Now, 1907 was also a pretty sharp financial crisis. The banks that failed were larger. And it was after that crisis that the Congress began to say, 'Well, wait a minute, maybe we need to do something about this, maybe we need a central bank, a government agency that can address the problem of financial panics.' . . . . Before the new central bank was established though, there was another serious financial panic in 1914. So as you can see, this really was a very serious problem for the U.S. economy. **So financial stability concerns were a major reason why Congress decided to try to create a central bank in the beginning of the 20th century**.")(emphasis added).

[48] Milton Friedman & Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (1963).

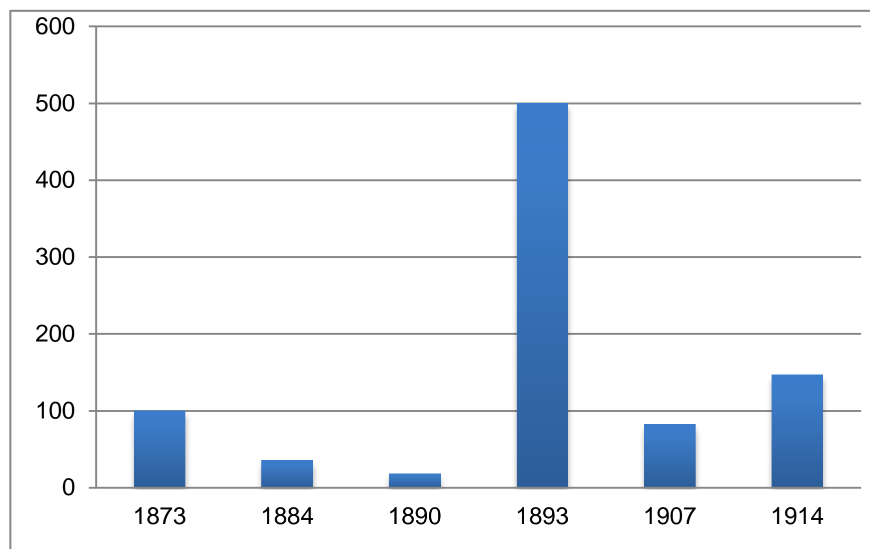
Senators Brown and Vitter argued in their *New York Times* op-ed article that the Federal Reserve's lender-of-last-resort authority was "intended for commercial banks that provided savings products and loans to American consumers and businesses." They described access to the Federal Reserve's lender-of-last-resort facilities as a form of "corporate welfare." But the Federal Reserve's lender-of-last-resort authority was inspired by and structured almost exclusively on Walter Bagehot's classic 1873 book on central banking, *Lombard Street: A Description of the Money Market.*[49]

Bagehot argued that during a financial panic central banks should lend freely to ***all*** financial institutions engaged in the maturity transformation process, provided that such loans are fully secured by any collateral that has a determinable value. He warned, however, that lender-of-last-resort facilities should distinguish between capital and liquidity. They should provide emergency liquidity to financial institutions, but not capital that would bail out their shareholders or creditors. To ensure this distinction, Bagehot stated that lender-of-last-resort facilities should be made available only to financial institutions that are solvent, that any loans should be fully secured by satisfactory collateral, and that any loans should be made at penalty (*i.e.*, above market) interest rates.

Central bank lender-of-last-resort facilities are ***not*** a form of "corporate welfare." They are designed to protect the public from the potentially catastrophic consequences of a collapse of the financial system and the knock-on effects of such a collapse in terms of increased unemployment, reduced output, social unrest and even war. Recall that the terrible economic conditions caused by the Great Depression, especially the relative weakening of Western democracies, were at least partially responsible for World War II.

Had the authors of the Brown-Vitter bill studied the lessons of banking history in the 19th century and early 20th century, their bill would expand the Federal Reserve's lender-of-last-resort authority to apply to all financial institutions engaged in the socially beneficial function of maturity transformation, at least if they are subject to the Federal Reserve's supervision in a bank holding company structure, and not contract that authority in the manner their bill proposes.

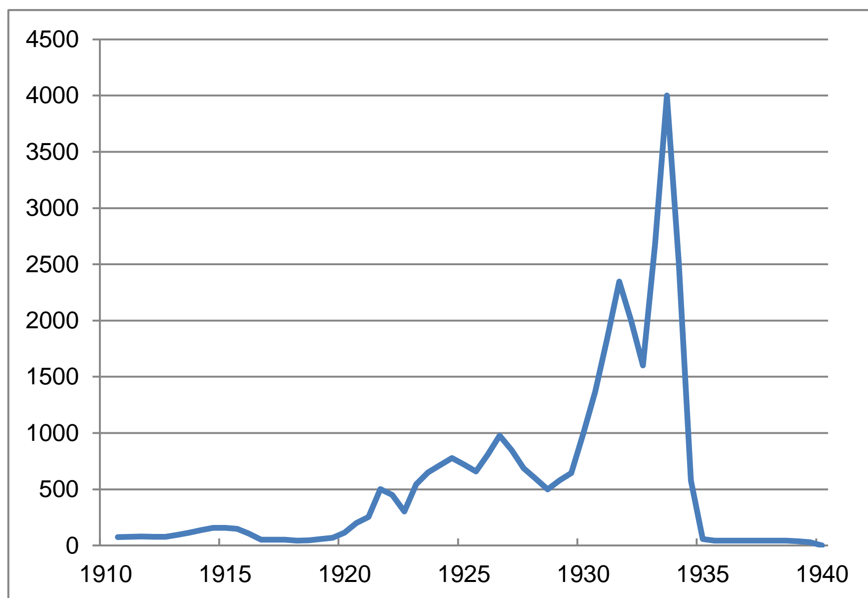
Figure 1: Bank Closings During Banking Panics, 1873 – 1914



Source: Ben S. Bernanke, *The Federal Reserve and the Financial Crisis* (Princeton 2013)

[49] Walter Bagehot, *Lombard Street: A Description of the Money Market*, electronic version available here.

