FEDERAL RESERVE BANK *of* NEW YORK

Bank Capital and Regulation

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Presentation outline

- Overview
- Observed weaknesses in the crisis
- Introduction of Basel III
- Fed’s new approach to assessing capital adequacy

Overview - supervisory interest in bank capital

- Strong capital levels reduce the potential for bank failures
  - Promote financial stability by reducing the chance a large institution with systemic risk will fail and adversely impact other financial institutions

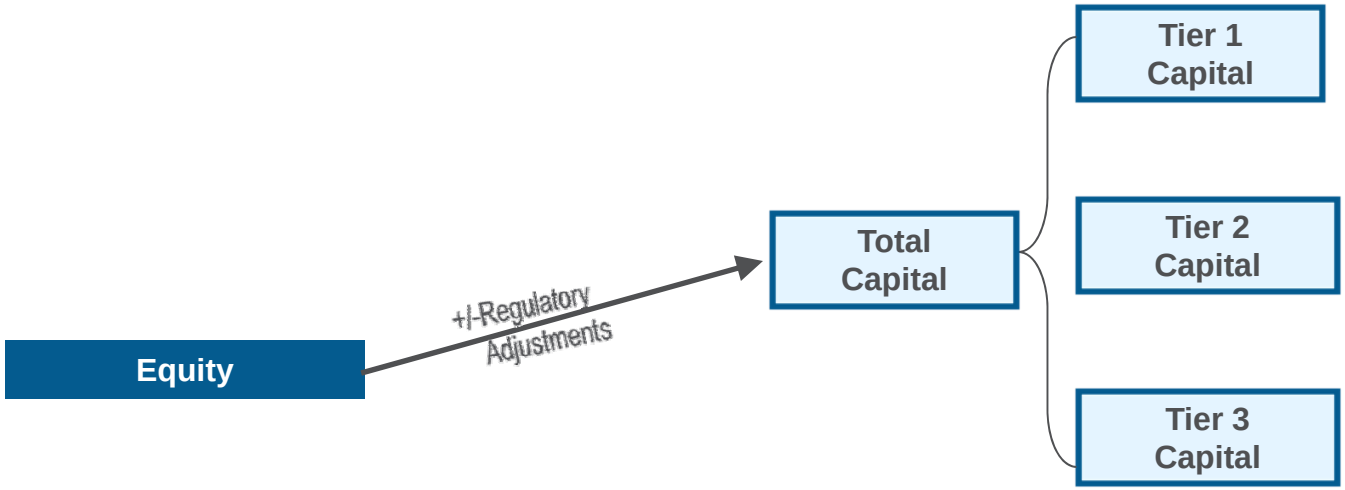
- Capital levels are an important indicator of safety and soundness
  - Supervisors have the broad authority to set prudential regulations for banks to ensure safety and soundness
  - Capital regulations are a key supervisory tool

- Banks are expected to maintain capital levels sufficient relative to their risk of loss
  - To help ensure capital adequacy, supervisors have historically prescribed minimum capital requirements, which they expect banks to exceed

Overview – measurement of capital adequacy

Bank's Balance Sheet

Bank's Regulatory Capital



Capital adequacy is measured as the amount of a bank's regulatory capital relative to the amount of its exposure to risk of loss (risk-weighted assets "RWA" or average on-balance sheet assets).

$$\frac{\text{Capital (Tier 1 or Total Capital)}}{\text{Exposure}} = \text{Capital Ratio}$$

Overview – evolution of bank capital and regulation

- U.S. minimum capital standards, based on 1988 Basel Accord (commonly known as Basel I) focusing principally on credit risk
  - Tier 1 risk-based capital ratio (Tier 1 Capital/RWA): 4% minimum
  - Total risk-based capital ratio (Total Capital/RWA): 8% minimum
  - Tier 1 leverage ratio (Tier 1 Capital/Average On-Balance Sheet Assets): 4% minimum and 3% for certain firms

- Capital requirement for market risk, added in 1996 (Market Risk Amendment)
  - Applies to firms with significant trading activity

- The Basel II framework amends the risk-based capital standards for large, internationally active banking organizations
  - Includes an explicit minimum capital requirement for operational risk in addition to credit and market risks

Overview – timeline

1988
- Basel I minimum capital standards established (tier 1 risk-based capital, total risk-based capital, and tier 1 leverage ratios)

1996
- Capital requirement for market risk (Market Risk Amendment) added to Basel I

April 2008
- Basel II advanced approaches become effective in the U.S. (includes specific requirements for operational, credit, and market risks)

July 2009
- BCBS finalizes Basel II.5 market risk and banking book securitization frameworks

December 2010
- U.S. agencies release notice of proposed rulemaking (NPR) for Basel II.5 Market Risk rules
- BCBS finalizes Basel III framework

