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For US banks, billions in regulatory manna

The unwind should help mid-tier banks, but the G-Sib impact is a complex balancing act

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NEED TO KNOW

- In 2018, US banking regulators issued a sheaf of proposals that will lighten the capital and compliance burden for US banks.
- Regional banks will see capital requirements cut by $8 billion and liquidity savings of $77 billion as a result of the Crapo bill.
- Proposed changes to the Fed's stress tests would generate another $10 billion to $45 billion in capital savings for regional banks.
- A proposed recalibration of the eSLR could net G-Sibs $9 billion in capital savings, while the move to SA-CCR would also reduce exposures, effectively cutting leverage requirements by another $3 billion.
- For G-Sibs, the benefits would be offset by the SCB, which would increase total CET1 capital requirements for these firms by an estimated $10 billion to $50 billion.
- In a best-case scenario, total capital and liquidity savings could hit $142 billion; in the worst, this drops to $40 billion, with G-Sibs seeing a net increase in minimum capital.

- The proposals are yet to be finalised and will be the subject of significant lobbying in 2019.

2018 was a heady year for regulatory change in the US. Proposals came thick and fast, with some hawked as a helping hand to US banking's mid-sized and small contenders.

As the year drew to a finish, it was evident that regional banks, especially the more muscled, would gain the most from the cross-thatch of proposals. The titans of finance, in contrast, appeared to have been snubbed at the regulatory buffet, but they hardly left empty-handed.

Risk.net took a bird's-eye view of what five major proposals and a final rule issued in 2018 would mean for capital and liquidity requirements across the spectrum of banks. Using publicly available data and the regulators' own impact assessments, we sifted through the proposals, with the caveat that much can change between the genesis of a proposal and day one.

The five wending their way through comment periods are: a **proposed approach** to categorising banks in answer to a Senate mandate; the **stress capital buffer** (SCB) proposal; a recalibration of the **enhanced Supplementary Leverage Ratio** (eSLR); changes to the **Volcker rule**; and one of the last implementations of the Basel III framework – the standardised **approach** to counterparty credit risk (SA-CCR) proposal.

The one finalised rule set **single-counterparty credit limits** (SCCL) and is being phased in.

The proposals will primarily benefit 20 of the largest US regional banks, which would see risk-based Common Equity Tier 1 (CET1) capital savings of $8 billion, coupled with a reduction in liquidity requirements of up to $77 billion.

For the eight US global systemically important banks (G-Sibs), minimum leverage-based Tier 1 capital requirements would be cut by nearly $12 billion – $9 billion as a result of the eSLR recalibration (the Federal Reserve says this will drop to $400 million due to CCAR constraints) plus an estimated $2.76 billion from the move to SA-CCR.

All told, the 29 largest US banks could see their minimum capital and liquidity requirements reduced by up to $97 billion as a result of these proposals.

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cross-jurisdictional activity, they have a free pass to grow to $700 billion

Hugh Conroy, Cleary Gottlieb Steen & Hamilton

The picture gets more complicated when the SCB is added into the mix. The proposal lowers the amount of CET1 capital that regional banks must hold to pass the Fed's annual stress tests by as much as $45 billion. But, for the largest banks, the opposite could happen, with CET1 capital requirements rising by as much as $50 billion.

It is impossible to reach a precise tally of regulatory winnings, given the overlap of regulations, the particularities of stress testing and the potential for double counting at each institution. Given those limitations, the top possible amount is $20 billion in capital savings and $77 billion shorn from liquidity requirements plus a $45 billion cut in stressed capital requirements for regionals. Using narrower, more conservative assumptions, this figure declines to $20 billion in capital savings and a $20 billion reduction in HQLA requirements, with the SCB being net neutral.

Gifts of Crapo

Arguably, the biggest shift in regulation came from the Economic Growth, Regulatory Relief and Consumer Protection Act, sponsored by Senator Mike Crapo and signed into law in May 2018. The bill was sold as a way to help the nation's mom-and-pop banks take on the bruisers of the banking world, and freed swathes of smaller banks from some of the strictures of the Dodd-Frank Act.

But it was the US super-regionals that were the biggest winners of the Crapo sweepstakes. While small banks are helped by the Fed's regulatory approach to implementing the bill, larger institutions with $250 billion or more in assets, though still below the very highest tier – Capital One, Charles Schwab, PNC and US Bancorp – were the main beneficiaries. Perhaps most importantly, these banks, known as Category III, get a long runway to grow before entering the strictest tier of the enhanced prudential standards: the $700 billion threshold.