Figure 2: Number of Bank Failures per Year, 1910 – 1940



Source: Ben S. Bernanke, *The Federal Reserve and the Financial Crisis* (Princeton 2013)

I. No Fail-Safe Protection for Regional, Mid-Size and Community Banks

Although the Brown-Vitter bill would not require the U.S. banking agencies to impose higher leverage ratios on regional, mid-size and community banks or their parent holding companies, except for a minimum 8% ratio for banking groups with more than $50 billion and less than $500 billion in total assets, there is nothing in the Brown-Vitter bill that would *prohibit* the U.S. banking agencies from doing so.

If the U.S. banking agencies became convinced that the Brown-Vitter 15% leverage ratio should be the new normal for the largest banks and their parent holding companies, there is nothing in the Brown-Vitter bill that would prohibit them from imposing the same 15% requirement on regional, mid-size and community banks and their parent holding companies.

Unless regional, mid-size and community banks and their parent holding companies can demonstrate that they would suffer a lower percentage of losses than the 18 largest bank holding companies during a severely adverse stress scenario similar to the one used by the Federal Reserve in the 2013 Dodd-Frank and CCAR stress tests, there is a substantial risk that the U.S. banking agencies would conclude that what is good for the goose is good for the gander as a matter of best practices. In fact, the Brown-Vitter bill would *require* regulators to impose on smaller institutions leverage requirements that are "comparable" to existing capital standards, giving regulators discretion to determine what is "comparable" and thereby creating a best practices trickle-down risk.

II. Analysis of Key Provisions of the Brown-Vitter Bill

A. Brown-Vitter Bill's Equity Capital Requirements for Financial Institutions

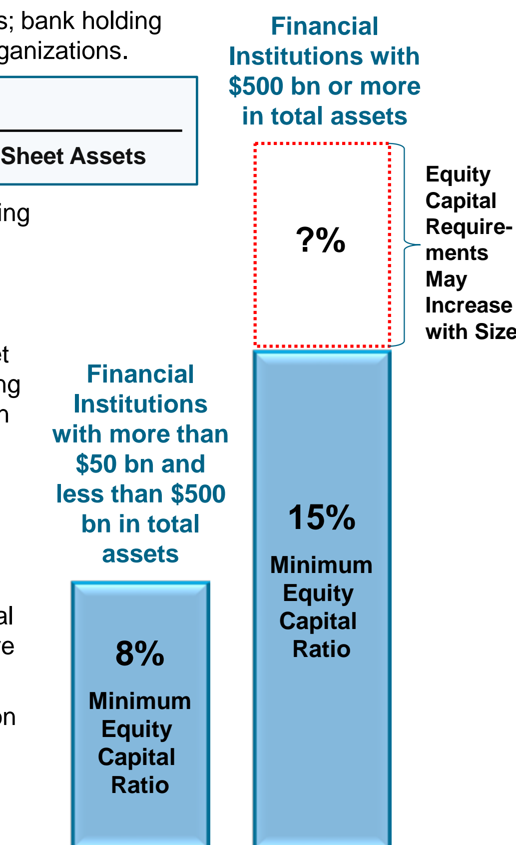
Echoing proposals by certain members of the U.S. and international regulatory communities, the Brown-Vitter bill would require U.S. banking agencies to establish minimum equity capital requirements for all financial institutions.

1. Visual Overview of the Brown-Vitter Bill's Equity Capital Requirements

Applies to "Financial Institutions": U.S. insured depository institutions; bank holding companies; savings and loan holding companies; and foreign banking organizations.

$$\text{Equity Capital Ratio (\%)} = \frac{\text{Equity Capital}}{\text{Total Consolidated On- and Off-Balance Sheet Assets}}$$

- Equity capital ratio is a **leverage ratio**. It is not capable of distinguishing between risky and non-risky assets.
- **Equity capital** consists of tangible common equity plus retained earnings.
- **Total assets** include, among other things, **(1)** certain off-balance sheet assets and **(2)** the fair value of derivative exposures without recognizing netting benefits ***unless*** certain netting and margin arrangements are in place.
- U.S. banking agencies must impose "no less stringent" equity capital requirements on **subsidiaries and affiliates** of those Financial Institutions that have $50 billion or more in total assets.
- U.S. banking agencies may **not** implement risk-based capital requirements for Financial Institutions with more than $20 billion in total assets ***unless*** "bank supervision is insufficient to prevent the excessive concentration of riskier assets."
- No minimum equity capital ratio for Financial Institutions with $50 billion or less in total assets. However, equity capital requirements for these institutions must be "comparable" to existing bank capital standards.
- U.S. banking agencies are prohibited from implementing the Basel III capital framework.



2. Scope of Application

The Brown-Vitter bill's equity capital requirements would apply to insured depository institutions, bank holding companies, savings and loan holding companies and foreign banking organizations[50] (collectively,

[50] The bill, as currently drafted, includes "a foreign bank subject to the Bank Holding Company Act of 1956" in its definition of "financial institution." Read literally, this could require the U.S. banking agencies to directly impose the bill's equity capital requirements on a foreign bank, regardless of the size of its U.S. footprint and irrespective of the fact that the foreign bank is subject to capital standards established by its home country regulator. It is unclear whether this is the intended outcome, especially since an earlier draft of the bill apparently applied the equity capital requirements to "U.S. affiliates of foreign banks."

"**Financial Institutions**"), as well as to certain of their subsidiaries and affiliates on a stand-alone basis, as discussed below.

