FS Regulatory Brief

US regulatory outlook – second half of 2013

Final enhanced prudential standards and Basel III rules

June 2013

Overview

The word "soon" has been used often by regulators to describe when delayed rulemakings would be released under the Dodd-Frank Act. Despite expectations that by this juncture – nearly three years since Dodd-Frank's passage – banks would finally gain some needed regulatory clarity, the fog still has not lifted. Key US rulemakings remain outstanding, including the elusive final Volcker Rule and several other rules pertaining to risk retention, affiliate transactions, and broker-dealer duties.

However, 2013 has brought some important regulatory developments so far, even if not enough. Regulators finalized several key mortgage rules early this year (on time), and provided some important derivatives specifications with respect to swap execution facilities, block trading, and the swap push-out rule (late). It is our view that the second half of 2013 will see far more regulatory development. Not just because of the additional derivatives guidance we expect (e.g., cross-border),[1] but because we believe that a host of rules will be finalized implementing outstanding prudential standards in the US – namely, Basel III quantitative capital and liquidity rules, and enhanced prudential standards ("EPS") affecting systemically important financial institutions ("SIFIs").

Making regulatory predictions has proven difficult over the past three years given the several factors that must come together to cross the finish line. We have seen delay caused by a lack of agreement among US regulators, with the Volcker Rule as a good example. We have seen the influence of Congressional oversight, a recent example being when the Federal Reserve and FDIC issued long awaited guidance for the largest banking organizations regarding their annual resolution plans the day before Congressional testimony on Too Big To Fail ("TBTF").[2] We have also seen market and other macro forces shift the regulatory debate.

Regardless, it is our view that US regulators are eager to complete the Basel III and EPS rules in 2013 in order to put in place the new baseline supervisory framework and deflect further criticism. Treasury Secretary Jack Lew hinted as much in his testimony before Congress in May when, in response to Congressional skepticism of Dodd-Frank, he asserted it is too early to judge Dodd-Frank's effectiveness until its outstanding supervisory remedies take effect. Shortly thereafter, on June 3rd, three non-bank financial firms disclosed that the Financial Stability Oversight Council ("Council") proposed designating them as SIFIs subject to Federal Reserve bank-like supervision (including elements of Basel III and EPS)[3] – a prediction we made in April 2012.[4]

This **Financial Services Regulatory Brief** provides (a) the "regulatory scorecard" for 2013 – what expectations were met by regulators and which were not – and (b) our view of the timing and content of the Basel III and EPS rulemakings that will occur over the rest of 2013.

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[1] See PwC's *Financial Services Regulatory Brief: Derivatives: Cross-border at the cross roads*.

[2] While most communications from the regulators on resolution plan requirements had been confidential, this guidance was made public.

[3] See PwC's *Financial Services Regulatory Brief: Nonbank SIFIs: FSOC proposes initial designations – more names to follow*.

[4] See PwC's *Financial Services Regulatory Brief: The FSOC finalizes rules and guidance for designating nonbank financial companies as SIFIs – Expect very few on tap, but many on watch* (stating that initial Council determinations would be issued "in the range of 2 to 3 firms").

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2013 regulatory scorecard

The following chart conveys the key regulations that were expected this year (and the regulator responsible for the rule writing). It denotes which US regulations were actually finalized and which will likely be further delayed. Importantly, we believe the Basel III and EPS rules will cross the finish line this year.

	Expected Rules/Guidance	Finalized (2013)	Expected (2013)	Delayed
Derivatives *(CFTC mostly)*	Swap Execution Facilities	✓		
	Block Trades	✓		
	Swap Push-Out guidance *(FRB)*	✓		
	Cross-Border guidance		✓	
	Uncleared Margin & Capital		✓	
Mortgage *(CFPB)*	Ability to Repay	✓		
	High-Cost Mortgages	✓		
	Servicing	✓		
Basel III *(FRB/OCC/FDIC)*	Capital		✓	
	Liquidity Coverage Ratio		✓	
EPS *(FRB)*	US Banks		✓	
	Foreign Banks and IHCs		✓	
Other	Volcker			X
	Risk Retention			X
	Affiliate Transactions			X
	Broker-Dealer Duties			X

Basel III

Final Basel Capital Rule

In July, US banking organizations can expect finalization of the quantitative capital rules for aligning the US with Basel III (or at a minimum their key elements). In 2012, US regulators released these changes to US capital standards through three Notices of Proposed Rulemaking ("NPRs"). The combination of these NPRs include more restrictive capital definitions, increased risk-weighted assets, added capital buffers, and heightened requirements for minimum capital ratios.[5]

We predicted earlier this month that the regulators would issue this final rule at about this time,[6] and the Federal Reserve today announced that it would hold its open meeting on the issue next week (on July 2nd). It is our view that the final approved rule will likely apply an effective date of January 1, 2014.

