MAYER | BROWN

Legal Update

August 10, 2023

A Road Not Taken: Where the US Capital Proposal Differs From Basel

On July 27, 2023, US federal banking regulators issued proposals to (i) significantly revise the risk-based regulatory capital requirements for certain midsize and larger US banking organizations (the "Capital Proposal") and (ii) change the method for calculating the capital surcharge for global systemically important banking organizations ("G-SIBs") (the "G-SIB Surcharge Proposal").[1] As we discuss in our earlier, comprehensive Legal Update, these proposals are of critical importance because the amount of capital a bank must maintain with respect to any particular loan, investment or activity is typically a significant—if not *the most* significant—factor in determining whether the relationship is profitable or even feasible.

One concern with the Capital Proposal that has received significant attention in recent weeks is the extent to which, and the areas in which, US regulators deviated from the international standards maintained by the Basel Committee on Banking Supervision ("Basel Committee"). In this Legal Update, we explore a number of these deviations and some of their implications for US banking organizations and the US financial markets.

The Proposals

US regulatory capital requirements are broadly derived from regulatory capital standards maintained by the Basel Committee.[2] The international standards were revised in 2017 by the Basel Committee, but, as with all US regulations, the changes are not binding on US banking organizations unless and until US regulators formally adopt them through the notice and comment rulemaking process.

The Capital Proposal would nominally implement the Basel Committee's changes. However, it proposes numerous deviations from the Basel Committee's standards, most of which would impose more stringent obligations on US banking organizations than their international peers.[3] This is often referred to as "gold-plating" the standards. US banking organizations experienced similar, comparatively more rigorous standards than peers in other jurisdictions in 2013 when the United States adopted the Basel III standards.

In this instance, however, the Basel Committee indicated that its changes would be capital neutral, a promise that had been echoed by US regulators.[4] In fact, the Capital Proposal would increase capital requirements by an estimated 19% for the largest US banking organizations, by an estimated 6% for the next largest US banking organizations, and by an estimated 14% for US banking organizations that are controlled by foreign banking organizations.

SCOPE

The Basel Committee's capital standards are intended to apply to "internationally active banks."[5] The Basel Committee has not defined the attributes of an internationally active bank, although a material level of international activity would seem to be a prerequisite.[6]

US regulators historically have applied most of the Basel Committee's capital standards to all US banking organizations, except for certain smaller banking organizations or where a statutory deviation is prescribed (i.e., the community bank leverage ratio), regardless of international activity or risk profile. Further, the United States applied the more sophisticated portions of the international standards (known as the "Advanced Approaches") to a tailored set of US banking organizations (i.e., top-tier Category I and II banking organizations). The Capital Proposal would apply the Basel Committee's latest revisions to all US banking organizations with $100 billion or more in total consolidated assets ("larger US banking organizations") regardless of their international activity or other attributes. In addition, the Capital Proposal would continue to apply the *older* Basel Committee standards for credit risk to all US banking organizations with $100 billion or more in total consolidated assets.

The Basel Committee has recognized that even among internationally active banks, there are meaningful distinctions in the risks a banking organization poses to financial stability. Therefore, it has prescribed frameworks for identifying and further regulating banking organizations that are of global systemic importance (i.e., G-SIBs) or domestic systemic importance ("D-SIBs").[7] US regulators adopted aspects of the Basel Committee's framework for D-SIBs in 2019 as part of a tailoring initiative for larger US banking organizations, which also implemented the Regulatory Reform, Economic Growth and Consumer Protection Act of 2017. The Capital Proposal would effectively undo many of the capital-related aspects of the tailoring initiative by treating all non-G-SIB banking organizations with more than $100 billion in total assets as D-SIBs and prescribing uniform capital requirements for them.

CREDIT RISK CAPITAL REQUIREMENTS—EXPANDED STANDARDIZED APPROACH

Basel Committee Standard	US Capital Proposal
New sets of risk weightings for most credit exposures.[8] No continued use of old risk weights.	**"Dual-stack"** approach in which larger US banking organizations must use existing and proposed risk-weight sets.

