

December 19, 2017

Bank Capital Requirements

Basel Committee Releases Standards to Finalize Basel III Framework

SUMMARY

On December 7, 2017, the Basel Committee on Banking Supervision released standards to finalize its Basel III capital framework (commonly referred to as “*Basel IV*”).¹ The Basel III capital framework was published in December 2010,² and, since then, has been supplemented and revised by numerous standards published prior to December 2017.³ Although the Basel III capital framework primarily addressed the components of regulatory capital (*i.e.*, the numerator of capital ratios) and the calibration of minimum required capital ratios (*i.e.*, the minimum percentages), Basel IV largely focuses on the denominator in capital ratios—in particular, risk-weighted assets (“*RWAs*”) for purposes of the risk-based capital ratios.

The Basel Committee describes Basel IV as finalizing post-crisis regulatory reforms for capital adequacy, but it is likely that the international framework for the regulation of bank capital will continue to evolve. Indeed, Basel IV and the Basel Committee’s accompanying materials note that the Basel Committee will (i) review the calibration of the revised market risk framework prior to its implementation on January 1, 2022,⁴ (ii) monitor the impact of leverage capital requirements on central clearing of derivatives and, by December 2019, conclude a review of the impact of leverage capital requirements on the provision of clearing services and resilience of central clearing,⁵ and (iii) review the treatment of credit loss provisions for purposes of calculating the output floor in light of the upcoming implementation of revised provisioning standards based on forward-looking expected credit loss methodologies.⁶

According to the Basel Committee, Basel IV is intended to, among other things, reduce variability in *RWAs* among banking organizations while not significantly increasing overall capital requirements.⁷ Basel IV seeks to reduce variability in *RWAs* by (i) eliminating model-based approaches for certain categories of *RWAs* (*e.g.*, operational risk *RWAs* and credit risk *RWAs* for equity exposures), with the

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effect that all banking organizations must apply a standardized approach to those categories, and (ii) where model-based approaches remain available, reducing the scope of model-based parameters and implementing exposure-level parameter floors.

With regard to the overall effect on capital requirements, the Basel Committee published a study that presents the Basel Committee's assessment of the quantitative impact of Basel IV;⁸ however, Basel IV will likely have significant and wide-ranging effects extending beyond the impact on overall capital requirements. Its ultimate impact will depend substantially on how Basel IV is implemented by national authorities. Basel IV, together with the revised market risk framework published in January 2016 (commonly referred to as the fundamental review of the trading book or "*FRTB*"),⁹ will significantly change bank capital requirements. Moreover, as discussed below, for U.S. banking organizations, there are many open questions on how the U.S. banking agencies will implement Basel IV and integrate it with the capital adequacy framework that has developed since the financial crisis and that will no doubt continue to change as Basel IV implementation approaches.

DISCUSSION

Basel IV encompasses six components: (i) an aggregate output floor, (ii) a revised standardized approach for credit risk, (iii) a revised internal ratings-based approach for credit risk, (iv) a revised operational risk framework, (v) revisions to the Basel leverage ratio framework, and (vi) a revised standard for credit valuation adjustment ("CVA") risk. Sullivan & Cromwell LLP prepared charts for The Clearing House that present a high-level summary of Basel IV and include comparisons to the Basel Committee's earlier proposals, as well as the current U.S. capital rules, where applicable. The Clearing House has published these charts on its [website](#). Additionally, we have addressed below key considerations arising out of Basel IV.

- **Output Floor.** Basel IV introduces an aggregate output floor for RWA calculations. Under Basel IV, a banking organization's RWAs are equal to the higher of (i) total RWAs calculated using the approaches the banking organization has supervisory approval to use (including both standardized and internal model-based approaches) and (ii) 72.5 percent of total RWAs calculated using only the standardized approaches. The output floor will be phased in from January 1, 2022, at 50 percent, through January 1, 2027, at which point it will be 72.5 percent. During the phase-in period (*i.e.*, from January 1, 2022 to December 31, 2026), national authorities may cap the incremental increase in total RWAs resulting from the application of the floor to 25 percent of a banking organization's RWAs. Because the Basel output floor is used to determine a banking organization's RWAs, it will apply for purposes of determining satisfaction of minimum capital requirements as well as capital buffers and surcharges.
 - Although the U.S. capital rules also include a floor, the U.S. floor differs from the Basel IV output floor in both scope and calibration. In the U.S. capital rules, there is a 100 percent floor that compares capital ratios calculated under the standardized approach to those calculated under the advanced—or model-based—approaches: the capital ratios for an advanced approaches banking organization are the lower of its ratios calculated using the U.S. standardized approach and the advanced approaches.¹⁰ Like the Basel IV output floor, the U.S. floor applies to both the minimum requirements and the capital buffers and surcharges.

