FS Regulatory Brief

Supervisory Expectations on Capital Assessment – Stepping up to Basel III

On November 4th, Governor Daniel Tarullo delivered a speech entitled "The International Agenda for Financial Regulation" before the ABA Banking Law Committee. While Governor Tarullo touched upon a number of topics including the additional efforts to complete international and domestic reform on capital and liquidity, cross boarder resolution, reliance on wholesale funding and OTC derivatives reform, his comments on capital, particularly how the US Supervisors will deal with the interim period, are of particular note.

Regarding the higher capital requirements under Basel III, Governor Tarullo stated that US Supervisors will not hold banks to the higher levels until required by rule, however US Supervisors expect that firms who do not currently meet the fully phased in Basel III capital levels demonstrate steady progress towards meeting the transitional and final requirements. His comments were as follows:

> "In the spirit of that statement, we will expect large bank holding companies that have not yet met the fully phased-in Basel III requirements (including any expected G-SIB [global systemically important bank] capital surcharge) to improve their capital ratios steadily during the transition period through prudent earnings retention policies, *even if they already meet any applicable intermediate targets*. In practical terms, we will monitor their progress through our review of the capital plans that we require large bank holding companies to submit annually. That is, we will be comfortable with proposed capital distributions only when we are convinced they are consistent with a bank holding company readily and without difficulty meeting the new capital requirements as they come into effect. We will provide more detail on this point in a few weeks when we issue guidance and instructions for the 2012 capital review."

Our interpretation

The US Supervisors' Comprehensive Capital Analysis and Review (CCAR), which will be expanded to those BHCs generally in excess of $50 billion in assets, will continue to be conducted annually; however, conclusions may be reassessed on a more frequent basis—perhaps even quarterly—to ensure that capital levels are steadily accreting. Regulators do not want firms to rely on a large capital raise conducted during the later phases of Basel III implementation to meet minimum capital requirements. Further complicating a firm's calibration of future capital needs is the implementation of elements of the Dodd-Frank Act (DFA) which may serve to decrease capital demands, e.g. derisking as a result of Volcker or the reduction of counterparty credit exposure due to the mandate of derivatives clearing.

It is our view that the ability of a firm to deliver on the earnings projections provided at the behest of Regulators for CCAR, particularly during the transition period, will be critical to maintaining dividend levels and stock buybacks. Failure to meet a projection which is incorporated in CCAR may have the consequence of US Regulators forcing the reduction of dividends, elimination of stock buy backs or compelling an external capital raise. Further, it is our view that US Supervisors are neither sensitive nor

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sympathetic to the shareholder's/market's perception of dividend volatility and may force an institution to cut a dividend midyear. It is likely that a single quarterly miss will not trigger such events, however US Supervisors will likely expect the firm to "earn it back" over subsequent quarters. Multiple quarters of misses will certainly draw the attention of US Supervisors and all the negative outcomes that entails.

It appears that US Supervisors are generally comfortable with a dividend payout ratio lower than 30% given the outcomes of CCAR 2011; however, a payout ratio close to that target may leave little flexibility for firms' whose earnings are volatile to deal with an earnings "miss". Consequently, it may make it more likely that US Regulators will first force firms to place stock buybacks on hold. To counter this, a firm may consider executing stock buybacks directly after the CCAR however that limits the firm's flexibility in dealing with the implications of an earnings miss in subsequent quarters.

Other comments of note

Governor Tarullo acknowledged that liquidity stress, regardless of capital levels, can cause the failure of an organization but stated that the market and regulators "virtually ignored" Tier 1 regulatory capital ratios and concentrated on tangible common equity capital levels. He also stated categorically that required capital levels were too low, particularly around trading book exposures and that the market and regulators focused on more forward looking estimates of capital—which considered capital sufficiency after accounting for estimated losses over a more adverse period.

Governor Tarullo pointed to DFA's prohibition on the use of NRSRO's ratings in supervision as why the US has not signed on to Basel 2.5 treatment of securitization and resecuritization. He asserted that the US has come up with a proposal which will generally converge with the international treatment, and is expected to be released shortly. He also stated that US rule on Basel will be released in 1Q12.

Governor Tarullo confirmed the importance of international quantitative standards regarding liquidity however acknowledged that there is considerable work to be done on both the Net Stable Funding Ratio (NSFR) and the Liquidity Coverage Ratio (LCR). He implied that NSFR will be a large lift for supervisors; and, given the LCR is to come into effect in 2015, the Basel Committee will focus on refining and recalibrating the LCR first. That work will focus on the assumptions regarding deposit run off, loan commitment draw downs and liquidity characteristics of assets which are not based on the assets' credit ratings.

Governor Tarullo stated that the G-SIB list is predicated on 2009 data and as such may not represent the list of institutions (less likely) or the segmenting of the buffer assigned (more likely). The more final list of firms that will be considered G-SIBs and their assigned surcharge will be revisited in 2014 for implementation in 2016, with revisions to the list recomputed yearly starting in 2017.

In the interim period before the final list in 2014, a list will be produced each November.

Additional information

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