

## Evolving Standards of Bank Capital

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With the economic troubles which have affected economies worldwide since 2007, many countries are attempting to both rebuild the integrity of existing financial organizations and substantially minimize the prospects of a similar collapse happening in the future through substantial financial regulatory reform. The United States and Europe have both pursued new systems of regulation, and these proposed changes reflect the overarching goal of balancing regulation to ensure the safety of financial organizations with permitting them the freedom to do the business necessary to revitalize their respective economies. One of the most significant areas getting substantial attention from reformers is that of capital requirements for financial organizations. Proposed changes will create significantly higher requirements than currently exist, and in doing so, will force a significant shift in the way banking organizations currently do business.

### *The Current Regulatory Climate*

The basic regulatory regime applicable to national banks currently establishes minimum requirements for both risk-based capital ratios and Tier 1 capital.<sup>1</sup> Currently, the Office of the Comptroller of the Currency (OCC) requires all national banks to maintain Tier 1 capital equal to at least three percent of the bank's total adjusted assets.<sup>2</sup> However, the OCC has the authority to require higher minimum capital ratios for an individual bank depending on its particular circumstances. Higher capital ratios could be required for newly chartered banks, banks with significant exposure due to fiduciary or operational risk, or banks that are exposed to a high volume of problem loans, for example.<sup>3</sup> Minimum capital ratios are not simply the product of a mathematical formula, but rather are intended to be based partly on subjective judgment. Factors that the OCC is to consider in creating these minimum capital ratios include the conditions or circumstances leading to the determination that higher

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minimum capital ratios are appropriate or necessary, the exigency of those circumstances or potential problems, the overall condition, management strength, and future prospects of the bank, the bank's liquidity, capital, risk asset and other ratios compared to the ratios of its peer group, and the views of the bank's directors and senior management.<sup>4</sup>

Bank holding companies (BHCs) (along with their "alter egos," financial holding companies) are regulated by the Federal Reserve, which provides similar regulations of capital and leverage ratios. BHCs are required to have a ratio of Tier 1 and Tier 2 capital to risk-weighted assets of eight percent, with at least four percent taking the form of Tier 1 capital, at a minimum.<sup>5</sup> Within the category of Tier 1 capital, qualifying cumulative perpetual preferred stock is limited to 25 percent of the sum of the common stock, qualifying perpetual stock, and minority interests. Total Tier 2 capital included in a BHC's total capital is limited to 100 percent of Tier 1 capital.

While these requirements are specific to national banks and bank holding companies, other agencies follow a similar pattern in their regulations. For the purposes of this article, we will be focusing on the regulations implemented by the OCC and the Federal Reserve as representative of the regulations currently in place for the many kinds of financial entities.

In response to the financial failures of the past several years, regulatory agencies have taken several steps in order to assess the current environment and halt the economic backslide as much as possible. In 2009, the Treasury Department conducted a series of stress tests looking at the 19 largest bank holding companies in order to assess the losses that each might suffer given an assumed set of economic indicators. Each of the holding companies was asked to perform a capital-adequacy stress test under two economic scenarios, the first was a baseline scenario reflecting the expectations as to the depth and duration of the recession, and the second was a more adverse but plausible scenario, with all of the variables being 10 to 15 percent worse than specified.<sup>6</sup> These stress tests incorporated granular analyses of factors specific to each bank holding company, such as past loan performance, portfolio composition, origination vintage, borrower characteristics, geographic distribution, international operations, and business mix.

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The results of these stress tests showed that under the more adverse scenario, 10 of the 19 bank holding companies would need to raise a total of \$75 billion in capital in order to reach the target capital buffers (Tier 1 capital in excess of six percent of risk-weighted assets, and Tier 1 Common capital in excess of four percent of risk-weighted assets).<sup>7</sup> By November 2009, the 10 banks requiring additional capital had increased their Tier 1 Common equity by more than \$77 billion, primarily by issuing new common equity, converting existing preferred equity to common equity, and selling businesses or portfolios of assets.