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- Under Basel IV, the standardized approaches used to calculate the output floor are those for (i) credit risk, (ii) counterparty credit risk, (iii) CVA risk, (iv) securitizations, (v) market risk and (vi) operational risk. In contrast, the U.S. capital rules currently do not include either CVA risk or operational risk in standardized approach capital calculations. In addition, for U.S. banking organizations subject to the market risk capital rule,¹¹ market risk capital requirements are substantially the same for purposes of standardized approach and advanced approaches capital calculations because the U.S. banking agencies have implemented only the model-based approach for market risk.
- Basel IV no longer requires national authorities to implement internal model-based approaches. Under Basel IV, a jurisdiction that does not implement some or all of the model-based approaches and instead implements only the standardized approaches will be compliant with the Basel framework.
- **Standardized Approach for Credit Risk.** Under the standardized approach for credit risk, banking organizations assign prescribed risk weights to exposures based on applicable exposure classes (e.g., retail exposures, bank exposures, corporates exposures, and real estate exposures) and other characteristics within each exposure class. Basel IV establishes new exposure classes and recalibrates risk weights for most existing exposure classes, with many risk weights that are lower than under the U.S. capital rules and some that are higher. The Basel IV standardized approach for credit risk also provides for more granular treatment and segmentation of exposures than under the U.S. capital rules.
 - Under Basel IV, for many exposure classes, there are two approaches for determining the applicable risk weight. For banking organizations formed in jurisdictions that allow the use of external credit ratings for regulatory capital purposes, the External Credit Risk Assessment Approach (“ECRA”) is available for rated exposures. Other banks must use the Standardized Credit Risk Assessment Approach (“SCRA”) for all exposures, whether or not rated. In general, the ECRA provides lower and more granular risk weights compared to the SCRA. Put differently, the ECRA generally provides preferential treatment compared to the SCRA. Because Section 939A of the Dodd-Frank Act prevents the U.S. banking agencies from using external credit ratings in the U.S. capital rules, under current law, only the SCRA would be available for U.S. banking organizations, which could place them at a disadvantage compared to banking organizations in jurisdictions that implement the ECRA.
 - Basel IV revises the credit conversion factors (“CCFs”) for unfunded commitments, notably applying a 10 percent CCF to unconditionally cancellable commitments. Under the current Basel standardized approach and U.S. capital rules, unconditionally cancellable commitments have a zero percent CCF, with the result that such commitments do not contribute to risk-based capital requirements. The impact of a 10 percent CCF for unconditionally cancellable commitments will likely vary across jurisdictions depending, in part, on the relative prevalence of lines of credit that are structured to qualify for the current zero percent CCF, such as certain credit card lines and home equity lines of credit.
- **Internal Ratings-Based Approaches for Credit Risk.** Basel IV limits the use of internal ratings-based (“IRB”) approaches for certain exposures and establishes additional minimum “floor” values for parameters estimated by banking organizations.
 - Under the advanced internal ratings-based (“A-IRB”) approach, banking organizations generally use their own estimates of probability of default (“PD”), loss given default (“LGD”) and exposure at default (“EAD”) to determine credit RWAs. Basel IV eliminates the A-IRB for exposures to banks, other financial institutions, and large and mid-sized corporates (generally defined as corporates with consolidated revenues greater than €500 million). For such exposures, the foundation internal ratings-based (“F-IRB”) approach remains available. Under the F-IRB, banking organizations use their own estimates of PD and prescribed