"These banks are pretty happy with the proposal," says Hugh Conroy, a partner at Cleary Gottlieb Steen & Hamilton in New York. "To the extent that they don't increase their cross-jurisdictional activity, they have a free pass to grow to $700 billion. None of them are near that size, so they are happy they can grow and not jump up into a new category."

These regionals and smaller banks **would net at least $8 billion** in risk-based CET1 capital savings, or around 0.6%, from the Fed's implementation of the Crapo bill. Capital One, PNC and US Bancorp represent $5 billion of those savings.

How does this happen? The proposal frees Category III and smaller Category IV banks from most elements of accumulated other comprehensive income (AOCI) in capital requirements. Including it more accurately reflects a bank's capital position, but can make requirements more volatile.

A. Aggregate impact of US rule changes

Source: Federal Reserve impact ana

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And there's more. The liquidity coverage ratio (LCR) would be greatly loosened and the smallest banks freed completely from it. The big regionals would still need to post 70% to 85% of their current full LCR (the exact percentage will be decided after the comment period ends on January 22).

If a 70% LCR were adopted, the Fed estimates the big super-regionals could shrink their high-quality liquid assets (HQLA) by $43 billion. For smaller banks, the elimination of the LCR would save them about $34 billion. A grand total of $77 billion in liquidity savings or a 2.5% cut in HQLA. It would also allow banks to reallocate capital to assets with higher returns.

If the LCR were set at the higher 85%, the savings at the super-regionals would drop to about $20 billion or a 0.6% cut in HQLA.

G-Sibs, as inherently larger and riskier operations, would see no change at all in their liquidity requirements.

But the Crapo bill was not the only source of comfort to banks outside the G-Sib fold. For banks subject to CCAR, **the proposed SCB** would shear their aggregate risk-based CET1 capital requirements by a cool $10 billion to $45 billion.

Buffer for the buffered

While the Crapo bill did nothing for the G-Sibs, neither did it take anything away. In contrast, the SCB **proposal** seemed to wrest more from them. The rule would replace the capital conservation buffer with a 'stress capital buffer' – equivalent to a bank's worst-case losses in the Fed's stress test – and modify CCAR in a way that could deliver significant capital savings.

The Fed has proposed moving from a dynamic to a static balance sheet, which would lower assumptions on risk-weighted assets (RWAs) over the stress-test cycle. At present, most forecasts assume RWA growth of 9% to 11%, but if flat growth is assumed, the difference could be a full percentage point or more in a firm's capital requirement, says David Wright, managing director for banking and securities at Deloitte in San Francisco.

For non-G-Sibs, this would have reduced CET1 capital requirements by $45 billion in 2018's stress tests, according to the Fed's analysis using 2017 data. The impact would vary from year-to-year, depending on the severity of the stress tests. Using 2015 data, non-G-Sibs would have seen a decrease of around $10 billion in post-stress CET1 capital requirements as a result of the SCB proposal.

For G-Sibs, the effects are more complex, but also beneficent. The move to a static balance sheet assumption would clip post-stress CET1 capital requirements by around $6 billion, according to *Risk.net*'s calculations using data from the third quarter of 2018.

The picture changes when applicable capital buffers come into play. The SCB would form part of G-Sibs' total Pillar 1 capital requirements, on top of the G-Sib surcharge, which is not currently included in CCAR. Including them both, however, would increase CET1 capital requirements for G-Sibs by $10 billion to $50 billion.

That amount would certainly overwhelm savings in other areas. Yet it is unlikely to trouble the apex banks. G-Sibs already keep excess capital on hand to pass stress tests in amounts that handily exceed the new required amount. In the third quarter, for instance, the minimum CET1 capital that G-Sibs had to hold was $629 billion; they actually held $791 billion – $162 billion more than needed, according to data from *Risk Quantum*. In essence, this portion of the rule would require no more than accounting changes.

And the big banks can draw some comfort from the eSLR proposal, which applies only to G-Sibs. It would replace the existing 2% eSLR with a new buffer, calibrated at 50% of a firm's G-Sib surcharge.

Analysis conducted by *Risk Quantum* finds this would cut leverage-based Tier 1 capital requirements for G-Sibs by a whopping $86 billion on a standalone basis (see figure 1).

1. US bank leverage ratios – Q3 2018

Source: Federal Reserve and Risk Quantum rese

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The Fed's own analysis, which looked at the amount of Tier 1 capital that G-Sibs are required to hold to meet their risk-based capital and leverage ratio minimums plus applicable buffers, shows the proposal would lower minimum leverage capital requirements for G-Sibs by a more modest $9 billion at the holding company level.

Regulators say that taking into account the capital constraints imposed by CCAR, these savings would shrink to about $400 million – a tiny bite of 0.04% in the aggregate Tier 1 capital held by banks in the third quarter.