3. Composition of the Equity Capital Ratio

The equity capital requirements center around the equity capital ratio, which is defined as the ratio of a Financial Institution's equity capital to its total consolidated on- and off-balance sheet assets. The equity capital ratio is therefore a leverage ratio.

- **Equity capital** consists of tangible common equity plus retained earnings. Confusingly, the bill defines tangible common equity as "common stockholders' equity less goodwill," and then lists "deferred tax assets, accumulated other comprehensive income, treasury stock, and intangible assets" before referring to "retained earnings." Unless Senators Brown and Vitter have determined that such intangible assets are actually appropriate measures of tangible common equity, which would represent a departure even from current Basel I-based generally applicable capital rules in the United States, we assume that this is a typographical error and that the list of intangible assets is intended to be included in the deductions from common stockholders' equity.
- **Total consolidated assets** include, among other things, the fair value of derivative exposures *without* recognizing the benefits of any netting arrangement, **unless:**
  (1) the netting arrangement is documented under a formal master netting agreement or other formal arrangement with a derivatives clearing organization; and
  (2) the Financial Institution, as a matter of ongoing business practice, exchanges collateral on a daily basis for the fulfillment of variation margin requirements on a net basis, and fulfills all contractual payment requirements, including payments for contract termination, on a net basis, with such net exchange of collateral and payments encompassing all derivative exposures covered by the formal arrangement.
- **Off-balance sheet assets** include any assets in which the Financial Institution has guaranteed performance by another party or provided a liquidity backstop should another party be unable to perform under the contractual obligation. Off-balance sheet assets exclude commitments to lend containing provisions or covenants that limit the risk to the Financial Institution with respect to future draws of liquidity.

4. Minimum Equity Capital Ratios

The Brown-Vitter bill would require the equity capital rules issued by each U.S. banking agency, in consultation with the other U.S. banking agencies, to meet the following minimum requirements, which vary depending on the size of the Financial Institution:

- **Small to Medium Financial Institutions:** The bill does not specify a minimum equity capital ratio for Financial Institutions with $50 billion or less in total consolidated assets. However, the equity capital requirements for these Financial Institutions must be "comparable" to existing U.S. bank capital standards under the prompt corrective action framework in effect as of May 1, 2013.[51] There is nothing in the bill that prevents the U.S. banking agencies from using their

[51] It remains to be seen how a stand-alone leverage ratio established for Financial Institutions with $50 billion or less in total consolidated assets pursuant to Section 3 of the Brown-Vitter bill can be "comparable" to the existing U.S. bank capital framework, which includes both leverage and risk-based capital standards. *See also* FDIA § 38 ("the capital standards prescribed by each appropriate Federal banking agency shall include [both] (i) a leverage limit; and (ii) a risk-based capital requirement.").

discretion to impose an 8% or even a 15% minimum equity capital requirement on small to medium financial institutions. They are excluded only from the bill's requirement, as explained below, for the U.S. banking agencies to implement capital requirements applicable to affiliates and subsidiaries of Financial Institutions that are no less stringent than those applicable to the Financial Institutions themselves.

- **Large Financial Institutions:** Financial Institutions with more than $50 billion in total consolidated assets must be subject to a minimum equity capital ratio of 8%. However, as discussed below, when a Financial Institution reaches the $500 billion asset threshold, the applicable minimum equity capital ratio would suddenly jump from 8% to 15%. In effect, the 15% minimum ratio would function as a *de facto* cap on growth for Financial Institutions that are currently below the $500 billion threshold.
- **Largest Financial Institutions:** Financial Institutions with $500 billion or more in total consolidated assets must be subject to a minimum equity capital ratio of 15%. In addition, the higher capital requirement for these Financial Institutions, referred to in the bill as the "capital surcharge," must fully account for and offset "any distortion of capital levels" resulting from certain federal government programs, including the federal safety net. The level of the capital surcharge would be informed by a study that the FDIC must conduct regarding the historical equity capital ratios of large depository institutions before the advent of the federal safety net. The capital surcharge may also increase with the size of the Financial Institution.
- **Well Capitalized Status:** Any Financial Institution that meets the equity capital requirements issued by the U.S. banking agencies would be considered "well capitalized."

5. Comparison with U.S. and Basel III Leverage Ratios

The equity capital ratio in the Brown-Vitter bill differs in several important respects from both the U.S. leverage ratio and the Basel III supplementary leverage ratio set forth in the recent U.S. Basel III proposals. These differences, including with respect to the scope of application, level of the ratio, and composition of the numerator and denominator, are highlighted in the **Appendix**.

6. Broad Anti-Evasion Provisions

Under the Brown-Vitter bill, any attempt by a Financial Institution to structure any activity, transaction, or affiliation for the purpose or effect of evading or attempting to evade the $500 billion asset threshold that gives rise to the capital surcharge would be considered a violation of the core banking law statutes applicable to such Financial Institution.

Furthermore, if a U.S. banking agency has reasonable cause to believe that a Financial Institution or any affiliate thereof has engaged in an activity, transaction, or affiliation in a manner that functions as an evasion of the asset threshold or otherwise violates the capital surcharge, it must order, after due notice and opportunity for hearing, the Financial Institution to restrict, restructure or divest the offending activities, transactions, or investments.

Read literally, these provisions could prevent a Financial Institution with $500 billion or more in total assets from selling assets to shrink its balance sheet below $500 billion, surely a strange result if the point of the Brown-Vitter bill is to discourage the formation or continued operation of the largest banking organizations. Unlike the U.S. banking agencies' proposed Basel III rules, which provide a mechanism for a banking organization exceeding the asset thresholds for the application of the advanced approaches

capital rules to reduce its size below the thresholds and thereby become subject solely to the standardized approach capital rules,[52] the Brown-Vitter bill does not explicitly provide for such a mechanism.