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- supervisory parameters for LGD and EAD to determine credit RWAs. The U.S. capital rules include the A-IRB but not the F-IRB for advanced approaches banking organizations that use model-based approaches to calculate credit RWAs.
- Basel IV establishes floors for the PD parameters under the A-IRB and F-IRB, and for the LGD and EAD parameters under the A-IRB. The U.S. capital rules generally do not have parameter floors for the A-IRB but, where they do, the Basel IV floors are higher.
 - Basel IV eliminates the use of model-based approaches for equity exposures and requires that equity exposures be calculated under the standardized approach.
 - Basel IV eliminates the 1.06 scaling factor that applied to RWAs calculated under the Basel II IRB approaches, which operates as a 6 percent add-on to IRB approaches RWAs. Currently, the U.S. capital rules apply a 1.06 scaling factor to advanced approaches RWAs for wholesale, retail, securitization and equity exposures. Basel IV also introduces a multiplier of 1.25 to the correlation parameter in the RWA formula for exposures to (i) regulated financial institutions with total assets greater than or equal to \$100 billion and (ii) all unregulated financial institutions (regardless of size).
 - **Operational Risk.** Basel IV eliminates the use of Basel II's model-based advanced measurement approach ("AMA") to calculate operational risk capital requirements and introduces a single standardized approach (referred to as the standardized measurement approach, or "SMA") that applies to all internationally active banking organizations—*i.e.*, banking organizations within the scope of application of the Basel capital framework. Currently, under the U.S. capital rules, operational risk capital requirements are determined using the AMA and are applicable only to advanced approaches banking organizations for their advanced approaches capital calculations; there is no operational risk capital requirement for purposes of standardized approach capital calculations for any U.S. banking organization.
 - The SMA calculates operational risk capital requirements based broadly on a banking organization's income, expenses and interest earning assets, as well as its historical losses, using Business Indicator ("BI"), BI Component ("BIC") and Internal Loss Multiplier ("ILM") calculations. BI is calculated using income statement and balance sheet items. The BIC is determined by multiplying the BI by certain prescribed marginal coefficients.
 - The ILM, which applies only to banking organizations with a BI greater than €1 billion, is a function of the BIC and the banking organization's Loss Component ("LC"). The LC is equal to 15 times a banking organization's average historical losses over the preceding ten years. Basel IV provides that insurance and other recoveries may reduce average historical losses for purposes of the LC calculation so long as the banking organization has received payment. Although this recognizes the risk-mitigating effects of insurance, the treatment of insurance in the Basel IV operational risk framework is fundamentally different from that in the AMA, under which qualifying insurance may reduce operational risk capital requirements by up to 20 percent.
 - Basel IV permits banking organizations to request supervisory approval to exclude operational loss events that are no longer relevant to its risk profile, including settled legal exposures and divested businesses.
 - At national discretion, authorities may set the value of the ILM equal to one, with the result that operational risk capital requirements are a function of only the BIC.
 - **Leverage Ratio.** Basel IV introduces a leverage ratio buffer for G-SIBs in an amount equal to 50 percent of the G-SIB's surcharge. Similar to the G-SIB surcharge and capital buffers, the Basel

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IV leverage ratio buffer imposes graduated constraints on a G-SIB's capital distributions and discretionary bonus payments if the G-SIB fails to meet its leverage ratio buffer requirement, with the constraints based on the amount of the shortfall. Beginning January 1, 2018, the U.S. capital rules will apply a uniform 2 percent buffer to U.S. G-SIBs' supplementary leverage ratio requirement.¹²