April 2011
- Public comment period ends on U.S. agencies' market risk NPR for Basel II.5

November 2011
- BCBS finalizes guidance on SIFI surcharge

January 2012
- U.S. agencies released revised notice of proposed rulemaking (NPR) for Basel II.5 market risk rules

During 2012
- NPR expected to be issued for Basel III definition of capital, counterparty, and leverage rules
- Expected implementation of Basel II.5 market risk rules

January 2013
- Expected transition to Basel III final rule definitions for capital, counterparty, and leverage
- Full implementation by January 1, 2019

Observed weaknesses during crisis

During the financial crisis, shortcomings in the regulatory framework and banks' own processes became pronounced. More specifically:

- Supervisory expectation that common equity serve as 'predominant' form of tier 1 capital was neither explicitly defined nor viewed as a binding constraint;
- Regulatory adjustments (e.g., deduction of goodwill) to tier 1 capital or total capital, not common equity led to overstatement of quality of capital; and
- Capital requirements were not commensurate with risks taken by banks, and the risks they posed to the financial system, particularly those realized in a stressed environment.

Introduction of Basel III

In December 2010, the Basel Committee on Banking Supervision (BCBS) finalized the Basel III package aimed at:

- Increasing the capacity of banks to absorb losses relative to risk;
- Constraining leverage through a credible, non-risk-based backstop;
- Increasing the capacity of banks to absorb shocks to funding and constraining structural funding mismatches;
- Incorporating systemic and macroprudential perspectives into capital framework; and
- Providing greater transparency so market participants can make informed assessments of banks' potential vulnerabilities to shocks.

Composition of capital

Revisions to composition of regulatory capital to increase its capacity to absorb losses on a ‘going concern’ basis.

- More stringent criteria for instruments to qualify as regulatory capital, for example, perpetual maturity and full discretion to cancel distributions;
- In the U.S., only instruments that will satisfy proposed tier 1 eligibility criteria are common equity and non-cumulative perpetual preferred stock (TRUPs would be excluded);
- Limited recognition (15% of tier 1 common) of mortgage servicing rights and deferred tax assets; and
- Deductions and filters to tier 1 common equity will flow through to tier 1 and total capital definitions.

Improve risk-weighted assets measure

Ensure capital requirements are commensurate with risks taken by banks, and the risks they pose to the financial system, particularly those that may be realized in a stressed environment.

- Revise Market Risk capital rules to capitalize appropriately credit-sensitive trading and securitization positions;
- Implement changes to capital requirements for re-securitization activities;
- Implement changes to capital requirements for counterparty credit risk, including charge for credit valuation adjustment losses for derivatives; and
- Increase capital requirements for credit exposures to large financial institutions, whether or not they are regulated, to disincent interconnectedness between financial firms.

Calibration

Introduction of tier 1 common, capital conservation buffer and SIFI surcharge requirements.

- Calibration of the tier 1 common minimum requirement should ensure that banks are regarded as viable going concerns by creditors and counterparties;

- Increase the amount of capital banks must hold relative to RWAs through imposition of higher minimum capital requirement and non-discretionary restrictions on capital distributions for banks that fail to maintain a buffer of capital above the minimum; and

- Introduction surcharge for systematically-important financial institutions (SIFI) should reduce the probably of failure of those firms by increasing their loss absorbency capacity.

