U.S. regulatory capital: Basel III supplementary leverage ratio final rule

Key highlights for advanced approaches banks

October 2014

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SLR denominator components highlights:

- On-balance sheet exposures
- Derivatives exposures
- Repo-style exposures
- Other off-balance sheet exposures

[1] On September 3, 2014, the Federal Reserve (Fed), Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) released Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio. The Fed, OCC and FDIC (collectively "U.S. regulators") adopted the SLR as a final rule.

U.S. Basel III SLR rule is finalized – key highlights

Relief provided on calculation frequency of off-balance sheet components

- **Calculation frequency for off-balance sheet components provides operational relief for banks**– month-end averages to be used instead of daily averages
- **The final rule is generally consistent with the notice of proposed rulemaking (NPR)**; however, further explains the total leverage exposure calculation for certain components of derivatives and repo-style transactions- including treatment of agency transactions with affiliates, cash variation margins, forward agreements for repo-style transactions, etc.
- **Still some interpretation issues remain** regarding derivatives and repo-style transactions, as well as calculation frequency/timing, and are being discussed and raised through industry forums
- **Reporting and effective timelines remain unchanged** for advanced approaches institutions[2]
  - Compliance with minimum ratios and buffers remains Q1, 2018 (same for foreign banking organizations (FBOs))
  - Reporting of SLR to U.S. regulators in FR Y-14Q/A continues and for Q3, 2014 using new schedule (Q1, 2017 for FBOs)
  - For non-FBO advanced approaches institutions SLR reporting starts Q1, 2015 regardless of parallel run status. Public disclosures also require explanation of differences from total consolidated accounting assets

[2] This SLR rule will apply to all Basel III advanced approach banks (i.e. ≥ $250 billion in total assets or ≥ $10 billion in foreign exposure). While FBOs that need to form an intermediate holding company(IHC) (i.e. with U.S. non-branch assets of ≥ $50 billion) are able to opt out from advanced approaches capital ratio calculation, as per the enhanced prudential standards rules issued in February 2014 and further clarified in FAQs, they will still be subject to all other requirements applicable to advanced approach banks, including SLR requirements, if they exceed the relevant size thresholds.

Observations and impacts from the final rule

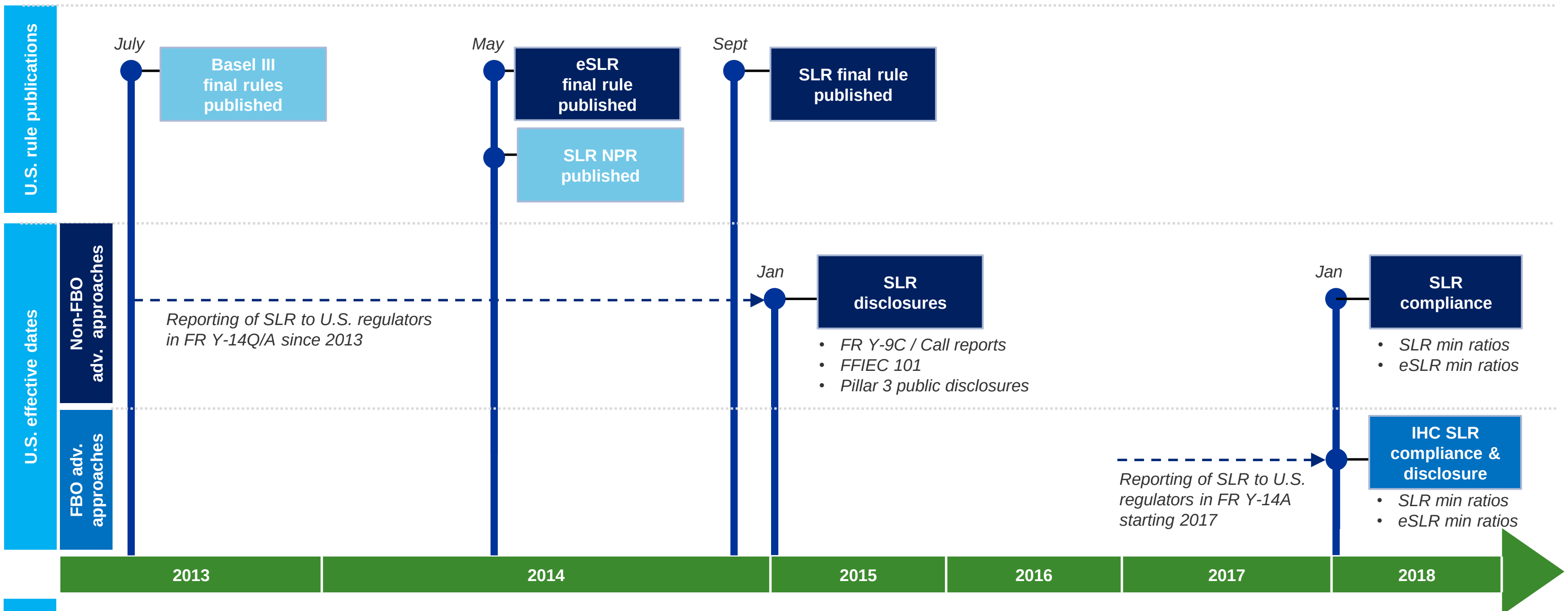
SLR will be a relevant backstop for advanced approaches banking institutions