- Basel IV also makes a number of notable modifications to the leverage ratio exposure measure, including replacing the current exposure method with a modified version of the standardized approach to counterparty credit risk (referred to as SA-CCR) for measuring derivatives exposures, deducting specific and general provisions, and implementing a specific treatment for unsettled transactions.
- The Basel Committee stated that it will continue to monitor the impact of the Basel leverage ratio on central clearing and that, by December 2019, it will conclude a review of the impact of the Basel leverage ratio on banking organizations' provision of clearing services and any related effects on the resilience of central clearing.
- **Credit Valuation Adjustment Risk.** Basel IV eliminates the internal models approach ("IMA") for calculating CVA risk and allows only the standardized approach and the basic approach. The U.S. capital rules apply CVA capital requirements to only advanced approaches banking organizations for purposes of determining capital ratios under the advanced approaches and permit both the current standardized approach and the IMA. Under the revised Basel IV CVA framework, all banking organizations must calculate CVA capital requirements, but an organization with an aggregate notional amount of non-centrally cleared derivatives less than or equal to €100 billion may set its CVA capital requirement equal to 100 percent of its counterparty credit risk capital requirement.
- **Implementation and Transitional Arrangements.** Basel IV generally would be implemented beginning on January 1, 2022, with a five-year phase-in period for the output floor. In its announcement of Basel IV, the Basel Committee noted that it will defer to January 1, 2022 the implementation date of its revised market risk framework (the FRTB) in order to align this framework with the introduction of the revisions for credit and operational risk and to allow for a review of the calibration of the FRTB.
 - In addition to providing that a jurisdiction will be compliant with the Basel framework even if it does not implement some or all of the internal models-based approaches, Basel IV allows jurisdictions to implement more conservative requirements and accelerated transitional arrangements.

OBSERVATIONS

As banking organizations continue to analyze Basel IV, and U.S. banking organizations prepare for the release of proposals to implement Basel IV by the U.S. banking agencies, they will need to consider a number of issues and uncertainties, including the following.

- **Scope of Applicability.** The Basel capital framework applies to internationally active banking organizations, and it remains to be seen which U.S. banking organizations will become subject to Basel IV's standardized approaches. In this regard, it is notable that the U.S. banking agencies' press release following the Basel Committee's December 2015 consultation on revisions to the standardized approach for credit risk stated that "[t]hese proposed revisions would apply primarily to large, internationally active banking organizations and not to community banking organizations,"¹³ and that their press release following the issuance of Basel IV observed that the Basel capital framework "was designed for internationally active banks."¹⁴

- **Numerical Thresholds.** Whether or not the U.S. banking agencies implement the Basel IV standardized approaches only for “internationally active” banking organizations, it also remains to be seen whether the agencies will revisit the current threshold for application of the advanced approaches: generally \$250 billion or more in total consolidated assets or \$10 billion or more in on-balance sheet foreign exposure. Notably, the revised final definition of “large and noncomplex” CCAR firms in the recent amendments to the Federal Reserve’s capital plan rule¹⁵ replaced the \$10 billion foreign exposure element of the advanced approaches threshold definition, which was included in the proposed definition, with a G-SIB status element, such that the final rule defines “large and noncomplex” as a firm that (i) has average total consolidated assets of less than \$250 billion, (ii) has average total nonbank assets of less than \$75 billion, and (iii) is not a bank holding company that is identified as a global systemically important bank holding company pursuant to the Federal Reserve G-SIB surcharge rule. In addition, the U.S. banking agencies have also recently sought comment on “whether they should consider a fundamental change to the manner in which banking organizations calculate and comply with minimum capital standards such as through the use of a simple U.S. GAAP based equity to assets ratio (leverage ratio) for non-GSIB banks.”¹⁶ Although the U.S. banking agencies have recently used the advanced approaches threshold as the dividing line for determining which banking organizations will benefit from extensions of transitional provisions and proposed simplifications to the U.S. capital rules, the agencies may be considering alternatives to this threshold.¹⁷
- **Output Floor vs. Collins Amendment.** It is unclear how the Basel IV output floor will operate alongside the floor required by Section 171 of the Dodd-Frank Act, commonly referred to as the “Collins Amendment.” Section 171 imposes a floor of the generally applicable risk-based and leverage capital requirements under the prompt corrective action framework for U.S. depository institutions on the capital requirements of advanced approaches banking organizations. As discussed above, the U.S. capital rules currently include a floor, the scope and calibration of which differ from the Basel IV output floor. How the Basel IV and Collins Amendment floors relate to each other will likely depend, in part, on whether the Basel IV standardized approaches apply only to a subset of U.S. banking organizations—e.g., those that are considered to be internationally active.
 - If there are multiple versions of the standardized approach in the U.S. capital rules, with Basel IV standardized approaches applying to only a subset of banking organizations, then there could be two floors: a Basel IV-based floor, which, when fully phased in, would be calibrated at 72.5 percent and would compare advanced approaches RWAs (RWAs calculated using standardized and, where available, model-based approaches) to Basel IV-based standardized RWAs for credit risk, counterparty credit risk, CVA risk, securitization exposures, market risk and operational risk; and another floor, calibrated at 100 percent of RWAs, comparing advanced approaches RWAs to standardized RWAs as calculated per the capital rules generally applicable to banking organizations regardless of size.
 - In the proposed U.S. Basel III-based capital rules, the floor would have applied only to the minimum requirements and advanced approaches banking organizations would have used advanced approaches capital ratios for purposes of the capital buffers; however, as finalized, the floor in the U.S. capital rules applies to both minimum requirements and buffers.¹⁸ The U.S. banking agencies’ rationale for applying the floor to the buffers was unrelated to the Collins Amendment. Accordingly, another potential mechanism to address the different scope and calibration of the Basel IV output floor and current U.S. floor could include revising the 100 percent U.S. floor to apply only to the minimum requirements and not the buffers.
- **Use of Model-Based Approaches.** Of course, a floor is relevant only if a banking organization uses model-based approaches. Basel IV expressly provides that a jurisdiction will be compliant with the Basel framework even if it does not implement some or all model-based approaches, and there is uncertainty as to the future role and relevance of the model-based approaches in the U.S. capital rules. Basel IV’s revisions to the IRB—constraining the use of the A-IRB and introducing

