The Fed's New Proposals Could Lead To Lower Capital For Some U.S. Banks

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The Federal Reserve (Fed) recently proposed various revisions to how it calculates minimum capital requirements for the country's largest banks. The proposal intends to integrate ongoing capital requirements for banks with assets greater than $50 billion with the Fed's annual stress test, also known as the Comprehensive Capital Analysis and Review (CCAR). This would also apply to intermediate holding companies of foreign banking organizations. The Fed is also attempting to simplify the regulatory capital regime by reducing the number of capital requirements to 14 from 24 in its proposal.

Under the proposal, the Fed would use the new proposed buffers to set certain firm-specific ongoing minimum capital ratios for the largest banks. The Fed would set certain required capital ratios for the a bank based on its annual performance in CCAR. In addition, the Fed proposed changes to the calculation of the Tier 1 leverage ratio and the supplementary leverage ratio (SLR), as well as a slight revision to total loss absorbing capacity (TLAC). Public comments are due over the next 60 days, and a final rule could be in place by next year's CCAR cycle. If executed as proposed, we think the credit effect of the new rules, for the most part, should be neutral for the globally systemically important banks (GSIBs) and negative for most non-GSIBs (i.e., regional banks) due to possible lower capital levels. Overall, to the extent that these modified regulations result in material capital reductions, we could lower ratings.

Overview

- The Fed has proposed various changes to its calculation of the largest banks' minimum capital requirements.
- Risk-based standardized minimum capital requirements will likely rise for some banks.
- Even so, the amount of capital banks with higher risk-based capital minimums could return to shareholders may actually increase if their current capital constraint is leverage based rather than risk based.
- The proposed changes to CCAR, particularly the assumption of no asset growth and only four quarters of dividend payments, could augment capital return for some banks.
- The proposal is a credit negative for most banks because it likely will permit them to reduce their current capital levels further.

Specifically, the new rules would set required capital ratios in large part based on a "stress capital buffer" (SCB), defined as the difference between a bank's starting risk-weighted capital ratio and its minimum capital ratio during the nine quarters of the stress test. A key change associated with the SCB is that it incorporates only four quarters of dividends rather than the current practice of including dividends over nine quarters and assumes no asset growth (see Appendix for a full summary). The SCB would replace the "capital conservation buffer," which is currently 2.5%. The bigger the SCB, the greater the capital requirement for a bank, although the SCB will be subject to a floor of 2.5%. If a countercyclical buffer were to be deployed, a GSIB's total required capital would add that to its SCB and GSIB surcharge.

According to the Fed's calibration, the proposal would reduce the common equity Tier 1 (CET1) capital requirements for banks that exceed $50 billion in assets--i.e., large regional banks that are not GSIBs--by $10 billion to $45 billion in aggregate, though the gap's magnitude depends on which CCAR cycle is used as the reference point. On the contrary, for GSIBs, the proposal would result in an increase in the required level of CET1 of $10 billion to $50 billion in aggregate--again with some variance by year. That said, the Fed noted that no GSIB would need to raise additional capital in order to avoid the proposals' limitations on capital distribution.

From a credit standpoint, we believe the Fed's capital proposal is largely negative as it pertains to regional banks. That's because we believe it permits these banks to reduce their current capital levels below their current CCAR constraints. The proposal will likely generate a higher stressed minimum capital ratio (less of a burndown from starting capital to a minimum level) because it includes an assumption of partial dividend payouts and no asset growth under stress (Note: The current stress test assumes asset growth and continued dividends for all nine quarters of the test). These measures, together with other proposals being considered in Congress, could suggest somewhat greater latitude in terms of capital rules for all but the GSIB banks and some super regional banks for which regulation will not ease according to the Senate bill (see "What The Senate Banking Bill Would Mean For Risk And Ratings In The Banking Industry," published March 27, 2018). That said, whether these will result in lower ratings will hinge on how regional bank managements respond to the new proposals in terms of capital planning and risk appetite.