7. Compliance Timing

The equity capital requirements issued by the U.S. banking agencies must become effective within five years of publication of final rules in the Federal Register. Each U.S. banking agency would be required to issue equity capital standards within one year of the enactment of the bill. The FDIC must report to Congress the results of its study on historical equity capital ratios of large depository institutions within 90 days of enactment. Within one year of the completion of the FDIC study, each U.S. banking agency must establish capital surcharges for Financial Institutions with $500 billion or more in total consolidated assets.

B. Capital Requirements for Subsidiaries and Affiliates of Financial Institutions

The Brown-Vitter bill would revise the functional regulation provisions in the Bank Holding Company Act ("**BHC Act**"), which were inserted by the Gramm-Leach-Bliley Act ("**GLB Act**"). Among other things, the bill would remove SEC-registered broker-dealers as well as CFTC-regulated futures commission merchants, commodity trading advisers, commodity pools, commodity pool operators, swap dealers and major swap participants from the definition of "functionally regulated subsidiary." As a result, the prohibition against the Federal Reserve directly imposing capital standards on any functionally regulated subsidiary of a bank holding company would no longer apply to those entities, but would continue to apply to the remaining functionally regulated subsidiaries, *i.e.*, registered investment companies, registered investment advisers and state-regulated insurance companies.

The bill would also amend the Home Owners' Loan Act ("**HOLA**") to include a parallel prohibition against the Federal Reserve directly imposing capital standards for a "functionally regulated affiliate" of a savings association or a "functionally regulated subsidiary" of a savings and loan holding company.

Having removed several obstacles presented by the existing functional regulation framework, the bill goes on to *require* the U.S. banking agencies to establish capital requirements for affiliates and subsidiaries of those Financial Institutions that have $50 billion or more in total consolidated assets. The capital requirements for affiliates and subsidiaries must be "no less stringent" than the equity capital requirements established for Financial Institutions.

In essence, the Brown-Vitter bill would *require* the U.S. banking agencies to directly impose capital standards on SEC-registered broker-dealers and on a broad range of CFTC-regulated entities that are affiliated with Financial Institutions, including those that are affiliated with foreign banking organizations. This represents a fundamental shift in the regulation of nonbank financial intermediaries in the United States. As one SEC Commissioner recently observed, "the regulation of broker-dealers is at the heart of the Exchange Act and, as such, has been under the [Securities and Exchange] Commission's regulatory purview for nearly eight decades."[53] Indeed, the Brown-Vitter bill goes even beyond the Federal Reserve's proposed enhanced prudential standards for foreign banking organizations, which would impose U.S. bank holding company capital standards on U.S. intermediate holding companies that would be required to be established by certain large foreign banking organizations, even where the U.S.

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[52] *See* Federal Reserve, OCC & FDIC, Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule, 77 Fed. Reg. 52,978 (Aug. 30, 2012).

[53] Daniel M. Gallagher, SEC Commissioner, *Remarks at "The SEC Speaks in 2013"* (Feb. 22, 2013), available here.

intermediate holding company does not control a U.S. bank and only controls a broker-dealer and other nonbank financial companies.

C. Risk-Based Capital Standards and Basel III

The Brown-Vitter bill would limit the ability of U.S. banking agencies to impose risk-based capital requirements on Financial Institutions. Specifically, a U.S. banking agency may not implement risk-based capital requirements with respect to a Financial Institution with more than $20 billion in total consolidated assets, unless all U.S. banking agencies agree that "bank supervision is insufficient to prevent the excessive concentration of riskier assets" and submit a joint report to Congress to this effect. Thereafter, a U.S. banking agency may supplement the bill's leverage ratio with risk-based capital standards.

1. Background on Risk-Based Capital Standards

Risk-based capital standards are centered on the ratio of a bank's regulatory capital (*e.g.*, Common Equity Tier 1, Tier 1 or total capital) to its risk-weighted assets ("**RWAs**"). This ratio is known as the risk-based capital ratio and is a core component of the Basel capital framework, which is implemented in all major financial centers around the world.

The basic concept behind RWAs is to assign a risk weight, in percentage, to the bank's on-balance sheet assets and off-balance sheet exposures. The level of the risk weight reflects the level of risk associated with the asset or exposure. For example, a U.S. Treasury bond that is backed by the full faith and credit of the U.S. government would receive a relatively low risk weight, whereas a loan to a private borrower would typically receive a higher risk weight to reflect the greater level of risk associated with the asset.

Under the Dodd-Frank Act's Collins Amendment, all U.S. banking organizations must calculate their RWAs using standardized risk weights prescribed by the U.S. banking agencies, which reflect the agencies' supervisory judgments regarding the level of risk associated with bank assets and exposures. Even so-the called "advanced approaches" banking organizations that are permitted to use *supervisor-approved* internal methodologies and models to calculate RWAs are subject to a permanent capital floor based on the standardized risk weights prescribed by the U.S. banking agencies.

2. Prohibition on U.S. Basel III Implementation

The Brown-Vitter bill would prohibit U.S. banking agencies from implementing the Basel III capital standards. All major economies, including the EU, Canada, Japan, Hong Kong, Australia, India and Singapore, have issued or are close to issuing final rules to implement Basel III.[54] As noted in the thousands of comment letters submitted to the U.S. banking agencies, the manner in which the U.S. banking agencies have proposed to implement Basel III in the United States, including the proposals' broad scope of application, raise a number of serious concerns and would impose significant regulatory and compliance burdens on all U.S. banking organizations, particularly smaller institutions. Yet, a complete refusal by the United States—the world's largest economy and financial center—to apply Basel III standards to *any* of its banks would deal a fatal blow to the Basel capital framework, have negative implications for international harmonization of bank capital standards and undermine key Basel Committee initiatives on liquidity and other prudential standards.