additional and more stringent parameter floors for the A-IRB and F-IRB—may, however, increase the likelihood that the U.S. banking agencies will retain model-based approaches for credit risk.

- **Interaction with CCAR.** Under the Federal Reserve’s capital plan rule, whether a CCAR firm “passes” the quantitative test is determined using the standardized approach—CCAR firms may not use the advanced approaches to calculate their capital ratios for purposes of CCAR.¹⁹ It is also unclear whether and, if so, how the standardized approaches in the Basel IV output floor but not the current U.S. standardized approach (operational and CVA risk) will be incorporated into CCAR. Also unclear is how, if operational risk RWAs are incorporated into CCAR, the Federal Reserve will address potential double-counting: in CCAR, projections and post-stress capital ratios reflect, among other things, operational risk losses. Under the SMA, operational risk losses affect operational risk RWAs through application of the LC and ILM calculations. A stressed operational risk loss could thus be recognized in capital twice: once through a reduction in earnings (and, therefore, the numerator) and a second time through increasing the LC and ILM (and, therefore, affecting the denominator). Similar issues could arise in connection with CVA, as the losses relating to changes in the credit quality of a counterparty are already captured through CVA adjustments and reflected in the numerator.²⁰
- **Stress Capital Buffer.** In September 2016, former Governor Tarullo previewed an approach to integrate the U.S. capital rules with the Federal Reserve’s stress testing and capital planning framework for CCAR firms, which centered on replacing the capital conservation buffer with a “stress capital buffer” based on the results of stress tests.²¹ The implementation of Basel IV, and the introduction of additional mandatory standardized approaches for internationally active banking organizations’ capital requirements, could affect whether, how, and when the U.S. capital rules and stress testing and capital planning frameworks are integrated, whether through the introduction of the stress capital buffer that Governor Tarullo described or through another mechanism.
- **Disparities between Standardized and Model-Based RWAs.** Basel IV eliminates model-based approaches for operational and CVA risk and, in general, use of model-based approaches is subject to supervisory approval. For purposes of the Basel IV output floor, in some (and possibly many) cases, the same standardized RWAs will therefore be reflected in both calculations of total RWAs. This will occur for CVA and operational risk (for which model-based approaches are no longer available), as well as for other exposures where banking organizations use the standardized approach (e.g., for market risk, if a banking organization has not received supervisory approval to use the model-based approach). The use of the same standardized RWAs for both calculations in the output floor will provide a cushion for greater disparities between standardized and model-based RWAs where model-based approaches are used.
- **Implementing the Operational Risk LC and ILM.** For the revised operational risk framework, Basel IV provides that national authorities may set the value of the ILM equal to one for all banks. In addition, Basel IV generally permits national authorities to adopt more conservative treatment. It is accordingly possible that national authorities, such as the U.S. banking agencies, could implement a version of the Basel IV operational risk framework in which (i) capital requirements are determined solely by reference to the BIC, with the ILM equal to a fixed coefficient and (ii) the fixed coefficient is higher than one, resulting in more stringent requirements than required under Basel IV.
- **Standardized Approach Risk Weightings.** The current U.S. standardized capital rules include risk weightings that, in a number of cases, are higher than those in the Basel capital framework. For example, the current Basel standardized framework generally assigns residential mortgage exposures a 35 percent risk weight; however, the U.S. capital rules assign those exposures either a 50 percent or 100 percent risk weight. It remains to be seen whether the U.S. banking agencies will implement the lower risk weightings in the Basel IV standardized approach and, if they do, whether the lower risk weightings will apply to all or only some U.S. banking organizations.