By contrast, the GSIB story is more complicated. For some, the new set of rules will likely be neutral from a credit standpoint. Our analysis shows that the proposal does not change the minimum risk-based capital levels for four of the eight GSIBs. It does, though, lighten the requirement for the leverage-based capital ratios for all the GSIBs. This in turn could result in additional capital returns to shareholders for some GSIBs, particularly those that are currently bound by leverage constraints, for example, Goldman Sachs, Morgan Stanley, and State Street Corp. (see "How U.S. Banks Returning Their "Excess Capital" Could Affect Ratings," published Feb. 21, 2018). But the higher risk-based constraints should curtail some of the possible capital reduction.

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A Modified Construct For Capital Return Requests

With the advent of CCAR in the post Dodd-Frank era, the process large U.S. banks follow to return capital to shareholders has been to request a pre-specified amount that is based on their performance in CCAR. By pre-specifying the capital distribution amount, banks were more or less bound by their request and effectively pre-capitalized these distributions, at least until the subsequent CCAR cycle. The Fed's latest proposal now incorporates a firm-specific stress capital ratio that factors in ongoing risk-based and leverage ratio minimums, which will be in place throughout the year. Consistent with prior procedure, the Fed requires banks to specify capital actions over the planning horizon. A bank could face limitations in exceeding the amount of capital distributions in its capital plan without prior notification and approval. For the largest and most complex banks only (generally those over $250 billion), the Fed expects to continue using qualitative reviews and reserves the authority to issue potential qualitative objections to their plan. Additionally, as under the current rule, the Fed may require a bank that materially underperforms its projected capital ratios to resubmit its capital plan if such underperformance results from material changes in the bank's risk exposures or operating conditions.

Scenario Analysis Of The Possible New Minimum Capital Requirements On An Individual Bank Basis

To assess the impact of the Fed's proposed changes, we ran a simulation based on the 2017 CCAR results to see how standardized minimum capital ratios could change. We caution that these figures at best approximate what could happen if the proposal goes into effect. That's because the results are expected to change year to year based on the parameters of the Fed's stress test and the change in composition of each bank's balance sheet. In addition, the current disclosure of the Fed stress test makes it difficult to assess how much balance-sheet growth and dividends contributed to minimum capital levels during the nine quarters of stress. As a result, we provided a range of estimated SCBs for some banks by assuming the minimum capital level would occur at some point between the beginning and ending quarters of the stress test.

CET1 standardized risk-based capital analysis

Our scenario analysis suggests the proposal could possibly result in higher risk-based capital ratio minimums than their current minimums for 10 of the 26 banks that participated in last year's test (see table 1). For the GSIBs, we find four of the eight could have higher required CET1 risk-based standardized ratios. Of these four banks, three (Goldman, Morgan, and State Street) would switch to being bound by risk-based capital constraints instead of non-risk-based capital (i.e., leverage-based) ratio constraints, which currently binds them. (Note: The fourth bank, Citigroup, is currently bound by a risk-weighted measure, according to our analysis). We expect non-risk-based ratio constraints to ease in the Fed's proposal, aided by the Fed's assumption that balance sheets will no longer grow under stressed conditions. As a result, the risk-based component becomes more of an obstacle to returning capital than the non-risk-based parameters, though these banks may still be able to return more capital than their current limitations.

Table 1

CET1 Stress Capital Buffer (%)

	Stressed capital buffer*	Proposed standardized CET1 minimum	12/31/17 CET1 under standardized approach (%)^	Standardized CET1 surplus (deficit) over (under) proposed minimum
Morgan Stanley	6.0-7.0	13.5-14.5	16.1	1.6-2.6
Goldman Sachs Group Inc.	4.7-5.4	11.7-12.4	11.9	(0.5)-0.2
CIT Group Inc.	2.5-5.3	7.0-9.8	14.4	4.6-7.4
Zions Bancorp.	2.5-3.5	7.0-8.0	12.1	4.1-5.1
Citizens Financial Group Inc.	2.5-3.3	7.0-7.8	11.2	3.4-4.2

Table 1

CET1 Stress Capital Buffer (%) (cont.)