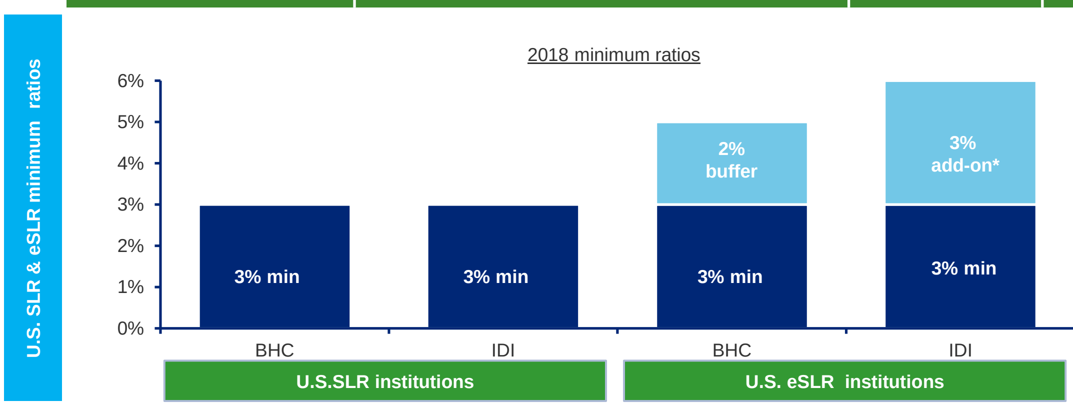
- U.S. SLR is generally aligned to the Basel Committee on Banking Supervision (BCBS) ratio, however the U.S. G-SIBs[3] are subject to higher minimum ratios compared to their foreign peers; ensuring that the SLR remains a relevant backstop for these firms
- Compared to risk-based capital measures, SLR creates binding constrains on certain types of exposures for example low-risk assets, repo-style transactions, etc.
- Impacts may be more pronounced for FBO advanced approaches institutions that have large broker-dealer operations
- Existing U.S. leverage ratio is still applicable but will be generally less binding than the SLR
- U.S. compliance dates are aligned for FBO and non-FBO advanced approaches institutions but cross-jurisdictional rule nuances cause further complexity to manage

[3] Eight U.S. bank holding companies (BHCs) identified by the Financial Stability Board as global systemically important banks (U.S. G-SIBs) as well as their U.S. insured depository institutions (IDIs) subsidiaries are subject to enhanced SLR standards (eSLR). eSLR requires these BHCs to maintain a minimum 3% ratio + 2% buffer and requires their IDIs to maintain a 6% ratio to be considered well-capitalized.

Implementation and reporting timelines

SLR and eSLR implementation timelines remain unchanged





** For IDIs to be considered 'well-capitalized'*

Applicability

U.S. SLR institutions are defined as:

- Banking organizations with ≥ $250 billion in total consolidated assets or ≥ $10 billion of on-balance sheet foreign exposures (i.e. U.S. Basel III advanced approaches BHCs and IDIs)
- Including FBOs with IHCs that meet advanced approaches requirements

U.S. eSLR institutions are defined as:

- G-SIB BHCs with > $700 billion in consolidated total assets or > $10 trillion in assets under custody (**eSLR BHC**)
- IDI subsidiary of these eSLR BHCs (**eSLR IDI**)

Ratio calculation overview

The final rule calculation is largely consistent with the NPR

$$\textit{Supplementary leverage ratio} = \frac{\textbf{Tier 1 capital}}{\textbf{Total leverage exposure}}$$