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- **Use of External Credit Ratings.** The preferential standardized credit risk weightings for jurisdictions that permit the use of external ratings may lead to an unlevel playing field with negative competitive effects for banking organizations formed in jurisdictions, such as the United States, that cannot use external ratings for regulatory capital requirements. Although many aspects of Basel IV implementation could be addressed by regulatory rulemaking, revisiting Section 939A of the Dodd-Frank Act in order to allow the United States to implement the ECRA would require legislative action.
- **Calculation of Leverage Buffer.** Unlike the Basel IV leverage ratio framework, which uses the G-SIB surcharge to assign non-uniform leverage buffer requirements on G-SIBs, the U.S. capital rules impose a uniform 2 percent buffer to the U.S. supplementary leverage ratio (commonly referred to as the “eSLR”). The U.S. banking agencies have also implemented a more stringent version of the G-SIB surcharge framework, where a U.S. G-SIB’s surcharge is equal to the higher of that calculated under two methods, the first of which reflects the Basel Committee’s methodology and the second of which generally results in higher surcharges.²² If the U.S. banking agencies revise the eSLR to track the structure of the Basel IV leverage ratio buffer, another question is whether the revised eSLR buffer would reflect 50 percent of the U.S. G-SIB surcharge (reflecting the higher surcharges under method one and method two), or 50 percent of the surcharge calculated in accordance with the Basel-based method one.
- **Broader Impacts.** Basel IV may have wide-ranging effects on the banking and other industries.
 - For example, the 10 percent CCF for unconditionally cancellable commitments may affect the pricing and availability of credit card lines and home equity lines of credit, which, in the United States, can be structured so that the undrawn commitment qualifies for a zero percent CCF under the current U.S. capital rules.
 - Moreover, as noted above, the SMA fundamentally revises the treatment of insurance in the operational risk capital framework. Under the SMA, insurance has the potential to reduce operational risk capital requirements only to the extent it results in recoveries and payments; absent a recovery and payment, operational risk losses factor into the LC and, therefore, operational risk RWAs, on a gross basis. Accordingly, it is possible that the introduction of the SMA will incentivize banking organizations that currently calculate their operational risk capital requirements under the AMA to restructure their insurance policies to lower deductibles in order to have more recoveries that can be netted against operational risk losses.