Citigroup Inc.	**3.0**	10.5	12.4	1.9
State Street Corp.	2.5-3.0	8.5-9.0	11.6	2.6-3.1
Capital One Financial Corp.	2.5-2.9	7.0-7.4	10.2	2.8-3.2
Ally Financial Inc.	2.5-2.8	7.0-7.3	9.5	2.2-2.5
Regions Financial Corp.	2.5-2.7	7.0-7.2	11.0	3.8-4.0
JPMorgan Chase & Co.	**2.5**	10.5	12.1	1.6
Bank of New York Mellon Corp.	2.5	8.5	11.5	3.0
Wells Fargo & Co.	2.5	9.0	12.0	3.0
Bank of America Corp.	**2.5**	9.5	11.7	2.2
Northern Trust Corp.	2.5	7.0	12.4	5.4
PNC Financial Services Group	**2.5**	7.0	9.8	2.8
U.S. Bancorp	**2.5**	7.0	9.1	2.1
American Express Co.	2.5	7.0	8.8	1.8
BB&T Corp.	**2.5**	7.0	10.2	3.2
Comerica Inc.	2.5	7.0	11.7	4.7
Discover Financial Services	2.5	7.0	11.6	4.6
Fifth Third Bancorp	2.5	7.0	10.6	3.6
Huntington Bancshares Inc.	2.5	7.0	10.0	3.0
KeyCorp	2.5	7.0	10.1	3.1
M&T Bank Corp.	2.5	7.0	11.0	4.0
SunTrust Banks Inc.	2.5	7.0	9.6	2.6

Note: *Bold figures display company reported SCB. Otherwise, stressed capital buffer estimated from 2017 DFAST results. ^Fully-phased when available. Showing transitional ratio for CIT Group, Comerica Inc., Fifth Third Bancorp, Huntington Bancshares Inc., KeyCorp, M&T Bank Corp., and Zions Bancorp.

Tier 1 leverage ratio analysis

The Tier 1 leverage ratio will no longer have a prescribed minimum threshold in CCAR. Instead, the Fed proposes to retain the complementarity between risk-based and leverage-based capital measures by proposing a Tier 1 leverage buffer--equating to the difference between a bank's starting Tier 1 leverage ratio and the minimum ratio that it burns down to during the CCAR test. The Fed proposes to add this difference to the current minimum Tier 1 leverage ratio of 4%. For example, if a bank has a starting Tier 1 leverage ratio of 7%, and its minimum reached during the stress test is 3%, the Fed would subtract three percentage points from 7% to get 4%. It would add that to the 4% minimum, resulting in a new required ongoing Tier 1 leverage ratio of 8%.

Our scenario analysis suggests that the introduction of the leverage buffer will not meaningfully affect banks, at least at first. Based on our analysis, all of the banks' current Tier 1 leverage ratios are already higher than the Tier 1 leverage ratio that the proposed capital rules would impose (see table 2).

Table 2

Tier 1 Leverage Stress Capital Buffer (%)

	Tier 1 Leverage stress capital buffer*	Proposed minimum requirement	Tier 1 leverage: 12/31/17^	Surplus over proposed minimum
Goldman Sachs Group Inc.	2.6-3.3	6.6-7.3	8.4	1.1-1.8
CIT Group Inc.	1.8-3.1	5.8-7.1	13.8	6.7-8
Citizens Financial Group Inc.	2.2-3.0	6.2-7.0	10.0	3.0-3.8
Zions Bancorp.	1.9-2.9	5.9-6.9	10.5	3.6-4.6
KeyCorp	1.8-2.7	5.8-6.7	9.7	3.0-3.9
Morgan Stanley	1.4-2.5	5.4-6.5	8.2	1.7-2.8
Regions Financial Corp.	1.6-2.5	5.6-6.5	10.0	3.5-4.4
Ally Financial Inc.	1.6-2.5	5.6-6.5	9.5	3.1-3.9
Capital One Financial Corp.	1.5-2.4	5.5-6.4	9.9	3.5-4.4
M&T Bank Corp.	1.3-2.2	5.3-6.2	10.3	4.1-5.0
Citigroup Inc.	1.4-2.2	5.4-6.2	8.7	2.5-3.3
SunTrust Banks Inc.	1.3-2.0	5.3-6.0	9.8	3.8-4.5
Fifth Third Bancorp	1.1-2.0	5.1-6.0	10.0	4.0-4.9
Discover Financial Services	0.9-1.9	4.9-5.9	10.8	4.9-5.9
Bank of America Corp.	1.1-1.9	5.1-5.9	8.6	2.7-3.4
Huntington Bancshares Inc.	1.1-1.8	5.1-5.8	9.1	3.3-4.0
BB&T Corp.	0.8-1.7	4.8-5.7	9.9	4.1-5.1
JPMorgan Chase & Co.	0.9-1.7	4.9-5.7	8.3	2.6-3.4
PNC Financial Services Group	0.7-1.5	4.7-5.5	9.6	4.0-4.9
Comerica Inc.	0.7-1.5	4.7-5.5	10.9	5.4-6.2
State Street Corp.	0.7-1.4	4.7-5.4	7.2	1.8-2.5
Wells Fargo & Co.	0.4-1.3	4.4-5.3	9.3	4.0-4.9
U.S. Bancorp	0.5-1.3	4.5-5.3	8.9	3.6-4.4
American Express Co.	0.0-0.4	4.0-4.4	8.4	4.0-4.4
Northern Trust Corp.	0.0-0.3	4.0-4.3	7.8	3.5-3.8

