Banking in the 21st Century: Navigating Uncharted Waters

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Even though the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed over 3.5 years ago, its likely effects on commercial banking are only now starting to take shape. Although the Commodity Futures Trading Commission has made material progress in implementing Title VII of the Dodd-Frank Act and the Consumer Financial Protection Bureau has made its mark on retail financial services, the specifics of the new regulatory environment for commercial banking have been slow to emerge. In 2013, that began to change as greater certainty emerged for regulatory capital requirements and the Volcker Rule was finalized. In early 2014, enhanced prudential standards for larger banking institutions under §165 of the Dodd-Frank Act also were finalized. Although a number of shoes are still to drop, including risk-based capital surcharges for the largest banking institutions, possible changes to the supplemental leverage ratio, possible minimum levels of long-term debt, and final liquidity standards, the new regulatory environment for banking in the 21st century is starting to take shape. What is still unclear, however, is how the different regulatory requirements will interact to shape bank balance sheets and how they will affect access to financial services for banks' commercial customers. It is clear that these requirements will have significant impacts on how banks finance, how they invest, the business that they conduct, and their willingness to lend.

In July 2013, the U.S. banking agencies approved a broad and comprehensive revision of the regulatory capital rules applicable to all U.S. banks and bank holding companies (except those with less than $500 million in total consolidated assets). The new rules, which will be phased in from 2014 to 2019, introduce Basel III standards for the components of, adjustments to, and deductions from, regulatory capital, as well as new minimum ratios under the U.S. prompt correction action framework. U.S. banks and bank holding companies are subject to the following minimum regulatory capital requirements: a common equity Tier 1 capital ratio of 4.5 percent (a newly introduced requirement), a Tier 1 capital ratio of 6 percent (increased from the current 4 percent), a total capital ratio of 8 percent of total risk-weighted assets (unchanged from the current requirement), a Tier 1 leverage ratio of 4 percent, and, for those U.S. banks and bank holding companies subject to the advanced approaches rule, an additional leverage ratio of Tier 1 capital to total leverage exposure of 3 percent. The rules also introduce regulatory capital buffers above the minimum common
equity Tier 1 ratio, including a capital conservation buffer of a further 2.5 percent of common equity Tier 1 capital to risk-weighted assets and, for those U.S. banks and bank holding companies subject to the advanced approaches rule, a countercyclical buffer of up to 2.5 percent of common equity Tier 1 capital to risk-weighted assets that may be deployed as an extension of the capital conservation buffer.

Basel III has narrowed the types of instruments that qualify for Tier 1 capital and establishes prescriptive criteria to be met for instruments to be considered Tier 1 or Tier 2 capital. In addition, Basel III introduces a series of regulatory capital deductions, which will serve to discourage banks from engaging in certain activities or generating certain types of assets. Regulatory deductions are required from common equity Tier 1 for, among other things, goodwill, net of associated deferred tax liabilities, deferred tax assets, and securitization gain on sale. Deductions from Tier 1 and Tier 2 capital are required for direct and indirect investments in the issuer's own capital instruments, as well as for reciprocal cross-holdings in financial institution capital instruments, and direct and indirect investments in unconsolidated financial institutions.

The higher capital requirements, and the reduced number of "tools," are likely to encourage banks to focus more closely on the incremental cost of capital associated with particular activities. In the United States, banks generally must satisfy their Tier 1 requirements through the issuance of common stock or non-cumulative perpetual preferred stock, which generally are more "expensive" means of raising capital. Gone are the days of "innovative" hybrid securities, like trust preferred securities or mandatorily convertible instruments, which permitted banks to raise capital on a tax efficient basis and obtain equity credit from the rating agencies. Unlike their European counterparts, U.S. banks cannot issue instruments that are classified as debt securities for additional Tier 1 capital purposes. European banks have found significant investor appetite for contingent capital, or debt securities that become convertible for equity upon the breach of specified regulatory capital triggers, which satisfies additional Tier 1 criteria. In fact, for European banks, the range of capital instruments (debt that becomes convertible into equity with a "low trigger" or a "high trigger," as well as debt that includes a principal write-down feature) seems to be multiplying and not necessarily getting simpler.

Banks can, of course, continue to issue debt securities to finance their activities. Given the existence of the orderly liquidation authority framework under Title II of the Dodd-Frank Act, investors have now been made aware that the holders of unsecured debt issued by bank holding companies may bear losses (or be "bailed in") in the event of a bank failure. In fact, in order to facilitate this single-point of entry orderly liquidation, regulators have advised that a new long-term debt requirement is likely to be imposed for larger institutions. This may result in bank holding companies having to review their debt maturity profile and issuing longer term debt. Regulators also have warned against overreliance by banks on short-term wholesale funding, such as securities financing transactions and repos. As a result, regulators are expected to propose regulations to discourage this. Similarly, regulators have generally discouraged reliance by banks on the issuance of secured debt, which would lead to excessive encumbrance levels at banks, and potentially affect adversely depositors.