Driven by the public pronouncements by Governor Daniel Tarullo (Federal Reserve), Comptroller of the Currency Thomas Curry (OCC), and Chairman Martin Gruenberg (FDIC), we believe the agencies are also considering imposing a higher leverage ratio and/or a larger SIFI surcharge for the very largest banking organizations. However, given the departure from the NPRs, we believe such adjustments would have to first be proposed and likely could not be finalized in the near term. A proposal will likely be issued this year and be applicable to only the larger more complex institutions, which are subject to the advanced approaches methodology. Given the implications to foreign banking organizations which previously have not been held to a leverage based capital standard, it is unclear whether US regulators would be able to get agreement on these possible proposals in the Basel Committee. As such, the higher requirement could end up being only US-based, creating a potential disadvantage for US institutions and intermediate holding companies ("IHC").

[5] See PwC's *A Closer Look: US Basel III Regulatory Capital Regime and Market Risk Final Rule*.

[6] See footnote 3 (stating "the current Basel III proposal for US implementation of capital standards will be finalized as soon as this month").

Proposed and Final Basel Liquidity Rules

Also this year, banks can expect a proposed rule that implements the Basel III Liquidity Coverage Ratio ("LCR") released by the Basel Committee in January 2013. The LCR is a short-term liquidity measure that considers liquidity stress, using a ratio of "high quality liquid assets" ("HQLA" – the ratio's numerator) compared to stressed "net cash outflows" (the ratio's denominator) over a 30-day period.[7]

We expect the US regulators will propose a rule that is consistent with what the Basel Committee intended. However, national discretion will likely allow for greater clarity on definitions of HQLA in the US, including treatment of agency mortgage backed securities.

Once the US version of the LCR rule is proposed (as soon as this Fall), we expect a relatively short window between closure of the comment period and finalization of the rule, as regulators will want to provide banks with a transition period that aligns with the LCR effective date laid out by the Basel Committee (currently identified as January 1, 2015). The short window may also be driven by the desire to finalize the EPS (discussed below) in alignment with the LCR's quantitative liquidity measures.

With respect to the longer-term liquidity measure – the Net Stable Funding Ratio ("NSFR") – the Basel Committee has yet to finalize an approach, and we do not anticipate a US proposed rule this year. The NSFR was proposed by the Basel Committee to restrain wholesale borrowing and to encourage stable funding over a one-year time horizon.

We believe the US will eventually propose a NSFR rule though. We know that US regulators are actively engaged with the Basel Committee on setting the global NSFR standard, so speculation that the US will not ultimately adopt the NSFR seems unwarranted. Our view is that the Basel Committee will issue an NSFR agreement late this year.

[7] See PwC's *Financial Services Regulatory Brief: Basel III Liquidity Regime – More practical but not yet workable*.

Enhanced prudential standards

Once the Basel III rules are final, US regulators will be better able to take the next step of finalizing the EPS and the early remediation requirements mandated under sections 165 and 166 of Dodd-Frank for both domestic and foreign banking organizations ("FBOs"). Much of the EPS's efficacy ultimately depends on approaches that are part of the Basel III rules.

We believe regulators will finalize, by year-end, the EPS and early remediation proposed rules for US bank holding companies with over $50 billion in assets and non-bank financial companies designated as systemically important (proposal published December 2011),[8] and for FBOs and foreign non-bank financial companies (proposal published December 2012). We believe both packages will be largely unchanged from the proposed rules in substance and implementation timing[9] with the exception of the Single Counterparty Credit Limit ("SCCL"). The SCCL is likely subject to some revisions or transition period depending on the outcome of a planned Quantitative Impact Study that was noted in February 2013 testimony by Governor Tarullo.

With respect to the three non-bank financial firms recently proposed for SIFI designation, the additional efforts that may be required by regulators to determine how bank-focused capital and liquidity rules will apply to them leads us to believe that the Federal Reserve may revisit or further tailor the EPS and early remediation requirements for these and other ultimately designated non-bank firms.[10]

All firms subject to these heightened requirements and requisite operational processes (e.g., a liquidity risk management framework, contingency funding plans, etc.), will need to consider significant changes to existing exposure capture, monitoring, and reporting practices, in addition to other process changes depending on how a firm is currently organized. For FBOs, implementation of EPS and early remediation requirements are complicated by the additional new requirement for an IHC.

Basel III/EPS timeline summary

The following outlines our best estimate of when key US rulemakings implementing Basel III and EPS are likely to occur, based on the above discussion:

- July 2013: Final Basel Capital Rule
- Fall 2013: Proposed Liquidity Coverage Ratio
- Year-end 2013:
  - Final Enhanced Prudential Standards and Early Remediation Requirements
  - Basel Agreement on Net Stable Funding Ratio
- 2014:
  - Final Liquidity Coverage Ratio
  - Final Single Counterparty Credit Limits
  - Proposed Net Stable Funding Ratio

See the **Appendix – US regulatory reform key dates**, for a graphic depiction of these and additional expected important rulemakings and timing, related to the Volcker Rule, derivatives, risk retention, and others.