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[54] *See* Basel Committee, *Report to G20 Finance Ministers and Central Bank Governors on Monitoring Implementation of Basel III Regulatory Reform* (Apr. 2013), available **here**.

D. Fundamental Changes to Existing Statutory Restrictions on Transactions Between a Bank and its Affiliates

1. Prohibition on 23A "Covered Transactions" Between Large Banks and Their Affiliates

The Brown-Vitter bill would make fundamental revisions to the long-standing statutory restrictions on transactions between a bank and its affiliates. In essence, the bill would amend Section 23A of the Federal Reserve Act to **prohibit**—rather than restrict or limit—a member bank[55] with $50 billion or more in total consolidated assets from engaging in any "covered transactions" with an affiliate or subsidiary that is not an insured depository institution.[56] This prohibition would presumably also extend to large non-member banks because the FDIA applies Section 23A to insured non-member banks in the same manner and to the same extent as if they were member banks.[57]

The Brown-Vitter bill contains narrow exceptions that would permit a member bank with $50 billion or more in total consolidated assets to engage in lawful dividend payments to its holding company and to make sales of property or securities to, or accept infusions of capital or other distributions from, its parent holding company.

Implications: As a result of this provision in the Brown-Vitter bill, a large U.S. bank would be banned from lending to, purchasing assets from, issuing guarantees to, and entering into derivatives and securities financing transactions with, its nonbank affiliates.

While the quantitative and qualitative restrictions on affiliate transactions in Sections 23A and 23B of the Federal Reserve Act have undergone a number of legislative amendments in their 80-year history,[58] including further strengthening by the Dodd-Frank Act, Congress has never sought to transform these limits into absolute prohibitions. This is clear recognition by Congress that banks of all sizes enter into covered transactions with their affiliates for a variety of risk management, hedging and other purposes that are consistent with safe and sound banking practices. It is also recognition that the existing quantitative and qualitative restrictions in Sections 23A and 23B, as fortified by the Dodd-Frank Act, are sufficient to ensure the safety and soundness of banks. These quantitative and qualitative restrictions are described further below.

***De Facto* Glass-Steagall:** For large banks, the Brown-Vitter bill's amendment to Section 23A of the Federal Reserve Act—which would establish an impenetrable wall between an insured bank and its affiliates—is tantamount to a *de facto* reinstatement of the Glass-Steagall Act, which prohibited

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[55] Member banks include all national banks as well as those state-chartered banks that elect to become members of the Federal Reserve System.

[56] Section 4 of the Brown-Vitter bill provides: "Except as provided . . . , only an insured depository institution that is a member bank **or an affiliate or subsidiary of a member bank** may engage in a covered transaction with another affiliate or subsidiary that is not an insured depository institution. . . . The term 'member bank' means a member bank having less than $50,000,000,000 of total consolidated assets." (emphasis added). On its face, the bill would permit an insured depository institution that has $50 billion or more in total consolidated assets to continue to engage in "covered transactions" as long as the insured depository institution is affiliated with a member bank with less than $50 billion in total consolidated assets.

[57] 12 U.S.C. § 1828(j).

[58] Section 23A originally was enacted as part of the Banking Act of 1933, and the restrictions of section 23A applied only to member banks. Since 1933, Congress has amended the statute several times, including a comprehensive revision in 1982. Congress also amended the FDIA in 1966 to apply Section 23A to insured nonmember banks in the same manner and to the same extent as if they were member banks. In addition, Congress revised HOLA in 1989 to apply Section 23A to insured savings associations in the same manner and to the same extent as if they were member banks. Congress enacted Section 23B of the Federal Reserve Act as part of the Competitive Equality Banking Act of 1987, and has subsequently expanded its scope to cover the same set of depository institutions as are covered by Section 23A.

combinations of commercial and investment banking. However, top U.S. regulators have warned that reinstating Glass-Steagall type prohibitions would not reduce systemic risk,[59] and would instead have a number of undesirable consequences.[60]

2. Existing Safeguards in Sections 23A and 23B of the Federal Reserve Act

Sections 23A and 23B of the Federal Reserve Act limit the risks to a bank from transactions with its affiliates and restrict the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the federal safety net. The statute accomplishes these purposes by imposing strict quantitative and qualitative restrictions on the ability of a bank to extend credit to, or engage in other covered transactions with, an affiliate.

Among other restrictions, Section 23A limits a bank's covered transactions with any single affiliate to no more than 10% of the bank's capital stock and surplus, and limits its covered transactions with all affiliates combined to no more than 20% of the bank's capital stock and surplus. In addition, certain covered transactions must be secured at all times by a statutorily defined amount of collateral and all covered transactions must be on terms and conditions that are consistent with safe and sound banking practices. Furthermore, Section 23B requires that covered transactions and certain other transactions between a bank and its affiliates be on market terms and on an arms-length basis.

The Dodd-Frank Act amended Sections 23A and 23B of the Federal Reserve Act in several respects. Among other things, it (1) expanded the definition of "covered transaction" to include credit exposures arising from derivatives and securities financing transactions; (2) required that collateral must be maintained at all times rather than only at the time the transaction was entered into; and (3) provided that debt obligations issued by an affiliate cannot be used to satisfy Section 23A's collateral requirements.

The Dodd-Frank Act also limited the Federal Reserve's discretion to provide exemptions from the restrictions in Sections 23A and 23B. As a result of the Dodd-Frank Act's amendments, the Federal Reserve may grant such an exemption by regulation (and not by order) only if: (1) the Federal Reserve finds the exemption to be in the public interest and consistent with the purposes of the Federal Reserve Act and notifies the FDIC of such finding; and (2) the FDIC does not object to the exemption during a 60-day notice period on the basis that the exemption presents an unacceptable risk to the Deposit Insurance Fund.