While these stress tests were designed as a method of evaluating the overall health of bank holding companies through the examination of the 19 largest banks, it appears that similar types of stress testing are occurring in virtually all bank examinations, irrespective of the size of the bank, at the moment. While regulators have not established this widespread stress-testing as an official policy, Daniel Tarullo of the Board of Governors of the Federal Reserve recently made remarks regarding the possibility of ongoing supervisory plans making public the results of stress test, which indicates that these stress tests are occurring on a regular basis, and not just in the context of a one-time sampling of the state of the industry.<sup>8</sup>

Another significant change which has occurred already came from an August 2009 policy statement issued by the Federal Deposit Insurance Corporation (FDIC). In this policy statement, the FDIC required private capital investors acquiring a failed bank's deposit liabilities to maintain a Tier 1 leverage ratio of 10 percent for the first three years of operation, after which period the depository institution must remain "well capitalized."<sup>9</sup> This higher capital ratio is designed to preserve the safety and soundness of these de novo institutions and to protect the Deposit Insurance Fund from unanticipated losses in these uncertain times. In view of these goals, an institution with capital below 10 percent will be viewed as "undercapitalized" for the purposes of Prompt Corrective Action.<sup>10</sup>

In Europe, capital requirements are proposed for the various member countries by the Bank for International Settlements, which serves as a center for international central bank cooperation. The current framework comes from a 2004 document issued by the Basel Committee on Banking Supervision, and calls for a total capital ratio of at least 8 percent.<sup>11</sup>

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The capital requirements were designed to be more risk-sensitive than older minimums, and employ a greater use of assessments of risk provided by banks' internal systems as inputs to capital calculations. These requirements were designed to be minimum levels, with individual countries permitted to use a higher requirement or supplementary measures of capital as a way to address local banking market environments.

### *Proposed Changes to the Regulatory System*

#### *United States*

In response to the changing economic climate, many proposals have been made calling for a variety of financial reforms. President Obama's June 2009 proposed economic reforms called for stronger capital requirements, stating that the previous requirements were "simply too low" to account for economic hard times.<sup>12</sup> While particular minimum requirements have not been proposed yet, with the suggestions having been more general as to the nature of the changes, these proposals indicate an increased emphasis on common equity over noncumulative perpetual preferred stock, and a significant de-emphasis on minority interests in the equity accounts of consolidated subsidiaries. By implication, this will mean less reliance on Tier 2 capital entirely.

Interactions by bank management with financial institution regulators indicate that this shift in policy is already taking place, with significant focus on common equity despite the lack of any statutory requirement to do so.

Some of the changes which have occurred have had the unintended consequence of limiting the availability of capital which is necessary for the recovery and further development of banks. One commentator has noted that with the change in capital rules, "it becomes more difficult for banks to attract this capital" because of changes like greater disclosures required from de minimis investors, and limitations on private equity investment in failed banks.<sup>13</sup> As a result, the practical availability of capital is being restricted just when it is needed the most by financial organizations.

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Another way to "skin the capital cat" is to prohibit depository institutions from engaging in businesses that would, in the minds of the regulators, subject the banks to undue risk. Reform proposals that require banks to separate their proprietary investments in or sponsorship of hedge funds, private equity funds, or proprietary trading operations from their core banking businesses are geared at "ring fencing" bank capital from such risks.

## *BASEL*

In Europe, similar attempts to evaluate the current regulatory system have been ongoing. In December 2009, the Basel Committee on Banking Supervision (Basel committee) issued a series of proposals designed to strengthen capital and liquidity management. Specifically, these proposals are designed to (1) raise the quality, consistency, and transparency of the capital base, to ensure that large, internationally active banks are in a better position to absorb losses; (2) strengthen the risk coverage of the capital framework by strengthening the capital requirements for counterparty credit risk exposures; (3) introduce a leverage ratio as a supplementary measure to the current risk-based framework; and (4) introduce a series of measures to promote counter-cyclical capital buffers that can be drawn upon in periods of stress.<sup>14</sup>

To update the capital base of banks, these proposals specifically call for an adjustment of the criteria for Tier 1 capital, which is intended to improve the quality and consistency of the common equity element; eliminate the subcategories of Tier 2 capital to encourage simplification; eliminate Tier 3 capital to ensure that market risks are met with the same quality of capital as credit and operational risks; and require disclosure of all elements of capital in order to improve transparency.<sup>15</sup>

The Basel committee is conducting a comprehensive impact assessment of these proposed changes, and a fully calibrated set of standards is expected by the end of this year, to be phased in by the end of 2012. These are designed to have a similar effect on European financial institutions that the United States capital requirements will have on U.S. banks.