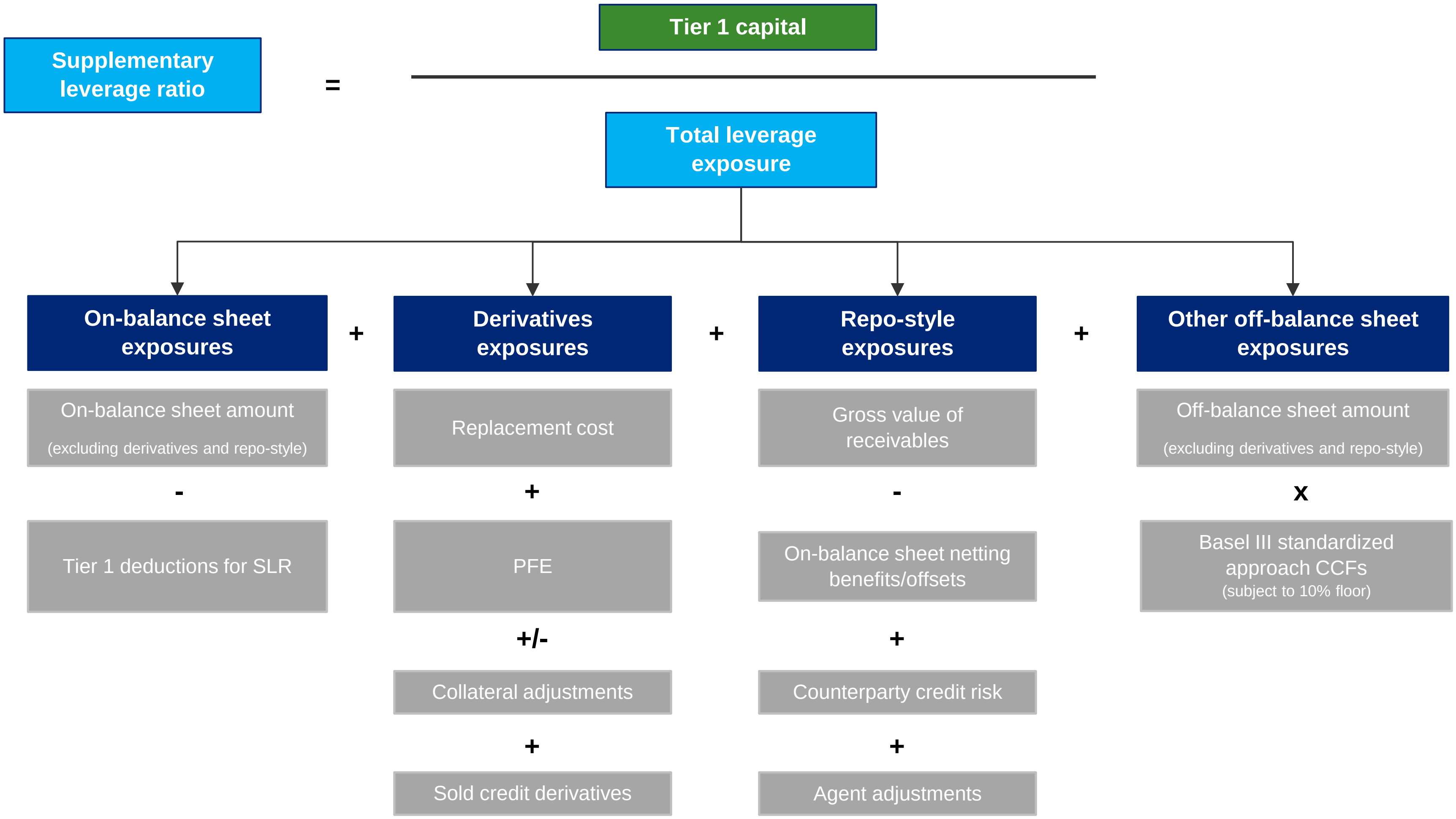
Main components of total leverage exposure:

On-balance sheet exposures (excluding derivatives and repo-style)	• The balance sheet carrying value of on-balance sheet assets • Amounts deducted from tier 1 capital are subtracted
Derivatives exposures[4]	• Replacement cost for derivative exposures • Potential future exposure (PFE) amounts for each derivative contract to which the bank is counterparty • Collateral adjustments and additional deductions • Effective notional amount of sold credit derivatives
Repo-style exposures[4]	• Gross value of receivables of repo-style transactions • Certain on-balance sheet netting benefits or offsets • Counterparty credit risk for repo-style transactions • Exposure for repo-style transactions where bank is acting as an agent
Other off-balance sheet exposures (excluding derivatives and repo-style)	• The notional amount of other off-balance sheet exposures multiplied by the credit conversion factors (CCFs) under the standardized approach • Minimum 10% CCF (i.e., for unconditionally cancellable commitments)

[4] includes transactions with central counterparties (CCP)

Total leverage exposure breakdown

A high-level representation of the ratio denominator



Changes in calculation frequency

On-balance sheet frequency remains the same, modifications to off-balance sheet and numerator calculation frequency

<u>**Total leverage exposure**</u> is calculated as the mean of **on-balance sheet assets** calculated as of each day of the reporting quarter, plus the mean of the **off-balance sheet assets** calculated as of the last day of each of the most recent three months minus applicable **deductions** defined in the Basel III capital rule