Basel Committee Standard	US Capital Proposal
New, more granular risk weights for **residential real estate exposures**, with more detailed application criteria.[9] Risk weights range from 20% to 105%.	Same as the Basel Committee but with risk weights set higher than those set by the Basel Committee.[10] Risk weights range from 40% to 125%.
Option for banks to use the **"loan splitting"** approach to determining risk weights for real estate.[11]	No adoption of the loan splitting approach.
Possibility of recognizing mitigation effect of **private mortgage insurance**.[12]	No recognition of mitigation effect of private mortgage insurance.
New, more granular risk weights for **retail exposures**, with more detailed application criteria.[13] Risk weights range from 45% to 100%.	Same as the Basel Committee but with risk weights set higher than those set by the Basel Committee. Risk weights range from 55% to 110%.
Standardized credit risk assessment approach for **exposures to a depository institution, a foreign bank or a credit union**.[14]	Same approach as the Basel Committee but with additional criteria for exposures to qualify for a preferential risk weight.
More favorable risk weighting for credit exposures to **small- and medium-sized businesses, securities firms and other nonbank financial institutions**; for credit exposures to covered bonds and highly capitalized banking organizations; or for short-term exposures to banking organizations.	No adoption of specified risk weights.[15]
No analogous treatment.	Permits **sovereign and public sector entity[16] exposures of OECD members with no Country Risk Classification** to qualify for a 0% or 20%/50% risk weight, respectively.
No analogous methodology.	New exposure methodology to calculate capital requirements for **off-balance sheet commitments without pre-set limits**.
No analogous treatment.[17]	Preferential risk weights for equity exposures to **public sector entities, Federal Home Loan Banks, and Farmer Mac**.

Basel Committee Standard	US Capital Proposal
No analogous treatment.	Minimum 20% risk-weight floor for the adjusted carrying value of any **equity exposure to an investment fund** under the proposed look-through approaches.
New **securitization standardized approach** for exposures to securitizations.	Same approach but with certain deviations for a prohibition against synthetic excess spread in a synthetic securitization and a requirement for a market-standard minimum payment threshold for a credit risk mitigant.
Option for banking organizations to use an alternative approach for calculating capital requirements for **simple, transparent and comparable securitizations**.[18]	No adoption of an alternative approach.
Explicitly recognizes that cash-funded credit-linked notes issued by a banking organization against exposures in the banking book that fulfill the criteria for credit derivatives satisfy the definition of "cash on deposit."[19]	No clarification regarding cash on deposit.

The Capital Proposal would generally adopt the Basel Committee's securitization standardized approach ("SEC-SA") for calculating the risk weight assigned to securitization exposures. Notably, while the Capital Proposal would follow the Basel Committee's suggested increase in the supervisory parameter, *p*, as described below, the proposal of the Council of the European Union as reflected in Capital Requirements Regulation III would not.[20]

The underlying model for SEC-SA is substantially similar to the underlying model for the simplified securitization standardized approach ("SSFA") under existing US requirements. The most notable change to the risk-weight calculation under the SEC-SA formula is the increase in the supervisory parameter, *p*, from 0.5 to 1.0 for a securitization exposure that is not a resecuritization exposure and from 1.0 to 1.5 for a securitization exposure that is a resecuritization exposure.[21] Under the SEC-SA formula, the increase in the supervisory parameter, *p*, generally leads to significantly higher risk weights for securitization exposures than under the SSFA formula.

Additionally, the Capital Proposal would generally adopt the Basel Committee's (i) minimum haircut floors for securities financing transactions and (ii) requirement that low-risk-weight corporate exposures involve a company that has or is controlled by a company that has a publicly traded security outstanding, both of which may be premature.[22] As noted by FDIC Director Jonathan McKernan, the European Union and United Kingdom have taken different approaches with respect to imposing such floors and trading requirements.[23]

CREDIT RISK CAPITAL REQUIREMENTS—ADVANCED APPROACHES

Basel Committee Standard	US Capital Proposal
Banking organizations may use a standardized approach, an internal ratings-based approach or an external ratings-based approach to calculate credit risk capital requirements.[24]	Larger US banking organizations may use only a standardized approach.

CREDIT RISK CAPITAL REQUIREMENTS—LEVERAGE RATIO FRAMEWORK

Basel Committee Standard	US Capital Proposal
Leverage ratio requirement based on a banking organization's aggregate on-balance sheet assets and off-balance sheet exposures.[25]	Separate leverage ratio requirements based on (i) on-balance sheet assets and (ii) aggregate on-balance sheet assets and off-balance sheet exposures.

MARKET RISK CAPITAL REQUIREMENTS

Basel Committee Standard	US Capital Proposal
Apply market risk capital requirements to all internationally active banks.[26]	Apply market risk capital requirements to all larger US banking organizations, as well as to any smaller banking organizations that have aggregate trading assets and trading liabilities equal to 10% or more of total assets or $5 billion or more.
Option to use internally modeled approach for calculating the default risk component of the market risk capital requirements.[27]	Only standardized approach to calculate default risk component.

