Bank Capital Reform

Treasury Department Proposes Bank Capital Reforms

SUMMARY

Late yesterday, the U.S. Treasury Department issued a policy statement entitled “Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms” (the “Policy Statement”). The Policy Statement, which was developed in consultation with the U.S. bank regulatory agencies, sets forth eight “core principles that should shape a new international capital accord”. Six of the principles relate directly to bank capital requirements. The seventh of these principles relates to liquidity and the eighth to non-banking organizations.

The Policy Statement expands substantially upon the preliminary indications of Treasury’s thinking regarding regulatory capital reform as reflected in its June 17 white paper on financial regulatory reform, “A New Foundation: Rebuilding Financial Supervision and Regulation”, and makes clear that Treasury is contemplating a fundamental revamping of capital standards, both internationally through the Basel Committee process and in the United States. It would involve substantial revisions to, if not replacement of, major parts of the Basel I and Basel II capital frameworks and affect all regulated banking organizations, large and small, as well as institutions of systemic importance that are not currently regulated as banking organizations.

The Policy Statement:

- Proposes higher capital requirements “across the board” for all banking firms — and even higher capital requirements for systemically-important financial firms — and that these requirements be designed to protect the stability of the financial system as a whole as well as the solvency of individual firms.
- Emphasizes the importance of the quality of capital, stressing the need for common voting equity to constitute a “large majority” of tier 1 capital and for tier 1 capital to constitute a “large majority” of total regulatory capital.
- Addresses the so-called “procyclicality” of current capital standards.
Expresses skepticism as to the reliability of credit ratings and internal models as tools for measuring capital requirements.

States that risk-weightings of some assets and exposures — including credit derivatives, structured asset-backed and mortgage-backed securities, off-balance-sheet vehicles, trading positions, and equity investments — should be a function of not only their own risk characteristics but "also should reflect the systemic importance of the various exposure types".

Acknowledges that the existing capital standards "too often are a lagging indicator of financial distress" and suggests the consideration of "supplemental triggers" for prompt corrective action based, for example, on non-performing loans or liquidity.

States that capital requirements "should reflect more forward-looking, through-the-cycle considerations" and rely less on value-at-risk models and point-in-time rating systems.

States that a leverage ratio, although "a blunt instrument", must be utilized.

Calls for a new "conservative, explicit liquidity standard".

Proposes a number of actions to prevent the "re-emergence of an under-regulated non-bank financial sector that poses a threat to financial stability".

THE POLICY STATEMENT

Although the Policy Statement contains only "high-level principles" and not numerical recommendations, it explicitly and repeatedly calls for higher and stronger capital requirements for all institutions and "substantially heightened" capital requirements for bank and non-bank financial firms deemed to pose a risk to financial stability due to their "combination of size, leverage, interconnectedness, and liquidity risk" (Tier 1 Financial Holding Companies or "Tier 1 FHCs"). What is not clear, however, is the base against which these higher standards would be measured. Most major U.S. banks today have capital ratios that are substantially above even well capitalized standards, and common equity has become an increasing element of Tier 1 capital. Accordingly, the impact of new capital standards could be less significant if the "higher" comparison is to current regulatory capital requirements rather than to current actual capital levels. Even in the case of the former, however, changes in the calculation of both the numerator (capital) and the denominator (assets and certain liabilities) of capital ratios could raise capital requirements substantially above current levels.

The new capital regime would have a number of objectives that reinforce the goal of higher and stronger capital. It should be "as simple as possible", be "able to respond to unanticipated changes", and incorporate a "macro-prudential" focus. The Policy Statement explicitly recognizes that "[s]tricter capital requirements . . . may limit credit availability," but this is apparently acceptable if credit availability is not "unduly curtail[ed]".

The Policy Statement suggests that these changes be phased in over a period of several years. The recommended schedule provides for a "comprehensive international agreement by December 31, 2010, with implementation of the reforms effective December 31, 2012". Although the Policy Statement stresses that the capital rules "should be as consistent as possible internationally", it remains possible that the U.S. bank regulatory agencies could officially adopt, or informally implement, some of these new capital standards at an earlier date.

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September 4, 2009
The following is a summary of the Policy Statement’s eight “Core Principles”.

**Core Principle #1:** Capital requirements should be designed to protect the stability of the financial system (as well as the solvency of individual banking firms).