The regulatory capital rules also modify the calculation of risk weights (the denominator in risk-based capital ratios) in order to comply with Basel III and, in the United States, to eliminate the reliance on credit ratings. As a result of these changes, certain types of assets
will be subject to higher risk weights. This is the case, for example, with securitization exposures. As a result of the risk weighting of securitization exposures, and the treatment of securitized products for liquidity coverage ratio purposes, as well as accounting changes, banks may no longer be able to obtain the benefits of securitization. At a minimum, the benefits of securitization will be reduced. Securitization historically permitted banks to "recycle" capital and make capital available for new loan originations. Now, many regulators have come to the conclusion that securitization as a financing tool was not itself a root cause of the financial crisis and acknowledge that securitization served a useful function as a means of financing mortgage originations. However, the regulatory change of heart alone will not be sufficient to revive the securitization market when new requirements actually discourage this financing approach. Risk weights also would discourage banks from holding securities of other financial institutions. Reduced to its simplest terms, under the risk-based capital requirements, banks would seem to have an incentive to favor activities with low risk weights, forcing borrowers in need of funds for higher risk ventures to turn elsewhere for funding.

In addition to meeting heightened risk-based capital requirements using fewer instruments, banks also will need to focus on more general leverage ratio and liquidity issues. In July 2013, the U.S. federal banking agencies proposed for comment a supplemental leverage ratio for U.S. banking organizations that are global systemically important banks (GSIBs). This would include a minimum supplemental leverage ratio of 6 percent of Tier 1 capital for any insured subsidiary bank of a GSIB, and a minimum supplemental leverage ratio of 3 percent, plus an additional "leverage buffer" of 2 percent, or a total 5 percent supplemental leverage ratio, of Tier 1 capital to be maintained at the holding company level, for GSIBs. This leverage ratio would take into account off-balance sheet and similar exposures, such as future exposure amounts arising under certain derivatives contracts and the notional amount of most other off-balance sheet exposures (excluding securities lending and borrowing, reverse repurchase agreement transactions, and unconditionally cancelable commitments).

In effect, contrary to the risk-based capital requirements, which encourage banks to hold low risk assets, the supplemental leverage ratio will discourage banks from holding lower risk assets by imposing the same or a similar capital charge on these assets as it does on higher risk assets. The ratio that is most binding on a particular banking institution may dictate the risk profile of its balance sheet.

With respect to liquidity, although banks have long been subject to general liquidity requirements through the supervisory process, going forward banks will be required to comply with a specific short-term liquidity coverage ratio (LCR), which is expected to be finalized in 2014. Under the proposed LCR, a larger bank would be required to hold high-quality, liquid assets (HQLA) of at least 100 percent of the company's total net cash outflows over a prospective 30-calendar-day period. Assets get a weighting with government bonds and cash-like instruments being favored. The rule details the manner in which the numerator (i.e., HQLA) and denominator (i.e., total net cash outflows) are calculated. This calculation would be more restrictive than the Basel LCR standard in certain respects. In effect, the LCR will encourage banks to hold more liquid and lower yielding assets even though the supplemental leverage ratio may discourage the holding of these same assets. Lest banks focus on short-term liquidity to the detriment of more stable long-term funding, Basel III introduces the net stable funding ratio (NSFR). The NSFR looks at the stability of available funding and the duration of assets. The amount of stable funding that is required would depend on the type of asset (assets are assigned a stable funding factor) and the liquidity of
the asset under stressed market scenarios. More stable funding is required for less liquid assets. Addressing the NSFR would require banks to focus on longer-term deposits and longer-term funding.

Although for different banks, the interaction of these many requirements will have very different consequences, it seems clear that bank balance sheets will be changing. Banks are likely to assess their business to determine the incremental capital costs associated with each line of business, as well as the impact of these requirements on their liquidity. Banks will continue to focus on retail deposits and may need to turn their attention to longer-term debt. It is not clear whether, over time, investors will reprice the debt securities of banks or simply disregard the "bail-in" risk. Banks may seek to limit business activities that would have an unfavorable effect on liquidity and leverage.

These uncertainties are compounded by the Volcker Rule, which prohibits proprietary trading by banking entities and, therefore, will have its own effects on the balance sheets of these entities, as well as on other new regulatory requirements. The cumulative effect of these requirements on individual entities and markets more generally, let alone bank customers, has not been modeled by regulators. Banking institutions, particularly larger banking institutions, will, of course, have to assess the cumulative effect of these requirements on their business models, but bank customers will also need to be aware of these changes and their likely effect on their own access to financial services and the pricing of those services. These effects may not be immediately apparent. The various regulatory requirements have different implementation dates that trail off into the future. Banks and financial markets will likely go through several stages as these requirements become effective. First, banking entities will need to comply with the law. They will likely focus on compliance with individual requirements on a requirement-by-requirement basis. In practice, they will have no other choice as the requirements are rolling out piecemeal and they will have to comply with some before others are even known. Following initial compliance, banks can begin to assess how the various requirements are likely to interact and then refine their business models to address these interactions. In addition, as the banking industry as a whole begins to react to the cumulating requirements, market changes and competition in the new environment will cause banking entities to again reassess their business models and make additional changes that will affect markets and competition. Finally, but no less significantly, changes in foreign markets and foreign banking competition will have to be considered as well as changes in the U.S. and foreign economies. This shake out will take some time. And the true effects of the Dodd-Frank Act may not be apparent for at least a decade after its passage.

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Endnotes:


2. The final Volcker Rule may be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf.