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ENDNOTES

- ¹ Basel Committee, *Basel III: Finalising Post-Crisis Reforms* (Dec. 2017) (hereafter, the “*Basel IV Standards Text*”), available at <https://www.bis.org/bcbs/publ/d424.pdf>.
- ² Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (rev. June 2011). For a detailed discussion of the Basel III framework, please see our Memorandum to Clients entitled *Basel III Capital and Liquidity Framework: Basel Committee Issues Final Revisions to International Regulation of Bank Capital and Liquidity* (Dec. 31, 2010), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Basel_III_Capital_and_Liquidity_Framework.pdf.
- ³ For example, the assessment framework for higher capital requirements for global systemically important banks (“G-SIBs”), referred to as the G-SIB surcharge, was released in November 2011 and revised in July 2013, and it is currently subject to a pending consultation issued for comment in March 2017. For additional information, please see our Memoranda to Clients entitled *Bank Capital Requirements: Basel Committee Issues Final Rule Regarding Common Equity Surcharge for Global Systemically Important Banks* (Nov. 10, 2011), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_11-10-11.pdf; *Bank Capital Requirements: Basel Committee Updates Framework for Assessing a Common Equity Surcharge on Global Systemically Important Banks* (July 26, 2013), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements.pdf; and *Bank Capital Requirements: Basel Committee Proposes Changes to the G-SIB Capital Surcharge Assessment Framework* (Apr. 6, 2017), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_04-06-2017.pdf.
- ⁴ Basel Committee, Press Release, *Governors and Heads of Supervision Finalise Basel III Reforms* (Dec. 7, 2017), available at <https://www.bis.org/press/p171207.htm>.
- ⁵ Basel IV Standards Text, at 142. The effect of capital requirements generally, and leverage capital requirements in particular, on central clearing has been a focus of industry participants, regulators and other policy makers. For example, the reports published by the U.S. Department of the Treasury on the U.S. regulatory system for depository institutions and the U.S. capital markets, in June 2017 and October 2017, respectively, both recommended revisions to leverage capital requirements to promote central clearing of derivatives. For additional information, please see our Memoranda to Clients entitled *Treasury Issues Comprehensive Report on Depository System Regulatory Reforms: Trump Executive Order Required Fundamental Reassessment of Existing Rules; Treasury Submits the First of Four Reports Examining Existing Financial Regulatory Framework* (June 14, 2017), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Treasury_Issues_Comprehensive_Report_on_Depository_System_Regulatory_Reforms.pdf, and *Treasury Issues Comprehensive Report on Capital Markets Reform: Trump Executive Order Required Fundamental Reassessment of Existing Rules; Treasury Submits the Second of Four Reports Examining the Regulatory Framework of U.S. Capital Markets* (Oct. 11, 2017), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Treasury_Issues_Comprehensive_Report_on_Capital_Markets_Reform.pdf.
- ⁶ Basel IV Standards Text, at 137. In October 2016, the Basel Committee published a discussion paper and a consultative document on the longer-term regulatory treatment of accounting provisions and transitional arrangements in connection with the upcoming implementation of revised accounting standards on credit loss provisioning. In March 2017, the Basel Committee released a final standard on transitional arrangements, permitting a transition period of up to five years to address the impact of the implementation of new provisioning standards on retained earnings and, therefore, capital. The discussion paper, consultative document and final standard on transitional arrangements are available at <https://www.bis.org/bcbs/publ/d385.pdf>.

ENDNOTES (CONTINUED)

- <https://www.bis.org/bcbs/publ/d386.pdf>, and <https://www.bis.org/bcbs/publ/d401.pdf>, respectively. For further information about the change in U.S. accounting standards regarding credit loss provisioning, please see our Memorandum to Clients, *Client Alert: FASB Expected Credit Loss Methodology* (June 23, 2016), available at https://www.sullcrom.com/siteFiles/Publications/S_Publication_Client_AlertFASB_Expected_Credit_Loss_Methodology.pdf.
- 7 Basel IV Standards Text, at 1.
- 8 Basel Committee, *Basel III Monitoring Report: Results of the Cumulative Quantitative Impact Study* (Dec. 2017), available at <https://www.bis.org/bcbs/publ/d426.pdf>.
- 9 Basel Committee, *Minimum Capital Requirements for Market Risk* (Jan. 2016), available at <https://www.bis.org/bcbs/publ/d352.pdf>.
- 10 Under the U.S. capital rules, advanced approaches banking organizations are generally those with \$250 billion or more in total consolidated assets or \$10 billion or more in on-balance sheet foreign exposure (including subsidiary depository institutions of bank holding companies that meet those thresholds). See 12 C.F.R. §§ 3.100(b) (OCC), 217.100(b) (Federal Reserve Board) and 324.100(b) (FDIC). An advanced approaches banking organization is not subject to the floor in the U.S. capital rules until it has completed the parallel run process.
- 11 Under the U.S. capital rules, the market risk capital rule generally applies if the banking organization has aggregate trading assets and trading liabilities equal to (i) 10% or more of quarter-end total assets; or (ii) \$1 billion or more. See 12 C.F.R. §§ 3.201(b) (OCC), 217.201(b) (Federal Reserve Board) and 324.201(b) (FDIC).
- 12 For more information on the U.S. leverage ratio buffer, see our Memorandum to Clients entitled *Bank Capital: Supplementary Leverage Ratio; Federal Banking Agencies Propose Revisions to the Supplementary Leverage Ratio's Exposure Measure and Approve Final Rules Implementing an Enhanced Supplementary Leverage Ratio for the Largest U.S. Banking Organizations* (Apr. 16, 2014), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Supplementary_Leverage_Ratio.pdf. The Federal Reserve Board has since amended the enhanced supplementary leverage ratio to align the applicability with the U.S. G-SIB surcharge rule, which is described in our Memorandum to Clients entitled *Bank Capital Requirements: Federal Reserve Board Approves Final Common Equity Surcharge For U.S. Global Systemically Important Banks* (July 29, 2015), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_7_29_2015.pdf.
- 13 Federal Reserve Board, FDIC and OCC, Press Release, *Banking Agencies' Statement Regarding the Basel Committee's Second Consultative Paper, "Revisions to the Standardized Approach for Credit Risk"* (Dec. 10, 2015), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20151210b.htm>.
- 14 Federal Reserve Board, FDIC and OCC, Press Release, *U.S. Banking Agencies Support Conclusion of Reforms to International Capital Standards* (Dec. 7, 2017), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171207b.htm>.
- 15 Federal Reserve Board, *Amendments to the Capital Plan and Stress Test Rules; Regulations Y and YY*, 82 Fed. Reg. 9,308 (Feb. 3, 2017).
- 16 Federal Reserve Board, FDIC and OCC, *Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996*, 82 Fed. Reg. 49,984, 49,996 (Oct. 27, 2017).