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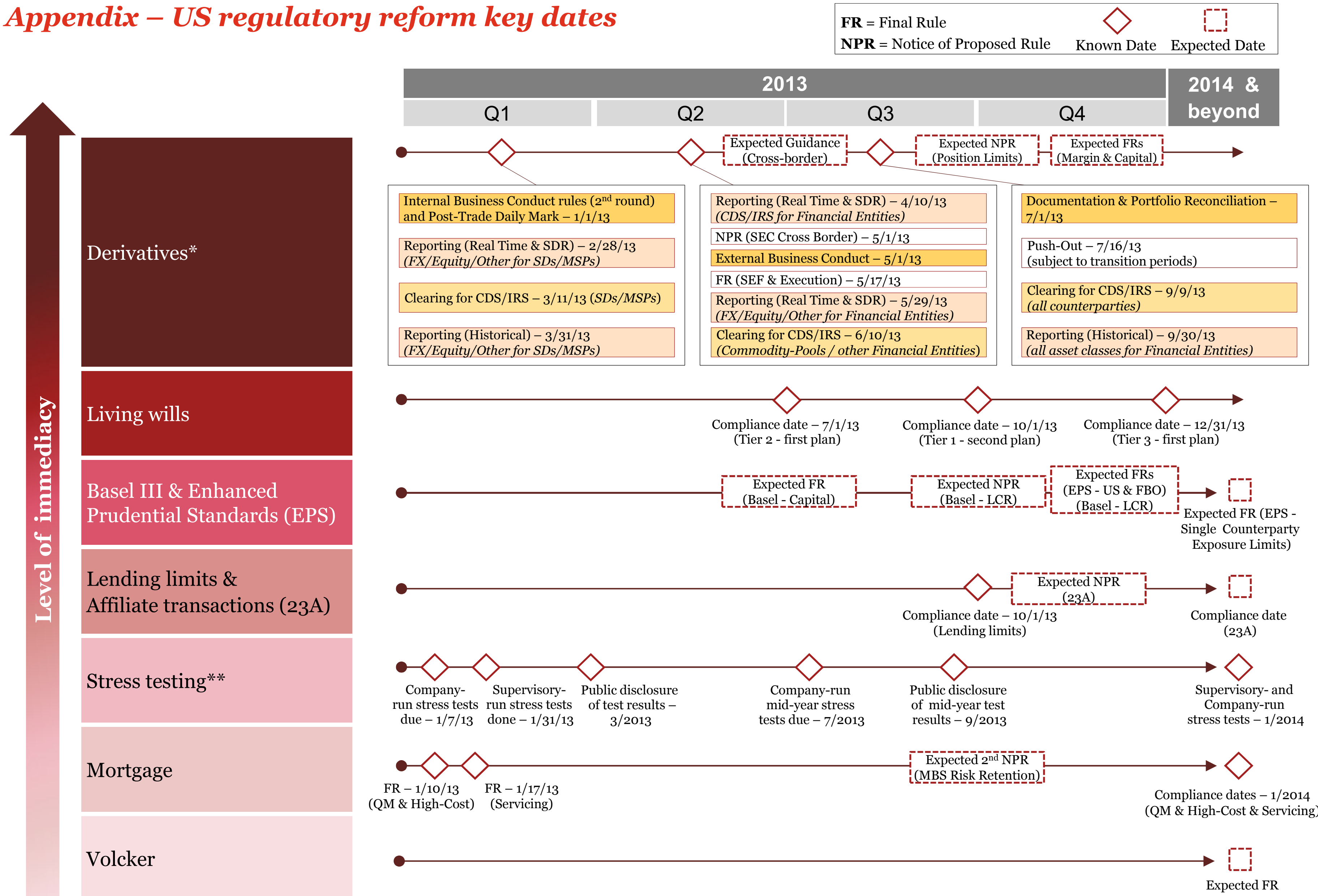
[8] See PwC's *Financial Services Regulatory Brief: The Federal Reserve's proposal to implement enhanced prudential standards for large bank holding companies*.

[9] One year from the effective date of the rule for US bank holding companies, and July 1, 2015 for FBOs.

[10] See footnote 3.

Appendix – US regulatory reform key dates



* Dates differ for foreign entities due to CFTC cross-border relief (set to expire 7/12/13 if not extended); dates for particular items may also differ due to other exemptive relief.

** Stress testing dates apply only to large BHCs that participated in the 2009 SCAP; however, stress testing on 1/7/13 and 1/2014 apply to all large BHCs.

Additional information

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