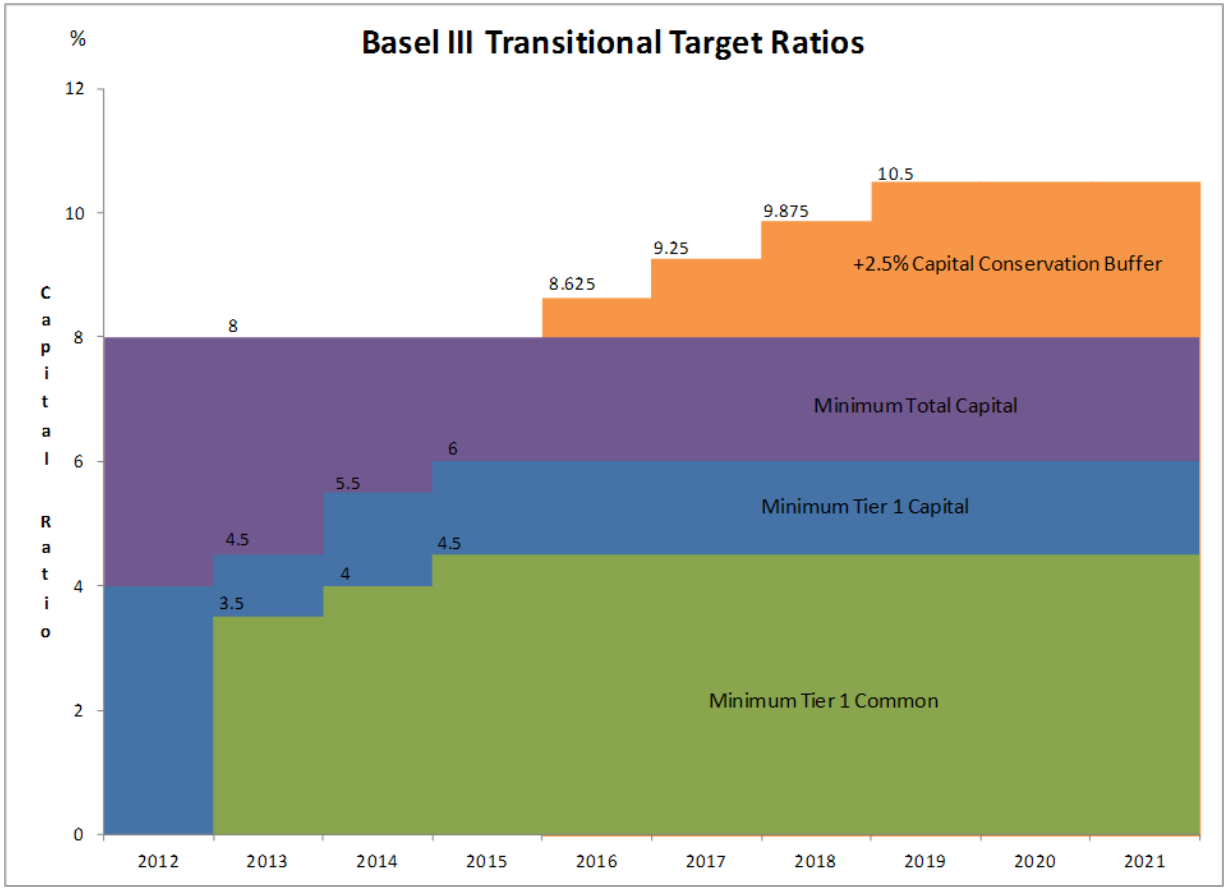
Leverage ratio

Introduction for the first time of a leverage ratio in the Basel context to complement (not substitute) for risk-based measures to help contain leverage in the banking system. More specifically,

- Standard meant to be straightforward and easily interpreted by the market;
- Measure compares banks' on- and off-balance sheet positions to tier 1 capital;
- The calibration of required capital for off-balance sheet measures to reflect economic risk (i.e., derivatives to be reflected on a net rather than gross positive basis); and
- Proposed calibration of 3% to be tested during a 'parallel run' phase from January 2013 to January 2017.

Basel III transitional target ratios

Minimum capital ratios will be phased in between January 2013 and January 2015, and the conservation buffer and SIFI surcharge (ranging between 1% to 2.5% depending on a bank's systematic importance) will be phased in from January 2016 to December 2018.



Comparison of minimum regulatory capital ratios

Capital ratios are not created equal as the definitions for composition of capital, RWAs and leverage exposures are not the same under Basel I/II and III.

Ratios	Basel I and II	Basel III
Risk-based Capital (RBC) Ratios - Minimum Capital Requirements		
Tier 1 Common Ratio	N/A*	4.5% + 2.5% (conservation buffer) + SIFI surcharge (firm-specific)
Tier 1 Capital Ratio	4%	6% + 2.5% (conservation buffer) + SIFI surcharge (firm-specific)
Total Capital Ratio	8%	8% + 2.5% (conservation buffer) + SIFI surcharge (firm-specific)
Leverage Ratios - Minimum Capital Requirements		
Tier 1 Leverage Ratio	3% or 4%	3%

•While there is no formal tier 1 common ratio requirement under current U.S. regulatory capital adequacy guidelines (Basel I or Basel II), for supervisory purposes, tier 1 common capital is calculated as tier 1 capital less non-common elements in tier 1 capital under the capital plan rules issued by the Federal Reserve in November 2011. This supervisory definition of tier 1 common capital ratio will remain in force under the capital plan rule until the Federal Reserve adopts the Basel III tier 1 common ratio. As part of supervisory assessment, banks are required to meet 5% minimum for the tier 1 common ratio under expected and stressful conditions throughout the planning horizon.

Fed's new approach to assessing capital adequacy

In addition to the new Basel III regulatory standards, in November 2011, the Federal Reserve issued its capital plan rules setting supervisory standards to assess firms' capital planning strategies and capital adequacy:

- Requires large bank holding companies to submit capital plans to the Federal Reserve on an annual basis. Differs from traditional capital adequacy assessment process:
  - 19 firms simultaneously instead of one at a time
  - Forward-looking planning horizon instead of a point in time
  - Expected and stressful conditions instead of current financial condition