That's not all. The proposal on SA-CCR would lower leverage exposures at G-Sibs by easing the way in which their potential future exposure to derivatives is calculated. This would cause their ratios to improve by around 0.3% on average. Put another way, the largest US banks could cut Tier 1 capital by $2.76 billion and still maintain their leverage ratios at current levels.

G-Sibs were required to have $686 billion in leverage-based Tier 1 capital in Q3; they actually held $919 billion – about $233 billion in excess.

The SA-CCR proposal would also, and somewhat perversely, result in a 0.06% reduction in G-Sibs' risk-based CET 1 ratios, compared with the existing current exposure method – a capital hit of roughly $475 million. However, this impact is very sensitive to any changes in the precise composition of derivatives portfolios.

A rejuvenated Volcker rule has been proposed that is expected to cut what are considered to be significant compliance costs; by how much is not clear, but this would again save the G-Sibs cash that can be retained as capital.

Calmer tone of 2019

So, have US prudential regulators delivered on one of president Donald Trump's more vivid campaign-trail promises to "do a number on Dodd-Frank"? Not quite, and nor do his top regulatory appointees seem inclined towards shock-and-awe change.

"The people Trump has appointed to the banking regulatory agencies – from the Fed governors to Joe Otting at the Office of the Comptroller of the Currency to Jelena McWilliams at the Federal Deposit Insurance Corporation (FDIC) – are mainstream kinds of people," says Patrick Parkinson, managing director at the Promontory Financial Group in Washington, DC.

"They are slightly more concerned with regulatory burdens and sympathetic to the banks' complaints, but are not proposing radical changes," says Parkinson, who held senior roles at the Fed for more than 15 years, including in its division of banking supervision and regulation.

Gabe Rosenberg, a partner at Davis Polk in New York, agrees on the tempered approach of the Trump financial team.

"Contrary to reports and expectations, the G-Sibs have not seen significant changes in regulatory requirements under the Trump administration," he says. "The proposals out there are exactly the type of reasonable and rational reconsiderations one would expect after 10 years of experience with an enormous regulatory sea change like the Dodd-Frank Act."

There has also been a gradual evolution in the stance of Fed vice-chairman of supervision Randy Quarles. Once seen as reflexively sympathetic to the banking industry, Quarles took the helm at the Financial Stability Board in December 2018 – a role that may complete his personal journey to a cautious central banker.

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"Bluntly, he will now carry responsibility if there were another financial crisis for which the world was inadequately prepared," says Paul Tucker, chairman of the Systemic Risk Council and once a deputy governor of the Bank of England. "Now that he has been appointed, he is incentivised to take responsibility for the stability of the international system as a whole."

"Quarles's personal reputation and standing will now be affected beyond his retirement by how he conducts this role," Tucker says.

The five proposals on the docket are set to be finalised this year, but some aspects – notably the SCB and Volcker rule – are likely to be re-proposed. The final text could be significantly different, market participants note.

Aside from general political aversion to deregulating big banks, the political equation in Washington has shifted, with Democrats taking the majority in Congress in November 2018.

“2019 might be the year we see some progress on these proposals, but there are a number of other dynamics in play with the Democrats in Congress now,” says Conroy at Cleary Gottlieb. “Regulators might want to stay under the radar somewhat.”

“Some of these things could get finalised, but in a ‘ho hum’ sort of way, or not get finalised at all if the Fed or FDIC think it too politically challenging to put out something that reduces capital ratios,” he adds.

Still, the horse-trading is not over, and banks will be lobbying hard to secure the proposed relief and pushing for more.

Stress management

G-Sibs will focus their efforts on reshaping the SCB. The Fed’s **shift towards** allowing banks to peek into some of the black boxes of stress tests was hailed, even if it fell short of the industry’s demands.

“I see Jerome Powell and Randy Quarles as genuinely more interested than most of their peers, and most of their predecessors, in transparency in supervision and regulation,” says Tucker, referring to the Fed chairman and supervision chief, respectively.

Quarles **announced** in November 2018 that the SCB would be delayed until 2020 while the Fed refined it to address industry concerns.

Banks had **complained** that integrating stress-test results with regulatory capital, as the SCB does, could produce zigzagging capital requirements from year to year. The Bank Policy Institute **has estimated** that about 40% of banks see volatility of more than one percentage point, effectively an additional 100 basis point buffer.

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Adam Gilbert, PwC

Adam Gilbert, global regulatory leader for financial services advisory at PwC, says Quarles has said there is a need for more openness on stress tests.

“He has said the Fed is going to let banks know before the banks have to decide on planned capital distributions for the next year – that is a big change and one that is welcome,” Gilbert says. “And there are other aspects of the stress-testing regime that Quarles talked about that are consistent with simplifying the process a bit, trying to review and eliminate some assumptions that may or may not make sense any more.”

