First take

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Ten key points about the new US supplementary leverage ratio

The US banking regulators yesterday finalized the Enhanced Supplementary Leverage Ratio ("ESLR") and released a Notice of Proposed Rulemaking ("NPR") to modify the exposure calculation (i.e., the denominator) of the underlying Supplementary Leverage Ratio ("SLR"). Although the SLR was issued as a final rule by the Fed and OCC in July 2013, the agencies re-opened it, which we had suggested as a possibility in our *Regulatory Brief, Heightened Leverage Ratio: US regulators unveil next act for regulating large banks* (July 2013).

1. **The final ESLR disadvantages the largest US banks versus their foreign peers:** Despite numerous comment letters (from banks, industry associations, Congress, and public interest groups), the final ESLR retains the key elements originally proposed in July 2013 that went beyond Basel's leverage ratio. Namely, the ESLR includes a 2% buffer at the bank holding company ("BHC") level for US G-SIBs *and* a 6% SLR requirement for their insured depository institutions ("IDIs") to be considered well-capitalized. The 2% buffer, which increases the SLR ratio for US G-SIBs to 5% from the 3% required of other Advanced Approaches BHCs, will act similarly to the capital conservation buffer under the US's implementation of Basel III capital standards by limiting capital distributions and discretionary bonus payments if the buffer is not met. However, for CCAR stress testing purposes, the SLR's 3% base requirement will serve as the minimum for G-SIBs (as the Fed's staff stated at yesterday's meeting in response to a question by Chair Yellen).
2. **US G-SIBs' Tier 1 capital shortfall has tripled since the Fed's prior estimation:** The NPR increases the stringency of the SLR's denominator, making it similar to Basel's, by calculating written credit derivatives exposure as the *notional* amount instead of the previous calculation of "current exposure" plus "potential future exposure." This change was a primary driver of the Fed's projected industry-wide Tier 1 capital shortfall of $68 billion for meeting the 5% ESLR. A bank's notional exposure, however, may be reduced by purchasing credit protection on the same reference name (if the purchased protection's maturity is at least as long as that of the sold position). It is worth noting that the probable other driver of the increase in the Fed's projected capital shortfall is the different asset mix held by banks at different times – the previously estimated $22 billion shortfall was calculated using mid-2012 data while the $68 billion estimate uses 2013 year-end data.
3. **US banks' position is otherwise generally improved by the NPR:** The SLR moves towards Basel's leverage ratio in several other ways. Most importantly, the NPR makes the SLR somewhat more palatable by applying credit conversion factors to off-balance sheet exposures (except for derivatives and repo-type transactions) in order to conform the SLR to Basel's approach (and to the US Basel III capital rule's standardized approach). These credit conversion factors reduce exposure by up to 90%, a large improvement from the earlier SLR which did not allow for reducing these exposures. Other changes to the SLR that benefit US banks include:

- Allowing for the netting of received cash variation margin against current derivatives exposure under certain conditions
- Allowing for the netting of repo-type and securities lending exposures when the securities are not re-hypothecated (however, now a counterparty credit risk charge applies).
- Basing the denominator's exposure amount on the average *daily* exposure for the reporting quarter (as opposed to the average *month-end* exposure under the previous SLR). From an operational perspective, the daily calculation of exposure is more challenging, but this change will reduce capital requirements for some institutions by limiting the impact of inflows causing ballooning of the balance sheet at month-end.

4. **Banking agencies remain in separate corners:** Yesterday's meetings of the FDIC and Fed continue to demonstrate that the FDIC remains focused on the leverage ratio, instead of the risk-based capital framework, as a primary prudential tool. In fact, the FDIC all but ignored the introduction of credit conversion factors (which are inherently risk-based) into the SLR. On the other hand, the Fed focused on the complementary relationship between the leverage ratio and risk-based capital standards, and the Fed also demonstrated concern over the ESLR's operational impact on US G-SIBs.
5. **The path to achieving compliance:** Firms have already been reducing their leverage exposure through trade compression (i.e., derivatives counterparties eliminating offsetting trades), unwinding of trades, and other related actions to reduce low risk-weight, high leverage-exposure assets. The long runway to the January 1, 2018 compliance date, for both the SLR and ESLR, gives firms time to reach the respective ratios' thresholds through these actions and retained earnings.
6. **Cash left on the table:** Despite discussion that US regulators would remove cash held by firms (including cash held in Fed reserves) from the leverage ratio's denominator, there does not appear to have been sentiment in favor of such a change at Basel. Thus, US regulators did not propose the change. Considering the Fed currently holds about $2.5 trillion in cash reserves (of about $16 trillion in US banking assets), this change would have been significantly beneficial for US banks.
7. **Managing to a new capital regime:** The optimal asset mix remains a moving target as it is still being defined by the combined impact of multiple developing regulations, including continuously rising CCAR expectations, the upcoming Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR), and other expected US proposed rulemakings such as a capital buffer for G-SIBs, bail-in debt, and short-term funding capital penalties. While the US Basel III capital framework and the LCR incentivize holding less risky assets, the SLR encourages holding riskier and higher-yielding assets (by penalizing non-risky, low-yielding holdings with a hefty capital charge).
8. **Limiting industry comment letters on the NPR:** The regulators sought to head-off comments on their re-proposed SLR by anticipating concerns in the preamble of the final ESLR. With respect to cash-like holdings, for instance, in both the ESLR's preamble and the Q&A session during yesterday's meetings, regulators asserted their view that excluding some assets potentially funded by debt would be inconsistent with the role of the leverage ratio as an overall constraint. Additionally, the regulators indicated that any steps taken toward excluding some assets would set off a series of requests to exclude the next asset on the list.
9. **Additional disclosure:** Under the NPR, BHCs would be required to publically disclose more specific elements of their SLR calculation than before and to explain material changes in their SLR calculation from one period to another. These new requirements are broadly consistent with the disclosure requirements imposed by Basel, and take effect in 2015.
10. **The Fed remains confident in its monetary policy:** Although industry comment letters in response to the ESLR suggested that banks would be disincentivized from holding excess cash reserves at the Fed given the high capital cost of doing so under the SLR, the Fed's meeting yesterday made clear that the Fed does not believe its ability to effectuate monetary policy would be impacted. Comment letters also suggested that banks would be similarly disincentivized from holding purchase agreements for treasury and agency securities which would reduce liquidity in the repo market (another conduit for monetary policy); however, the Fed again disagreed with this assertion and expressed its view that there are other profitable reasons for banks to engage in the repo market.

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

David Sapin
Financial Services Regulatory Practice Leader
646 471 8481
david.sapin@us.pwc.com

Armen Meyer
Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com

Contributors: Kevin Clarke, Charles Andrews, and Steve Pearson.

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