ENDNOTES (CONTINUED)

- ¹⁷ See *id.*, at 49,984; Federal Reserve Board, FDIC and OCC, *Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations That Are Not Subject to the Advanced Approaches Capital Rules*, 82 Fed. Reg. 55,309 (Nov. 21, 2017).
- ¹⁸ See Federal Reserve Board, FDIC and OCC, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 Fed. Reg. 52,792, 52,803, n.33 (Aug. 30, 2012); Federal Reserve Board and OCC, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 Fed. Reg. 62,018, 62,036 (Oct. 11, 2013).
- ¹⁹ “CCAR” refers to the Federal Reserve’s Comprehensive Capital Analysis and Review of capital plans filed annually by bank holding companies with \$50 billion or more in total consolidated assets and U.S. intermediate holding companies of foreign banking organizations under the Federal Reserve’s capital plan rule, Section 225.8 of Regulation Y, and supervisory and company-run stress tests under its Dodd-Frank Act Stress Test rules, Subparts E and F of Regulation YY, 12 C.F.R. Part 252. Section 225.8(d)(10) of Regulation Y precludes the use of advanced approaches capital calculations in CCAR.
- ²⁰ See, e.g., Federal Reserve Board, *Dodd-Frank Act Stress Test 2017: Supervisory Stress Test Methodology and Results* (June 2017), at 69 (CVA) and 72 (operational risk), available at <https://www.federalreserve.gov/publications/files/2017-dfast-methodology-results-20170622.pdf>.
- ²¹ Governor Daniel K. Tarullo, Speech: Next Steps in the Evolution of Stress Testing at 17 (Sep. 26, 2016), available at <https://www.federalreserve.gov/newsevents/speech/files/tarullo20160926a.pdf>. For a discussion of this speech, please see our Memorandum to Clients entitled *Banking Organization Capital Plans and Stress Tests: Federal Reserve Governor Tarullo Previews Proposal for Multiple Revisions to Capital Plans and Stress Tests That Will Increase Effective Capital Requirements for G-SIBs and May Reduce Effective Capital Requirements for Other CCAR Banking Organizations* (Sep. 26, 2016), available at https://sullcrom.com/siteFiles/Publications/SC_Publication_Banking_Organization_Capital_Plans_and_Stress_Tests.pdf.
- ²² For more information on the U.S. G-SIB surcharge rule, please see our Memorandum to Clients entitled *Bank Capital Requirements: Federal Reserve Board Approves Final Common Equity Surcharge For U.S. Global Systemically Important Banks* (July 29, 2015), available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_7_29_2015.pdf.

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