OPERATIONAL RISK CAPITAL REQUIREMENTS

Basel Committee Standard	US Capital Proposal
Internal loss multiplier may be set to 1 or based on a banking organization's average historical losses and the absolute magnitude of its operational risks.[28]	Internal loss multiplier is based on a banking organization's average historical losses and the absolute magnitude of its operational risks, **with an absolute minimum of 1**.

Basel Committee Standard	US Capital Proposal
Excludes from the calculation of fees/services component any income and expenses from insurance or reinsurance activities, as well as premiums paid and reimbursements received from insurance or reinsurance policies.[29]	Includes in fees/services component all underwriting income from insurance and reinsurance activities and income from other insurance activities.

CREDIT VALUATION ADJUSTMENT RISK CAPITAL REQUIREMENTS

Basel Committee Standard	US Capital Proposal
Imposes credit valuation adjustment risk capital requirements for uncleared derivatives and securities financing transactions that are fair-valued by a banking organization for accounting purposes if a regulator determines that potential losses from securities financing transactions are material.[30]	Imposes credit valuation adjustment risk capital requirements only for uncleared derivatives.
Option for banking organizations to use a reduced version of the basic approach for credit valuation adjustment risk that does not recognize hedging.[31]	No option for banking organizations to use a reduced version of the basic approach for credit valuation adjustment risk.

Many derivatives market participants already have commented on the potential effects of the Capital Proposal for US banking organizations and for derivatives end-users. Commercial end-users benefit from certain limited exemptions from clearing and other requirements.[32] For a similar policy purpose, US banking regulators, through the Standardized Approach for Counterparty Credit Risk rule ("SA-CCR"), effectively have required lower multipliers if a banking organization's counterparty to a derivatives trade is a commercial end-user, which has served to lessen the impact of the higher capital requirement that resulted from the application of the SA-CCR. However, as part of the Capital Proposal, the SA-CCR benefits for end-users would be negated. In the United States, Category III and Category IV banking organizations, which are not now subject to the Advanced Approaches, would be required to calculate capital requirements for credit valuation adjustment risk.

G-SIB SURCHARGE PROPOSAL[33]

Basel Committee Standard	US G-SIB Surcharge Proposal
Generally uses year-end financial information to calculate risk indicator values.[34]	Requires larger US G-SIBs to use **average data** from over the fiscal year, instead of point-in-time data, to calculate indicators.
Assigns G-SIBs an additional risk-based capital requirement based on their indicator scores in 50-basis point increments.[35]	Measures US G-SIB surcharges in 10-basis point increments instead of the current 50-basis point increments.

TRANSITION PERIOD

The Basel Committee's standards generally contemplate a five-year transition period for credit and operational risk-related requirements and the overall output floor, with a one-year phase-in for market risk-related requirements.[36] Further, the changes to the requirements were subject to a multi-year period between their announcement and the effective date by which countries were expected to have implemented them. The Capital Proposal would provide a three-year phase-in for the changes to the credit, market, operational, and credit valuation adjustment risk capital requirements. In the first year, US banking organizations would be required to recognize 80% of the changed amount of risk-weighted assets, stepping up to 85% in year two, 90% in year three, and 100% thereafter.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Matthew Bisanz
+1 202 263 3434
mbisanz@mayerbrown.com

Jeffrey P. Taft
+1 202 263 3293
jtaft@mayerbrown.com

Andrew Olmem
+1 202 263 3006
aolmem@mayerbrown.com

Anna T. Pinedo
+1 212 506 2275
apinedo@mayerbrown.com

Jerry R. Marlatt
+1 212 506 2539
jmarlatt@mayerbrown.com

Stuart M. Litwin
+1 312 701 7373
slitwin@mayerbrown.com

Christopher B. Horn
+1 212 506 2706
cbhorn@mayerbrown.com

Brian L. Kuhl
+1 312 701 8765
bkuhl@mayerbrown.com

The Free Writings & Perspectives, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up-to-the-minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or "late stage" private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities-related topics that pique our and our readers' interest. Our blog is available at: www.freewritings.law.

Endnotes

1 FDIC, *Board Meeting* (July 27, 2023), https://www.fdic.gov/news/board-matters/2023/board-meeting-072723-open.html; Federal Reserve, *Board Meeting* (July 27, 2023), https://www.federalreserve.gov/aboutthefed/boardmeetings/20230727open.htm. The US federal banking regulators consist of the Board of Governors of the Federal Reserve System ("Federal Reserve"), Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation ("FDIC").