The SCB proposal’s easier assumptions were seen as advantageous, and there could be further relaxation (as some market participants are speculating) if the Fed decides to drop the buffer altogether for the leverage ratio.

“Moving to this SCB approach, relaxing the more stringent assumptions around the Fed’s stress test – capital distributions and risk-weighted assets assumptions – as well as dropping the requirement to meet post-stress requirements for the supplementary leverage ratio, and potentially even the leverage ratio… This is the most significant relief we have seen this year,” says Wright at Deloitte, referring to the G-Sibs.

G-Sibs may angle for the proposed CCAR changes to be unglued from the SCB itself. The Fed could make the change from dynamic to static balance sheet independent of the SCB proposal, says Conroy – for example, in the documentation the Fed issues ahead of the CCAR process in January.

“There is no reason why the flat balance sheet assumption can’t be put in place outside of the SCB,” he says. “That is what the banks and trade associations want – for the regulators not to think of it as a package, but to put in the tweaks to CCAR while fixing the SCB volatility on a longer timeframe.”

Rewriting leverage

Another major event for G-Sibs was the proposal to recalibrate the eSLR. Clearing firms had been hoping for some **recognition of derivatives collateral** in the ratio. While they were disappointed, the SA-CCR proposal in October **rekindled that hope**.

Yet changes to the eSLR remain controversial. The Systemic Risk Council has submitted a **comment letter** objecting to the proposal, saying it would threaten the stability of the financial system.

One of the council’s concerns is that if the Fed ends up reducing operating capital at banks, “then at the very least they ought to substitute for it by introducing rules to make US banks carry more internal TLAC", says Tucker, referring to total loss-absorbing capacity.

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> **Paul Tucker, Systemic Risk Council**

"Behind the idea that operating bank equity can fall is a doctrine that holding companies are a source of strength and it is the capitalisation of holding companies that matters," Tucker says. "The crisis revealed that is not completely true as it is the legal entities that fail."

Promontory's Parkinson says the Fed is just trying to bring the eSLR more in line with the Basel III standard.

"The Fed managed to get the Europeans to agree to impose a surcharge above the minimum 3% leverage requirement, but it was still lower than that of the US," he says. "So now the US has proposed to lower it to what was agreed internationally."

Parkinson says the proposal affects all G-Sibs, but especially those with relatively low G-Sib scores, because the new eSLR is half the risk-based surcharge under the proposal, as opposed to the current flat 2% at holding company level (see figure 1). For these banks, such as the custodial banks, "that is meaningful relief, with their eSLR buffers going from 2% to potentially 0.5% with the eSLR buffer".

Cleary's Conroy says that despite some holdouts on the FDIC board, he expects the agencies to move in the direction of the proposal when it is finalised this year, "regardless of the people complaining that banks should not get any further capital relief".

The economic effects of the proposals will only be clear once they have been in place for a while. Tucker at the Systemic Risk Council says it is prudent to take a composite, overarching view of regulatory changes once they go into motion.

"Regulatory authorities rarely publish the cumulative effects of their policy changes on individual institutions," he says, but they should – even if the information is anonymised. "One advantage of this transparency is that it forces a regulatory body or a policy-making body to work out what exactly they have done."

"Sometimes they might find they like what they have done, sometimes they might not," Tucker adds. "But I am not convinced they always know exactly what they have done, perhaps especially when they soften policy in subtle ways."

The borders of SA-CCR

Beyond its role in the leverage ratio, there are big questions on SA-CCR's scope; notably whether it will be embedded in derivatives exposure calculations in other rules, such as **Single-Counterparty Credit Limits** (SCCL), and in calculations between banks' insured depository institutions and their affiliates.

"The big question is: what are the follow-on regulations that suddenly adopt SA-CCR and do banks actually want that? Or do they just want SA-CCR's greater risk sensitivity to replace the Current Exposure Method in the capital rule and not see it broadly used in other areas?" says Cleary Gottlieb's Hugh Conroy. "The proposal does not answer these questions."

There were other significant proposals in 2018, as well as finalised rules. Among them was the SCCL. **This rule became** effective in October and limits a large bank's credit exposure to a single unaffiliated counterparty to 25% of the bank's Tier 1 capital. The SCCL impact analysis says banks can all meet the rule with only "modest adjustments".

The original proposal estimated that the exposures of affected firms beyond the limit would be less than $100 billion, mostly accounted for by the largest counterparties' exposures to each other. The text of the final rule suggested it "contains a number of recommended modifications that would reduce this estimated impact".

Additional reporting and data analysis by Louie Woodall