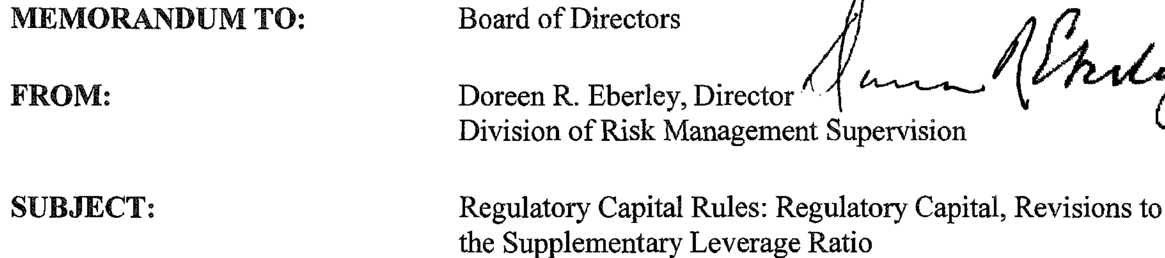
September 3, 2014

MEMORANDUM TO: Board of Directors



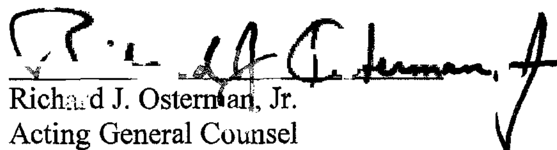
FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio

Summary: In January 2014, the Basel Committee on Banking Supervision ("BCBS") released various revisions to the denominator measure for the Basel III leverage ratio, in a publication entitled, *Basel III leverage ratio framework and disclosure requirements* ("BCBS 2014 revisions"). In May 2014, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) published a proposed rule in the *Federal Register* for public comment to revise the denominator measure for the supplementary leverage ratio in a manner consistent with the BCBS 2014 revisions and introduce related public disclosure requirements ("proposed rule" or "NPR"). Staff now is seeking the approval of the FDIC Board of Directors ("Board") of the attached final rule, which includes certain technical revisions and clarifications based on comments received on the proposed rule ("final rule"). The final rule would apply to all advanced approaches banking organizations, including those that are subject to the enhanced supplementary leverage ratio standards. The regulatory compliance date for the final rule would be January 1, 2018, consistent with the effective date of the supplementary leverage ratio included in the 2013 revised capital rule, and the effective date for certain reporting purposes would be January 1, 2015.

Recommendation: That the Board approve the attached final rule and authorize its publication in the *Federal Register*.

Concur:



Richard J. Osterman, Jr.
Acting General Counsel

Discussion:

Background

In July 2013, the Board adopted an interim final rule that comprehensively revised the general risk-based and leverage capital rules for state nonmember banks and state savings associations ("FDIC-supervised institutions"), which was substantively identical to a joint final rule adopted by the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System.[1] The interim final rule was adopted as final in April 2014 ("2013 revised capital rule"). Importantly, the 2013 revised capital rule introduced a supplementary leverage ratio requirement for FDIC-supervised institutions subject to the advanced internal-ratings based approaches ("advanced approaches"), consistent with the international leverage ratio for large, internationally active banking organizations under Basel III.

Concurrent with the adoption of the 2013 revised capital rule, the Board also approved an interagency final rule to apply enhanced supplementary leverage ratio requirements to U.S. top-tier bank holding companies with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody ("enhanced supplementary leverage ratio standards"). Specifically, the enhanced supplementary leverage ratio standards require the covered bank holding companies ("BHCs") to maintain a supplementary leverage ratio capital buffer of 2 percent, in addition to the 3 percent minimum, for a total requirement of 5 percent. In addition, an insured depository institution ("IDI") subsidiary of a covered BHC is required to maintain a 6 percent supplementary leverage ratio to be considered well capitalized for purposes of the prompt corrective action ("PCA") framework.

In contrast to the generally applicable leverage ratio that has long applied to U.S. IDIs, the supplementary leverage ratio includes certain off-balance sheet exposures in the denominator measure. The 2013 revised capital rule applies the supplementary leverage ratio to IDIs and bank and savings and loan holding companies that are subject to the advanced approaches risk-based capital rules, and establishes a minimum supplementary leverage ratio requirement of 3 percent. Although the supplementary leverage ratio was generally consistent with the Basel III

[1] The Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System issued a joint final rule on October 11, 2013 (78 FR 62018) and the FDIC published in the *Federal Register* a substantially identical final rule on April 14, 2014 (79 FR 20754).

leverage ratio when the 2013 revised capital rule was adopted, the agencies indicated in the preambles to the 2013 revised capital rule and the final rule for the enhanced supplementary leverage ratio standards that they would consider whether subsequent BCBS revisions to the Basel III leverage ratio are appropriate for implementation in the United States.