In a major conceptual departure from the existing regulatory capital regime, the new capital framework would have a “macro-prudential focus” designed to promote the stability of the financial system as a whole. The implicit suggestion is that individual banks could be required to maintain capital above that required “for the solvency of individual firms”. This new focus is described as a “macro-prudential approach to the regulation of banking firms [which] requires a broad shift in the way capital and related regulations are conceived and analyzed”. This macro-prudential approach is designed to mitigate the procyclical effect of capital and accounting rules by reducing the extent to which they both “permit risk to accumulate in boom times, exacerbating the volatility of credit cycles”, and discourage the accumulation of “larger capital cushions in good times”. The Policy Statement expresses a particular concern with system-wide “liquidity shocks” resulting from a rapid deleveraging of one or more financial firms.

**Core Principle #2:** Capital requirements for all banking firms should be higher, and capital requirements for Tier 1 FHCs should be higher than capital requirements for other banking firms.

This clear principle is supplemented with one specific policy recommendation. The Gramm-Leach-Bliley Act requirements for financial holding company (“FHC”) status, which enables bank holding companies to engage in a broader range of financial activities, are currently imposed only at the bank level. Under the Policy Statement, the “well capitalized” and “well managed” requirements would also be applied to the parent FHC on a consolidated basis.

The “substantially heightened” capital requirements to be imposed on Tier 1 FHCs are explicitly designed “to force them to internalize the costs of . . . potential spillover effects”. They are to be designed for effectiveness “under extremely stressful economic and financial conditions”.

**Core Principle #3:** The regulatory capital framework should put greater emphasis on higher quality forms of capital.

The Policy Statement distinguishes between “going concern loss absorption capacity of capital” and “merely the capacity of capital to serve as a buffer against taxpayer losses in the event of firm liquidation”. The former is regarded as considerably more valuable and is described as “particularly important for Tier 1 FHCs”.

This principle sets forth three standards for achieving its objectives. The first is consistent with existing published capital standards, but the last two may represent somewhat of a departure (or at least make more formal previously informal policies):

- A large majority of a banking firm’s tier 1 capital should consist of common equity.
- Tier 1 capital should constitute a large majority of a banking firm’s total regulatory capital.
- Voting common equity should also represent a large majority of a banking firm’s tier 1 capital.
In addition, this principle calls for “strict, internationally consistent qualitative and quantitative limits” on deferred tax assets and non-equity hybrid and other innovative securities as elements of capital.

**Core Principle #4:** Risk-based capital requirements should be a function of the relative risk of a banking firm’s exposures, and risk-based capital ratios should better reflect a banking firm’s current financial condition.

This principle reflects the concern that the “capital inadequacy of some of our largest banking firms during the recent crisis stemmed in significant part from the inadequate capture of risk exposures in our capital rules”. The Policy Statement singles out for particular criticism “excessive regulatory reliance on internal banking firm models or ratings from credit rating agencies”, both of which are key components in determining capital requirements under existing standards for securitizations and trading portfolios and are even more central to capital calculations under Basel II in its current form.

Under the macro-prudential approach, higher risk-based capital charges would apply to exposures deemed to exhibit “a high correlation with the economic cycle, or whose prevalence is likely to contribute disproportionately to financial instability in times of economic stress”. The Policy Statement identifies as a “key example” of the latter, the structured finance credit protection purchased by many banking firms from AIG, the monoline insurance companies and other thinly capitalized special purpose derivatives products companies.

The Policy Statement identifies five types of “systemically important exposure types” that could attract higher capital charges:

- Implicit and explicit exposures to off-balance-sheet vehicles sponsored by the banking firm.
- Proprietary and other trading positions.
- Equity investments.
- Structured asset-backed securities and mortgage-backed securities.
- Counterparty credit risk exposures to financial firms, including non-centrally cleared derivatives and securities financing transactions (repurchase and reverse repurchase agreements, securities lending and borrowing transactions, and margin loans).

This principle also focuses on the need for “regulatory capital ratios more transparently [to] reflect the current condition of the firm”. As one element of this transparency, the Policy Statement appears to suggest that unrealized gains or losses on available-for-sale securities should be included in capital calculations. A reference to the recently completed stress tests for U.S. banks could be read to suggest that capital ratios should incorporate stress beyond current conditions.

A significant element of the Policy Statement is its proposal to revise substantially the U.S. prompt corrective action (“PCA”) framework, which is designed to enable supervisors to intervene early in troubled firms. Noting that “far too many banking firms [have gone] from well-capitalized status directly to failure”, the Policy Statement suggests the addition of supplemental triggers based on non-performing loans or liquidity.
Core Principle #5: The procyclicality of the regulatory capital and accounting regimes should be reduced and consideration should be given to introducing countercyclical elements into the regulatory capital regime.