Table 2

Tier 1 Leverage Stress Capital Buffer (%) (cont.)

	Tier 1 Leverage stress capital buffer*	Proposed minimum requirement	Tier 1 leverage: 12/31/17^	Surplus over proposed minimum
Bank of New York Mellon Corp.	0.0	4.0	6.4	2.4

*Estimated from 2017 DFAST results. ^Fully-phased when available. Showing transitional ratio for BB&T Corp., Capital One Financial Corp., Discover Financial Services, Fifth Third Bancorp, Huntington Bancshares Inc., M&T Bank Corp., Northern Trust Corp., Regions Financial Corp., SunTrust Banks Inc., U.S. Bancorp, and Zions Bancorp.

SLR analysis

Banks that meet the capital rules' criteria for being considered an "advanced-approaches organization" (generally those with at least $250 billion in total consolidated assets or at least $10 billion in total on-balance-sheet foreign exposure) must also meet an SLR requirement, which considers off-balance-sheet exposures. The Fed's proposal is to change the minimum SLR requirement for the consolidated entity from 5% to 3% plus half the entity's GSIB buffer, and for the bank-level entity from 6% to 3% plus half the entity's GSIB buffer.

However, the proposal does not consider easing the method of calculating the denominator of the SLR by removing some riskless assets, as has been proposed in the Senate bill for trust banks. Notably, there will be no SLR stress buffer, and the SLR will no longer be part of CCAR. This aspect should benefit Goldman Sachs, which our scenario analysis shows is currently bound by the SLR in CCAR. Nevertheless, with an SCB that we estimate is above the 2.5% floor, reflecting its higher risk-based capital constraint, we believe the new proposal will likely offset some or all of this positive development.

We analyzed the banks that currently have to disclose their SLR ratios to determine the new required levels of SLR (see table 3).

Table 3

Supplementary Leverage Ratio Proposal (%)

	Current SLR minimum at NOHC	SLR minimum at NOHC under proposal	SLR 12/31/17**	Surplus
Wells Fargo & Co.	5	4.00	8.0	4.0
Northern Trust Corp.	3	3.00	6.8	3.8
Bank of America Corp.	5	4.25	6.9	2.7
State Street Corp.	5	3.75	6.4	2.6
Citigroup Inc.	5	4.50	6.7	2.2
Bank of New York Mellon Corp.	5	3.75	5.9	2.2
Morgan Stanley	5	4.50	6.4	1.9
JPMorgan Chase & Co.	5	4.75	6.5	1.8
Goldman Sachs Group Inc.	5	4.25	5.8	1.6

Note: Northern Trust Corp. not affected by proposal, but added for comparison purposes. **Fully-phased, with the exception of Northern Trust.

TLAC analysis

The proposal also aims to integrate the changes to SLR into the current TLAC calculation for the GSIBs. Specifically, the proposal would modify the TLAC rule by replacing the GSIB 2% leverage buffer with a buffer set at 50% of a bank's GSIB surcharge. It would also revise the leverage component of the long-term debt part of the TLAC rule (currently a static 4.5%) to equal 2.5% of total leverage plus 50% of the GSIB surcharge. (Note: The proposal doesn't make clear whether the 2.5% buffer in the risk-based TLAC requirements will change to incorporate the SCB). Given that all GSIB surcharges are currently below 4%, the proposal could lower TLAC requirements of the leverage-based component of the calculation and could reduce the amount of debt some of the GSIBs need to issue.