For purposes of the denominator measure of the supplementary leverage ratio, the BCBS 2014 revisions[2] are intended to better capture a banking organization's economic exposure to its off-balance sheet activities. For example, for purposes of consistency with the BCBS 2014 revisions, a banking organization that provides credit protection in the form of a derivative or other similar instrument must include in the denominator a measure of its exposure to the underlying reference entity. For repo-style transactions, the revisions impose conditions for recognizing the offsetting effects of multiple repo-style transactions with a single counterparty. Similarly, with respect to derivative contracts, the revisions impose additional conditions on a banking organization's ability to reduce the exposure measure for derivative contracts to recognize cash variation margin exchanged between counterparties. These conditions are intended to ensure the cash collateral is in substance a pre-settlement payment of the derivative contract obligation.

Other aspects of the BCBS 2014 revisions to the denominator measure of the supplementary leverage ratio may offset increases in leverage capital requirements resulting from the provisions described above. For example, the revisions would permit a banking organization to measure the notional amount of its off-balance sheet exposures using the credit conversion factors ("CCFs") set forth in the standardized approach for risk-weighted assets, subject to a minimum CCF of 10 percent.[3] In addition, the revisions clarify the exposure calculation for a clearing member banking organization with regard to cleared derivative contracts that are intermediated on behalf of a client with a central counterparty, to ensure that

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[2] See BCBS, "Basel III leverage ratio framework and disclosure requirements" (January 2014), available at http://www.bis.org/publ/bcbs270.htm. See also BCBS, "Revised Basel III leverage ratio framework and disclosure requirements - consultative document" (June 2013), available at http://www.bis.org/publ/bcbs251.htm.

[3] Prior to the BCBS 2014 revisions, the Basel III leverage ratio required banking organizations to assign a 100 percent CCF to the notional amount of all off-balance sheet items.

the banking organization is not required to hold leverage capital for the portion of the transaction to which it has no economic exposure.

The BCBS 2014 revisions also set forth public disclosure requirements for the Basel III leverage ratio. Specifically, a banking organization must publicly disclose any differences between its total assets under Generally Accepted Accounting Principles ("GAAP") (or the accounting standards relevant to the banking organization) and its denominator measure under the Basel III leverage ratio, as well as additional information regarding the components of the denominator measure. The public disclosures are intended to improve transparency and market discipline by ensuring that information regarding a banking organization's Basel III leverage ratio is provided in a comparable and consistent manner.

Proposed Rule

In May 2014, the agencies published a proposed rule in the *Federal Register* for public comment to revise the denominator measure for the supplementary leverage ratio in a manner consistent with the BCBS 2014 revisions and introduce related public disclosure requirements. The agencies sought comment on all aspects of the proposed rule and received 14 public comments from banking organizations, trade associations representing the banking or financial services industry, an options and futures exchange, a supervisory authority, a public interest advocacy group, two private individuals, and other interested parties. In general, comments from financial services firms, banking organizations, banking trade associations and other industry groups were supportive of the proposed rule, arguing that it would provide a more risk-sensitive approach to the denominator of the supplementary leverage ratio and enhance international consistency; however, comments were critical of certain aspects of the proposed rule. Comments from an organization representing smaller banking organizations or their supervisors, a public interest advocacy group and the public generally were supportive of the NPR, but they also expressed concern over certain aspects of the proposal. Staff of the agencies have carefully considered and, in the preamble of the final rule, have responded to the specific comments received on the proposed rule. Certain technical revisions and clarifications to the final rule are based on these comments. Despite these technical revisions and clarifications to the proposed

rule, staff of the agencies believe that the requirements of the final rule are substantively similar to the proposed rule.

Final Rule

Summary of the final rule requirements:

In general, the final rule is designed to strengthen the supplementary leverage ratio by more appropriately capturing the exposure of a banking organization's on- and off-balance sheet items. For example, the final rule captures in total leverage exposure the effective notional principal amount of credit derivatives and other similar instruments through which a banking organization provides credit protection ("sold credit protection"), and introduces graduated CCFs in the treatment of off-balance sheet commitments. The final rule also modifies the total leverage exposure calculation for derivative contracts and repo-style transactions in a manner that is intended to ensure that the supplementary leverage ratio appropriately reflects the economic exposure of these activities. Moreover, the final rule ensures consistency across internationally active banking organizations, in keeping with the objectives of the BCBS 2014 revisions, and responds to certain comments raised during the public comment period for the enhanced supplementary leverage ratio standards.