Definition of Covered Transaction: Under Section 23A of the Federal Reserve Act, "covered transaction" means, with respect to an affiliate of a member bank:

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[59] *See e.g.,* Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *Semiannual Monetary Policy Report to the Congress Before the Senate Committee on Banking, Housing, and Urban Affairs* (Feb. 26, 2013) ("I don't think that that Glass-Steagall by itself really would be all that helpful, because after all, in the crisis, some of the firms that fail were straight investment banks and some of the firms that were in trouble were straight commercial banks.").

See also William C. Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, *Solving the Too Big to Fail Problem* (Nov. 15, 2012), available **here** ("In my opinion, there are shortcomings to reimposing Glass-Steagall-type activity restrictions or strict size limits. With respect to Glass-Steagall, it is not obvious to me that the pairing of securities and banking businesses was an important causal element behind the crisis. In fact, independent investment banks were much more vulnerable during 2008 than the universal banking firms which conducted both banking and securities activities.").

[60] *See e.g.*, Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, *Industry Structure and Systemic Risk Regulation* (Dec. 4, 2012), available **here** *(*"The reinstatement of Glass-Steagall would mean that bank clients could no longer retain one financial firm that would have the capacity to offer the whole range of financing options--from lines of credit to public equity offerings--depending on a client's needs and market conditions.").

- A loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase;
- A purchase of or an investment in securities issued by the affiliate;
- A purchase of assets from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Federal Reserve by order or regulation;
- The acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company;
- The issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate;
- A transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate; or
- A derivative transaction with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.

Section 23A also includes an attribution rule whereby any transaction by a member bank with any person shall be deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate.

E. Limitations on Federal Assistance Programs

The Brown-Vitter bill provides that, except in connection with the resolution of any insured depository institution or financial company for which the FDIC has been appointed as receiver, **no affiliate or subsidiary of a Financial Institution or nonbank financial company** may receive any assistance through the following mechanisms:

- Asset purchases or investments in debt or equity made by the U.S. government, loans from the U.S. government or capital injections from the U.S. government;
- The Deposit Insurance Fund established under the FDIA;
- Sections 10B, 13 and 13A of the Federal Reserve Act, which authorize the Federal Reserve Banks to extend discount window credit to depository institutions in the form of discounts and *collateralized* advances;
- The Exchange Stabilization Fund established under the Gold Reserve Act of 1934; and
- Any assistance program or facility established by the Federal Reserve under Section 13(3) of the Federal Reserve Act.
  - The Dodd-Frank Act already limited Section 13(3) assistance to a "program or facility with broad-based eligibility," rather than to any single and specific individual, partnership or corporation that is not part of such a broad-based program. The Dodd-Frank Act also placed further substantive and procedural safeguards around the exercise of Section 13(3) authority.[61]

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[61] As a result of the Dodd-Frank Act, the Federal Reserve must: (1) establish by regulation, in consultation with the Treasury Secretary, policies and procedures governing emergency lending designed to ensure that any emergency lending program or facility is designed to provide liquidity to the financial system and not to aid a single and specific failing financial company; that collateral for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion; (2) obtain the Treasury Secretary's approval before establishing a program or facility under Section 13(3); and (3) provide to (*cont.*)

Even though Senators Brown and Vitter intended to prohibit nonbanks from accessing the discount window, deposit insurance and other federal programs, the prohibition, as currently drafted, would capture **insured** banks as well. This is because the prohibition would apply to an "affiliate or subsidiary of a financial institution," which includes insured depository institution subsidiaries of bank holding companies.

Exclusion for Monetary Policy: The prohibition would not apply to transactions or operations implementing monetary policy matters under the direction of the Federal Open Market Committee or the Federal Reserve.

Systemically Important FMUs: The Brown-Vitter bill would repeal provisions in Title VIII of the Dodd-Frank Act that allow the Federal Reserve to permit systemically important financial market utilities ("**FMUs**")[62] to establish an account at the Federal Reserve banks and to access the discount window. Systemically important FMUs play an important role in clearing and settling transactions between financial institutions. Preventing them from accessing emergency funding through the discount window during periods of market stress would exacerbate, rather than reduce, risk in the financial system.

Section 13(c)(4)(G) of the FDIA: The Brown-Vitter bill would repeal Section 13(c)(4)(G) of the FDIA. Section 1106 of the Dodd-Frank Act already amended Section 13(c)(4)(G) to limit its scope. Specifically, the Dodd-Frank Act limits the FDIC's authority to provide assistance to individual banks upon a systemic risk finding to only those banks that have been placed in receivership and only for the purpose of winding up the institution. Furthermore, Section 1106 of the Dodd-Frank Act provides that the FDIC may not exercise its authority under Section 13(c)(4)(G) to establish any widely available debt guarantee program for which Section 1105 of the Dodd-Frank Act would provide authority.

F. Relief for Community Banks

The Brown-Vitter bill includes an assortment of measures designed to relieve the regulatory burden on community banks. The heavy burden that the U.S. Basel III proposals and other Dodd-Frank requirements place on all banks, particularly small banks, is a serious concern that has broad economic implications. However, as discussed in Part I, the bargain being offered to community banks in the Brown-Vitter bill is a Faustian one and the bill "has a significant chance to be strike three for community banks, big banks and [the U.S. banking] industry as a whole."[63] Among other things, the bill would:

- Prohibit U.S. banking agencies from implementing the Basel III capital standards. However, the bill would *require* regulators to impose on smaller institutions leverage requirements that are "comparable" to existing capital standards, giving regulators discretion to determine what is "comparable" and thereby creating a best practices trickle-down risk.
- Extend the Federal Reserve's Small Bank Holding Company Policy Statement, which generally applies to bank holding companies with less than $500 million in consolidated assets, to bank holding companies with less than $5 billion in consolidated assets.[64] By way of background,

(*cont.*)

Congress, within seven days, a report that justifies the exercise of authority and describes the material terms of the assistance. Upon the request of the Chairman of the Federal Reserve, certain information (including the identity of the participants in the program or facility) may be kept confidential.