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These proposals appear to be focusing on the separation of riskier investment banking and trading activities from the more traditional forms of commercial banking. By raising capital limits and restricting the types of investments that banks can participate in, these regulations will prompt a serious shift in the way banks currently do business. Applying more stringent credit underwriting standards is a necessary result of crimping a bank's ability to hedge its risk in its trading desk. Forcing banks and credit rating agencies to have a more disciplined approach to diligence and a more jaundiced eye toward investment quality will inevitably tighten the flow of available credit. Returning to a pre-Gramm-Leach-Bliley organizational structure which segregates commercial banking from investment banking and trading will increase the cost of a banking business, evade the symbiosis developed in recent years between the two businesses and likely create a whole new group of competitors to take advantage of the immediate dislocation and long term restructuring. Add to this the costs of maintaining yet higher capital levels, and banking has inevitably entered a new phase.<sup>16</sup>

Banking organizations have publicly stated their fears that these restrictions could undermine their "ability to carry out viable activities that serve clients, which will hold back economic recovery and future growth."<sup>17</sup> Standard & Poor has stated that the Basel III proposals could force significant changes for wholesale-funded institutions, which will have more difficulty complying with the capital requirements than smaller, deposit-funded retail banks. Banks may shift towards more short-term lending to cope with an overly restrictive approach to the definition of liquid assets, and could move to the use of qualified clearing houses to cope with the proposed regulatory capital charges.<sup>18</sup>

While economic events of the previous years have demonstrated the need for some type of financial reform and Congress is debating the tenets of the new regime as we write, it is not clear precisely what form these changes will (or should) take. Some of the current proposals regarding capital requirements and investment activities are significantly more stringent than the current regime, and will prompt a sizeable shift in the manner in which financial organizations do business. The real question is whether this shift will result in a safer and sounder banking system, or if instead it will unintentionally hinder the rebuilding and development of the global financial markets.

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<sup>1</sup> Tier 1 capital is comprised of "(1) common stockholders' equity; (2) noncumulative perpetual preferred stock and related surplus; and (3) minority interests in the equity accounts of consolidated subsidiaries, except . . . [for] . . . (i) minority interests in a small business investment company or investment fund that holds nonfinancial equity investments and minority interests in a subsidiary that is engaged in a nonfinancial activities and is held under one of the legal authorities listed in section 1(c)(23) of this appendix A." 12 C.F.R. Part 3 Appendix A Section 2.

<sup>2</sup> 12 C.F.R. § 3.6(b).

<sup>3</sup> 12 C.F.R. § 3.10.

<sup>4</sup> 12 C.F.R. § 3.11.

<sup>5</sup> 12 C.F.R. Part 225, App. A.

<sup>6</sup> Lessons from the Crisis Stress Tests, Remarks by Daniel K. Tarullo, Member, Board of Governors System at the Federal Reserve Board International Research Forum on Monetary Policy, March 26, 2010.

<sup>7</sup> *Id.* at 5.

<sup>8</sup> *Id.* at 8–10. Governor Tarullo mentions as an option the Federal Reserve providing details about the assumptions and methods employed in stress tests while withholding the results for individual banks, indicating that the testing will be ongoing for banks in general.

<sup>9</sup> Federal Deposit Insurance Corporation, Press Release, Final Statement of Policy on Qualifications for Failed Bank Acquisitions, August 26, 2009.

<sup>10</sup> This would have the practical effect of limiting the range of non-complying banks' business activities, including those with increased risk taking.

<sup>11</sup> Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version, June 2006.

<sup>12</sup> Financial Regulatory Reform: A New Foundation, Department of the Treasury.

<sup>13</sup> Viewpoint: Clear Up Capital Regs, Free Up Capital Access, American Banker, Thomas Vartanian, April 20, 2010.

<sup>14</sup> Basel Committee on Banking Supervision, Strengthening the resilience of the banking sector, December 2009.

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<sup>15</sup> *Id.* at 15.

<sup>16</sup> As of the date of publication, the most recent reform proposals continue to add more restrictions on commercial bank investments. In the Restoring American Financial Stability Act (RAFSA) of 2010, the so-called Volcker Rule as passed by the Senate would prevent commercial banks from owning and investing in hedge funds and private equity funds, and would also limit the trading banks may conduct for their own accounts. These proposed changes continue the trend of restricting the permissible operations of commercial banks and moving towards a serious shift in the business of banking. RAFSA, section 619.

<sup>17</sup> *Banks Decry Proposed Basel Mandates on Cash, Capital*, Bloomberg BusinessWeek, April 15, 2010, available at <http://www.businessweek.com/news/2010-04-15/banks-decry-proposed-basel-mandates-on-cash-capital-update1-.html>.

<sup>18</sup> *S&P Says Basel III Could Strengthen Banks, But May Have Unintended Consequences*, Standard & Poor's, April 15, 2010, available at <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245210159884>.

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