Specifically, under the final rule and consistent with the 2013 revised capital rule, total leverage exposure continues to include the following items:

- The balance sheet carrying value of all of a banking organization's on-balance sheet assets, less amounts deducted from tier 1 capital;
- The off-balance sheet amount of a banking organization's derivative contracts, as determined under the standardized approach for risk-weighted assets in the 2013 revised capital rule, without regard to any collateral that may be recognized under the 2013 revised capital rule to reduce the exposure amount for such derivatives; and
- 10 percent of the notional amount of any unconditionally cancellable commitment of the banking organization.

Certain commenters on the proposed rule encouraged the agencies to exclude all highly liquid and low-risk assets from the denominator, arguing that not doing so would penalize core aspects of the custody bank business model, including intermediation of high-volume, low-risk

financial activities and broad reliance on essentially riskless assets, notably central bank placements. As an alternative, the commenters suggested that the agencies discount or cap the exposure of highly liquid and low-risk assets included in the total exposure measure. Staff believes that excluding broad categories of assets from the denominator of the supplementary leverage ratio is generally inconsistent with the intended role of the supplementary leverage ratio, as an overall limitation on leverage that does not differentiate across asset types. A closely related point is that such exclusions or limits would create the perverse outcome of permitting the essentially unlimited use of debt to finance certain types of assets. Therefore, the final rule defines total leverage exposure as including all on-balance sheet assets and does not exclude or cap any specific asset type.

In addition, consistent with the BCBS 2014 revisions, the final rule requires a banking organization to include in total leverage exposure:

- Any cash collateral that is received from, or posted to, a counterparty to a derivative contract, except for cash variation margin that meets certain requirements that are consistent with the requirements under GAAP for the recognition of cash collateral in determining the mark-to-market value of a derivative contract;
- A measure of the banking organization's exposure to the reference entity for a credit derivative (or other similar instrument) under which the banking organization provides credit protection. The final rule permits the banking organization to offset its exposure to the reference entity by protection purchased on the same underlying reference entity, provided that certain conditions are satisfied;
- The amount of any adjustment (under GAAP) to accounting assets for repo-style transactions that do not meet certain conditions designed to ensure that the adjustment is appropriate and reflective of the banking organization's economic exposure;
- A measure of counterparty credit risk for repo-style transactions; and
- The notional amount of all other off-balance sheet exposures (excluding securities lending, securities borrowing, reverse repurchase transactions, derivatives and unconditionally cancellable commitments) multiplied by the appropriate CCF under the standardized approach for risk-weighted assets, and as set forth in section 33 of the 2013 revised capital

rule. However, for purposes of determining total leverage exposure, the minimum CCF that may be assigned to an off-balance sheet exposure is 10 percent.

Consistent with the BCBS 2014 revisions, the final rule clarifies the calculation of total leverage exposure for a clearing member bank with regard to cleared derivatives contracts that are intermediated on behalf of a client with a central counterparty ("CCP"). Specifically, where a clearing member banking organization does not guarantee the performance of the CCP, it is not required to include in total leverage exposure the exposure amount of any derivatives transaction between the banking organization and the CCP. This treatment recognizes that, in such a situation, the clearing member banking organization has no payment obligation to the client in the event of a CCP default.

In response to comments received in connection with the enhanced supplementary leverage standards, the final rule also modifies the calculation of the supplementary leverage ratio to address concerns regarding sudden substantial inflows of deposits that some banking organizations may experience at the end of reporting periods. Specifically, under the final rule, a banking organization calculates the total leverage exposure as the sum of the average of the on-balance sheet assets calculated as of each day of the reporting quarter and the average of the off-balance sheet exposures calculated as of the last day of each of the most recent three months, using the applicable deductions under the 2013 revised capital rules. Using average daily balances for on-balance sheet assets addresses concerns about deposit inflows, while using the end-of-month balances for off-balance sheet exposures addresses concerns about the potential cost of performing such calculations on a daily basis.

Conclusion

FDIC staff recommends that the FDIC Board adopt the attached final rule and authorize its publication in the *Federal Register*.

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