[62] In July 2012, the Financial Stability Oversight Council designated eight FMUs as systemically important under Title VIII of the Dodd-Frank Act.

[63] *Id.*

[64] The current text of the Brown-Vitter bill states: "The policy statement of the Board in the Small Bank Holding Company Statement found at Part 225 of the appendix to title 12, Code of Federal Regulations (or any successor thereto), shall apply to financial institutions that are otherwise subject to that policy statement with consolidated assets of **more than** $5,000,000,000." (Emphasis (*cont.*)

under the Dodd-Frank Act, small bank holding companies subject to the Small Bank Holding Company Policy Statement are exempt from the minimum risk-based and leverage capital standards required by the Collins Amendment.[65] As a result of this exemption, the U.S. Basel III proposals would not apply to small bank holding companies.[66] The Brown-Vitter bill would also amend the Collins Amendment to expressly exempt savings and loan holding companies with less than $500 million in total consolidated assets.

- Establish within the Federal Financial Institutions Examination Council ("**FFIEC**") an Office of Examination Ombudsman. Among other duties, the Ombudsman is required to: (1) receive and, at the Ombudsman's discretion, investigate complaints from Financial Institutions concerning supervisory examinations, examination practices or examination reports; (2) review examination procedures of U.S. regulatory agencies to ensure that their written examination policies are being followed in practice and adhere to the standards for consistency established by the FFIEC; and (3) conduct a continuing and regular program of examination quality assurance for all examination types conducted by U.S. regulatory agencies.
- Exclude financial institutions with $10 billion or less in total consolidated assets from the small business loan data collection provisions of the Equal Credit Opportunity Act, which were inserted by the Dodd-Frank Act.
- Define the term "rural" for purposes of rules issued by the Bureau of Consumer Financial Protection ("**CFPB**") regarding qualified mortgages. The CFPB's final rules on qualified mortgages would treat certain balloon-payment mortgages as qualified mortgages if they are originated and held in portfolio by small creditors operating predominantly in "rural" or underserved areas. Under the CFPB's final rules, a county is considered to be rural if it is neither in a metropolitan statistical area nor a micropolitan statistical area adjacent to a metropolitan statistical area, as those terms are defined by the U.S. Office of Management and Budget. The Brown-Vitter bill would define "rural" as any area other than (1) a city or town that has a population of greater than 50,000 inhabitants; and (2) any urbanized area contiguous and adjacent to a city or town that has a population of greater than 50,000 inhabitants.

(*cont.*)

added). We assume that this is a typographical error and that the authors of the bill intended to use the phrase "less than $5,000,000,000."

[65] Dodd-Frank Act § 171.

[66] *See* Federal Reserve, OCC & FDIC, *Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 Fed. Reg. 52,792, 52,795 n.8 (Aug. 30, 2012) ("Section 171 of the Dodd-Frank Act by its terms does not apply to small bank holding companies, but there is no exemption from the requirements of section 171 for small savings and loan holding companies.").

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Appendix: Chart Comparing Brown-Vitter Equity Capital Ratio with the U.S. Leverage Ratio and Proposed Basel III Supplementary Leverage Ratio

	Brown-Vitter Equity Capital Ratio	U.S. Leverage Ratio	Basel III Supplementary Leverage Ratio
Scope of Application	▪ Would apply on a consolidated basis to all insured depository institutions, bank holding companies, savings and loan holding companies and foreign banking organizations (collectively, "**Financial Institutions**"). ▪ **Affiliates:** U.S. banking agencies must establish capital requirements for affiliates and subsidiaries of those Financial Institutions with $50 billion or more in total consolidated assets. ▪ The capital requirements for affiliates and subsidiaries must be "no less stringent" than the equity capital requirements for Financial Institutions. ▪ U.S. banking agencies would not be authorized to establish capital standards for "functionally regulated subsidiaries" such as registered investment companies, registered investment advisers and state-regulated insurance companies. However, the bill would amend the definition of "functionally regulated subsidiary" to exclude SEC-registered broker-dealers and CFTC-regulated entities.	▪ Under the U.S. Basel III proposals,[1] the U.S. leverage ratio would apply to all U.S. national banks, state member and nonmember banks, state and federal savings associations, all U.S. bank holding companies except those with less than $500 million in total consolidated assets, and all U.S. savings and loan holding companies (collectively, "**U.S. Banking Organizations**"). ▪ Under the Federal Reserve's proposed Dodd-Frank enhanced prudential standards for domestic firms ("**Domestic 165 Proposal**"),[2] the U.S. leverage ratio would apply on a consolidated basis to U.S. nonbank financial companies designated as systemically important by the FSOC ("**nonbank SIFIs**"), subject to any case-by-case tailoring. ▪ Under the Federal Reserve's proposed Dodd-Frank enhanced prudential standards for foreign firms ("**Foreign 165 Proposal**"),[3] the U.S. leverage ratio would apply on a consolidated basis to any U.S. intermediate holding company ("**IHC**") that is required to be established by a foreign banking organization with $50 billion or more in global total consolidated assets ("**Large FBO**"). ▪ The U.S. leverage ratio would apply on a consolidated basis to any U.S. IHC that is required to be established by a foreign nonbank SIFI, subject to any case-by-case tailoring.	▪ Under the U.S. Basel III proposals, the Basel III supplementary leverage ratio would apply to U.S. Banking Organizations that are subject to the advanced approaches capital rules ("**Advanced Approaches Banking Organizations**"). ▪ A U.S. Banking Organization would be subject to the advanced approaches capital rules if its total consolidated assets are $250 billion or more, its consolidated total on-balance sheet foreign exposures are $10 billion or more, or if it elects, subject to U.S. regulatory approval, to use the advanced approaches capital rules. ▪ A U.S. nonbank SIFI that is subject to the advanced approaches capital rules as a result of the Domestic 165 Proposal would be subject to the Basel III supplementary leverage ratio on a consolidated basis, subject to any case-by-case tailoring. ▪ The IHC of a Large FBO that is subject to the advanced approaches capital rules as a result of the Foreign 165 Proposal would be subject to the Basel III supplementary leverage ratio on a consolidated basis. ▪ The IHC of a foreign nonbank SIFI that is subject to the advanced approaches capital rules as a result of the Foreign 165 Proposal would be subject to the Basel III supplementary leverage ratio on a consolidated basis, subject to any case-by-case tailoring.