Possible Ramifications Of The Fed's Proposal

The introduction of an SCB will make capital management more dynamic, albeit slightly tougher for GSIB banks because their buffers will change during the course of the economic cycle. A bank's annual minimum capital ratio will now hinge on the composition of its balance sheet--which changes year to year--and the design of the Fed's stress test--which also changes annually. As a result, banks may opt to increase the buffer they keep over their minimum required capital levels (typically 50 basis points now) to ensure they hold enough capital for a year in which their minimum ratios may rise significantly.

Capital management will become tougher for banks because their buffers will change on a yearly basis.

Banks' loan loss rates and income levels, as determined by the Fed's CCAR models, will likely continue to hold importance for bank management teams. In past CCAR results, banks' assessments of their loss rates have varied widely from the Fed's. If higher loss rates or lower-than-expected income derived by the Fed's models were to result in a higher SCB charge, banks may push harder for the Fed to disclose the rationale for the loan loss rate differential as the higher SCB will now be reflected throughout the year, depicted by a higher minimum CET1 and Tier 1 leverage ratio minimum. Notably, banks can request reconsideration of the SCB calculated by the Fed within 15 days from receipt of their SCB.

The proposal applies greater tailoring of capital requirements to those banks that are most likely to increase risk-oriented activities versus those banks that are growing lower-risk activities. The competitive advantage of banks with a lower required ongoing capital ratio could grow, and as result, these banks could take market share from peers with a higher SCB. On the positive side (from a credit perspective), banks with higher SCBs may attempt to further derisk their balance sheets to narrow their competitive disadvantage.

The proposal didn't lower or propose any modification to its calibration of the U.S. GSIB surcharge, but we can't rule this out as part of a subsequent proposal or the final rule.

Finally, it's possible that while the proposal's goal is to be more forward-looking by varying the buffers more during the course of the economic cycle, the tests could add to greater pro-cyclicality.

The proposals still aren't final--and neither are the bills in Congress--so we will monitor what they could mean for capital retention and distribution and the extent to which they may weaken bank ratings.

Appendix

Among the key facets of the Fed's proposed changes to large banks' capital requirements, are that they:

- Establish a stress capital buffer that would be equal to the decrease from the starting point to the minimum of a bank's CET1 capital ratio in CCAR under the severely adverse scenario
- Require a bank to pay out only four quarters of planned common stock dividend requirements
- Modify the current assumption in CCAR that a bank's balance sheet continues to grow under stress and instead assume it stays flat
- Replace the 2.5% standardized risk-weighted-assets component of a bank's capital conservation buffer so that this buffer is floored at 2.5%
- Retains the current "advanced-approaches" risk-weighted-assets capital calculation. The SCB is only incorporated in deriving standardized risk–weighted capital ratios.
- Remove the 30% dividend payout ratio threshold for heightened supervisory scrutiny
- Introduce a stress leverage buffer requirement, which is the difference between a bank's starting Tier 1 leverage ratio and its minimum projected under CCAR, plus the firm's planned common stock dividends for each of the fourth through seventh quarters of the planning horizon under CCAR. The stress leverage buffer would be added to the minimum ongoing Tier 1 leverage requirement (4%). The Tier 1 leverage minimum of 4% would be removed from CCAR.
- Replace the current 2% leverage buffer as it applies to the SLR with a measurement based on 50% of each GSIB's risk-based-capital surcharge
- Replace the current 5% and 6% threshold for the SLR at the holding company and bank level, respectively, with a threshold of 3% plus 50% of the GSIB surcharge
- Modify the TLAC rule by replacing the GSIB 2% leverage buffer with a buffer set at 50% of a bank's GSIB surcharge and revise the leverage component of the long-term debt component of TLAC rule (currently a static 4.5%) to equal 2.5% of total leverage exposure plus 50% of the GSIB surcharge

Related Research

- What The Senate Banking Bill Would Mean For Risk And Ratings In The Banking Industry, March 27 2018
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