2 Basel Committee, Basel Framework (Aug. 8, 2023), https://www.bis.org/basel_framework/index.htm.

3 Certain immaterial deviations from the Basel Committee's standards have existed since the US requirements were revised in 2013. *See* Basel Committee, *Regulatory Consistency Assessment on the United States* (Dec. 5, 2014). This Legal Update does not catalog these types of immaterial deviations.

4 *See* Basel Committee, *Reflections of a Basel Committee Chairman* (Nov. 30, 2016); Neil Roland, *US Fed aims to adopt last Basel III part by January 2023 with 'capital neutral' calibrations across system*, MLex (June 3, 2021).

5 Basel Committee, SCO 10.1.

6 *E.g.,* Basel Committee, *Preliminary Regulatory Consistency Assessment on the United States* 8 (Oct. 1, 2012) ("the term 'internationally active' is not specifically defined in the Basel text").

7 Basel Committee, SCO 40, SCO 50.

8 *See* Basel Committee, *Finalising post-crisis reforms* (Dec. 7, 2017).

9 Basel Committee, CRE 20.69-20.91. Application criteria include dynamic loan-to-value ("LTV") ratios, reliance on cash flow from the property, and the creditworthiness of the underlying borrower.

10 The Capital Proposal would continue divergent treatment of statutory multifamily mortgages, pre-sold construction loans, and high-volatility commercial real estate exposures, each of which is required by US law.

11 Basel Committee, CRE 20.83, 20.86.

12 Basel Committee, CRE 20.76.

13 Basel Committee, CRE 20.63-20.68.

14 Basel Committee, CRE 20.9, 20.11-20.12.

15 The Capital Proposal would allow some exposures to small- and medium-sized businesses to have a more favorable risk weight if the business exposure qualifies for retail treatment. The Capital Proposal would include a risk-weight approach for covered bonds in the trading book but not those in the banking book.

16 A public sector entity is a state, local authority, or other governmental subdivision below the sovereign level.

17 *See* Basel Committee, CRE 20.53-20.62.

18 Basel Committee, CRE 40.66.

19 Basel Committee, CRE 22.34(a).

20 Celeste Tamers, *Partial relief for synthetic securitisation in final EU rules*, Risk.net (July 5, 2023).

21 Parameter *p* is a supervisory adjustment factor that imposes a surcharge on securitizations, which arguably is designed to account for certain risks embedded in other aspects of the securitization framework. Even before the proposed increase, the

supervisory parameter has been the subject of criticism that it is somewhat arbitrary and does not accurately reflect underlying risks. *See, e.g.,* Anna Brunetti, *EBA proposes cutting capital charges on qualifying ABS*, Reuters (June 26, 2015) ("The p factor is still a random number … [and] fails to reflect the real risks").

[22] *See* Basel Committee, CRE 22.46, 56.

[23] FDIC, *Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework* (July 27, 2023).

[24] *See* Basel Committee, CRE 21, CRE 30.

[25] Basel Committee, LEV 20.5.

[26] Basel Committee, MAR 11.8.

[27] Basel Committee, MAR 33.18-33.39.

[28] Basel Committee, OPE 25.8-25.11. Setting the internal loss multiplier to 1 has been proposed as the implementation option in the European Union and United Kingdom.

[29] Basel Committee, OPE 10.3. It further states that when a banking organization acts as an insurance intermediary and, therefore, is not the insurance provider (i.e., the risk taker), the related income and expenses may be included in the calculation.

[30] Basel Committee, MAR 50.5.

[31] Basel Committee, MAR 50.13.

[32] *E.g.,* 7 U.S.C. 2(h)(7)-(8).

[33] The US G-SIB Surcharge Proposal addresses the methods for determining and calculating the capital surcharge for US G-SIBs. It is different from the Capital Proposal and is not connected to the Basel Committee's 2017 revisions.

[34] Basel Committee, *2022 G-SIB Assessment Instructions* § 2.10 (Jan. 2023).

[35] Basel Committee, RBC 40.4.

[36] Basel Committee, CRE 90.1, OPE 25.10, RBC 90.1, MAR 90.1.

Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world's three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our "one-firm" culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience.

Please visit mayerbrown.com for comprehensive contact information for all our offices.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England & Wales), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) and non-legal service providers, which provide consultancy services (collectively, the "Mayer Brown Practices"). The Mayer Brown Practices are established in various jurisdictions and may be a legal person or a partnership. PK Wong & Nair LLC ("PKWN") is the constituent Singapore law practice of our licensed joint law venture in Singapore, Mayer Brown PK Wong & Nair Pte. Ltd. Details of the individual Mayer Brown Practices and PKWN can be found in the Legal Notices section of our website.

"Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2023 Mayer Brown. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.