[1] Davis Polk's memorandum and visuals on the U.S. Basel III proposals are available here.

[2] Davis Polk's memorandum and visuals on the Domestic 165 Proposal are available here.

[3] Davis Polk's memorandum and visuals on the Foreign 165 Proposal are available here.

	Brown-Vitter Equity Capital Ratio	U.S. Leverage Ratio	Basel III Supplementary Leverage Ratio
Minimum Ratio	▪ **Small to Medium Financial Institutions:** No specified minimum for Financial Institutions with $50 billion or less in total consolidated assets. However, the equity capital requirements for these Financial Institutions must be “comparable” to existing U.S. bank capital standards. ▪ **Large Financial Institutions:** At least **8%** equity capital ratio for Financial Institutions with more than $50 billion in total consolidated assets. ▪ **Largest Financial Institutions:** At least **15%** equity capital ratio for Financial Institutions with $500 billion or more in total consolidated assets. Equity capital requirements may increase with the size of the Financial Institution. ▪ **Well Capitalized Status:** Any Financial Institution that meets the equity capital requirements issued by the U.S. banking agencies would be considered “well capitalized.”	▪ The U.S. Basel III proposals would eliminate the 3% minimum U.S. leverage ratio that currently applies to U.S. Banking Organizations with a composite CAMELS or other applicable supervisory rating of 1 that do not expect to grow significantly. The proposals would also eliminate the 3% minimum that currently applies to bank holding companies that have implemented the market risk capital rules. ▪ Accordingly, as proposed, all U.S. Banking Organizations would be subject to a minimum **4%** U.S. leverage ratio. ▪ A U.S. insured depository institution must maintain a U.S. leverage ratio of at least **5%** to be considered well capitalized.	▪ Under the U.S. Basel III proposals, the minimum Basel III supplementary leverage ratio is **3%**. ▪ Under the U.S. Basel III proposals, there is no well capitalized category with respect to the Basel III supplementary leverage ratio. ▪ The Basel III supplementary leverage ratio is still being calibrated at the Basel Committee level.
Numerator of Ratio	▪ **Equity capital** consists of tangible common equity (defined as common stockholders’ equity less goodwill, deferred tax assets, accumulated other comprehensive income, treasury stock, and intangible assets) plus retained earnings.	▪ **Tier 1 capital**. ▪ The U.S. Basel III proposals would narrow the definition of Tier 1 capital, which consists of Common Equity Tier 1 and Additional Tier 1 capital. ▪ The U.S. Basel III proposals would introduce a number of new deductions from and adjustments to Tier 1 capital.	▪ **Tier 1 capital**. ▪ The U.S. Basel III proposals would narrow the definition of Tier 1 capital, which consists of Common Equity Tier 1 and Additional Tier 1 capital. ▪ The U.S. Basel III proposals would introduce a number of new deductions from and adjustments to Tier 1 capital.

	Brown-Vitter Equity Capital Ratio	U.S. Leverage Ratio	Basel III Supplementary Leverage Ratio
Denominator of Ratio	▪ **Total consolidated assets** include both on- and off-balance sheet assets. ▪ Total consolidated assets include, among other things, the fair value of derivative exposures without recognizing the benefits of netting, **unless** certain netting and margin arrangements are in place. ▪ Off-balance sheet assets include any assets in which the Financial Institution has guaranteed performance by another party or provided a liquidity backstop should another party be unable to perform under the contractual obligation. ▪ Off-balance sheet assets exclude commitments to lend containing provisions or covenants that limit the risk to the Financial Institution with respect to future draws of liquidity.	▪ Average **total on-balance sheet assets** minus amounts deducted from Tier 1 capital.	▪ **Total leverage exposure**: Under the U.S. Basel III proposals, "total leverage exposure" would equal the sum of the following exposures: ▪ The balance sheet carrying value of all of the U.S. Banking Organization's on-balance sheet assets minus amounts deducted from Tier 1 capital; ▪ The potential future exposure amount for each derivative contract to which the U.S. Banking Organization is a counterparty (or each single-product netting set for such transactions) determined in accordance with the standardized approach for calculating capital requirements (*i.e.*, the Current Exposure Method); ▪ 10% of the notional amount of unconditionally cancellable commitments made by the U.S. Banking Organization; and ▪ The notional amount of all other off-balance sheet exposures of the U.S. Banking Organization (excluding securities lending, securities borrowing, reverse repurchase transactions, derivatives and unconditionally cancellable commitments).
Effective Date	▪ Within 5 years after final rules on equity capital requirements are published by the U.S. banking agencies in the Federal Register.	▪ The U.S. leverage ratio is currently in effect. ▪ The effective date of the U.S. Basel III rules is presently unclear.	▪ Proposed effective date is January 1, 2018. ▪ Beginning on January 1, 2015, Advanced Approaches Banking Organizations would be required to report their Basel III supplementary leverage ratio.