This principle calls for modification of regulatory capital and accounting frameworks to reduce their procyclicality. The key element of this approach would be a requirement that banking firms hold a buffer over their minimum capital requirements during good economic times, which would be available for drawdown in bad economic times. Both the minimum capital requirement and the buffer would be substantial. The former “must remain credible in the eyes of the financial markets even under severe economic downturn conditions”. The latter “must be sufficient to address likely capital impairment through the credit cycle with minimal credit contraction or deleveraging behavior by banking firms”. The Policy Statement lists two principal options for implementing the supplemental buffer requirement, both of which are described as having advantages and disadvantages:

- Fixed, time-invariant target capital ratio(s) above the minimums, with capital distribution restrictions as the penalty for falling below the target ratios.
- Time-varying minimum capital ratio(s), where the applicable minimum capital ratio for banking firms at a particular time is a function of one or more contemporaneous macroeconomic indicators.

This principle also calls for “more forward-looking, through-the-cycle considerations” intended to result in higher capital requirements during the early phases of the credit cycle. These would supplement or replace procyclical measures, such as value-at-risk models and point-in-time internal rating systems.

This principle takes a similar approach for loan loss reserves, which should be more forward-looking and extend beyond recent historical experience. The objective is recognition of higher provisions earlier in the credit cycle.

Of particular importance, the Policy Statement urges that regulatory capital disincentives to robust provisioning be reduced or eliminated. The Policy Statement cites, as one such disincentive, existing U.S. risk-based capital rules under which reserves are included in regulatory capital only up to a specified percentage of risk-weighted assets. A number of banks and their trade organizations have been urging the federal banking agencies to remove the current limit, and the Policy Statement may reinvigorate this effort.

The Policy Statement also suggests examining the merits of providing favorable regulatory capital treatment for, or even requiring some banking firms, such as Tier 1 FHCs, to issue, “appropriately designed contingent capital instruments”. These could include:

- Long-term debt instruments that convert to equity capital in stressed conditions.
- Fully secured insurance arrangements that pay out to banking firms in stressed conditions.
**Core Principle #6:** Banking firms should be subject to a simple, non-risk-based leverage constraint.

This principle provides that, in addition to risk-based capital rules, banking firms should also be subject to “a simple leverage ratio” which would “make the regulatory system more robust by limiting the degree to which gaps and weak spots in the risk-based capital framework can be exploited”. The Policy Statement also suggests that this leverage requirement would provide macro-prudential benefits. The Policy Statement acknowledges, however, that the leverage ratio “is a blunt instrument that, viewed in isolation, can create its own set of regulatory arbitrage opportunities and perverse incentive structures”. To mitigate against these, the Policy Statement recommends that the leverage ratio “should at a minimum incorporate off-balance sheet items”.

**Core Principle #7:** Banking firms should be subject to a conservative, explicit liquidity standard.

This principle differs from the others in that it relates to liquidity rather than capital, and it represents a major departure from current practice, although liquidity has always been monitored during the examination process.

The Policy Statement proposes the creation of a liquidity regulation regime independent from the regulatory capital regime. The liquidity regulations would be designed to accomplish two goals:

- Enhancing the short-term resiliency of banking firms by requiring them to hold a pool of unencumbered liquid assets sufficient to cover likely funding shortfalls in the event of an acute liquidity stress scenario.
- Reducing longer-term structural asset-liability maturity mismatches at banking firms.

The “core attributes” of the regulations should include: simplicity; comparability; conservative assumptions about the liquidity of assets during times of financial stress; and conservative stress-case assumptions about runoff rates for all types of liabilities, as well as collateral calls by derivative counterparties, draws by borrowers on committed credit facilities, and implicit support that would be provided to vehicles sponsored and advised by the banking firm. These regulations would also be adopted as part of a strong macro-prudential liquidity framework aimed at reducing system-wide liquidity risk.

The principle also suggests consideration of the merits of making regulatory capital requirements a function of the liquidity risk of banking firms.

**Core Principle #8:** Stricter capital requirements for the banking system should not result in the re-emergence of an under-regulated non-bank financial sector that poses a threat to financial stability.

In order to achieve this objective, the Policy Statement suggests a number of actions:

- Tier 1 FHC regulation.
- Banking firms will be required to consolidate sponsored and advised vehicles for financial statement purposes.
Money market mutual funds will be subject to tighter regulation, including tighter regulation of their 
credit and liquidity risks.

Derivative transactions will be subject to reporting requirements and higher margin and capital 
requirements, and standardized derivative transactions will be subject to central clearing and central 
trading requirements.

Securitization markets will be subject to greater transparency standards and requirements to align the 
incentives of loan originators and securitization sponsors with those of investors.

The terms on which financing is extended from banking firms to non-bank financial firms will be 
carefully monitored in order to limit the build-up of leverage in the non-bank financial sector.

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