<table>
<tr><th>SLR component</th><th>SLR NPR</th><th>SLR final rule</th></tr>
<tr><td>Tier 1 capital</td><td>• As of the last day of the reporting quarter</td><td>• As of the last day of the reporting quarter[5]</td></tr>
<tr><td>Tier 1 capital deductions for SLR</td><td>• As of the last day of the previous reporting quarter</td><td>• As of the last day of the reporting quarter[5]</td></tr>
<tr><td>On-balance sheet assets
(excluding derivatives and repo-style)</td><td rowspan="4">• Daily average for the reporting quarter</td><td>• Daily average for the reporting quarter</td></tr>
<tr><td>Derivatives</td><td>• Daily average for on-balance sheet components for the reporting quarter[5]
• Month-end average for off-balance sheet components for the reporting quarter</td></tr>
<tr><td>Repo-Style</td><td>• Daily average for on-balance sheet components for the reporting quarter[5]
• Month-end average for off-balance sheet components for the reporting quarter</td></tr>
<tr><td>Other off-balance sheet
(excluding derivatives and repo-style)</td><td>• Month-end average for the reporting quarter</td></tr>
</table>

[5] The calculation frequency of these components is not clear from the SLR final rule and is being discussed and raised through industry forums. Clarification may occur with further confirmations from U.S. regulators and future publication of updated reporting forms/instructions.

What's next for SLR

The final rule represents a milestone, but additional changes expected

- With timelines finalized banks will need to continue to make SLR compliance a high-priority:
  - For banks which have already made substantial implementation progress based on NPR; incremental changes are needed for regulatory reporting readiness (including reconciliation challenges across reports)

- SLR interpretation issues need to be resolved and future SLR changes expected, including:
  - Off-balance sheet calculation frequency to be monitored; U.S. regulators will revisit the monthly calculation frequency if there are supervisory concerns, especially for institution subject to eSLR
  - Future phased-out of current exposure method (CEM); U.S. regulators will consider changes to total leverage exposure to incorporate BCBS standardized approach for measuring counterparty credit exposures (SA-CCR)

- Broader U.S. rule making continues and continues to redefine regulatory targets for institutions, including:
  - Anticipated U.S. G-SIB capital buffers, which may further raise minimum ratios for the largest banks
  - Upcoming short-term wholesale funding limitations, and long-term debt requirements
  - Liquidity coverage ratios was finalized along with SLR, but net stable funding ratio (NSFR) is outstanding
  - Finalization of financial sector concentration limits
  - Implementing numerical floors for collateral haircuts in securities financing transactions (SFTs)

SLR denominator components highlights

- On-balance sheet exposures
- Derivatives exposures
- Repo-style exposures
- Other off-balance sheet exposures

On-balance sheet exposures

On-balance sheet exposures **(excluding derivatives and repo-style)** = **On-balance sheet amount** - **Amounts deducted from Tier 1 capital for SLR**

Key considerations for main components of <u>on-balance sheet exposures</u>:

	On-balance sheet assets
On-balance sheet amount	On-balance sheet carrying value (excluding derivative and repo-style transactions, but including cash collateral received in derivative transactions): On-balance sheet exposures generally include loans, investments (debt securities, equity), trading assets, other assets (cash, fixed assets) etc.

	Basel III capital numerator
Amounts deducted from tier 1 capital for SLR	All amounts deducted from Basel III tier 1 capital except for: • Accumulated net gain and add any accumulated net loss on cash flow hedges included in accumulated other comprehensive income (AOCI) that relate to the hedging of items that are not recognized at fair value on the balance sheet • Net gain and add any net loss related to changes in the fair value of liabilities that are due to changes in the bank's own credit risk

Derivative exposures

Derivative exposures = Replacement cost + PFE +/- Collateral adjustment + Effective notional *(for sold credit derivatives)*

Key considerations for main components of <u>derivatives exposures</u>:

	Single derivatives	Netted derivatives	Cash received	Cash provided	Sold credit derivatives[6]	Cleared[6] 1. Guarantee client 2. Guarantee CCP
Replacement cost	Current exposure of the derivative contract (positive mark to market)	Current exposure after on-balance sheet netting, excluding cash margin offsets				Guarantee of client or CCP performance treated as single or netted derivatives
PFE	PFE = credit conversion factor x notional principal	PFE adjusted = 0.4 x A_{Gross} + 0.6 x net-to-gross ratio x A_{Gross} Where: • A_{Gross} is the sum of individual PFEs for netted derivatives			• For single derivatives, set PFE to zero • For netted derivatives reduce A_{gross} in PFE by credit derivative notional amount	Guarantee of client or CCP performance treated as single or netted derivatives
Collateral adjustment			Reduce exposure by the liability related to cash margin received, when margin meets specified SLR criteria	Increase exposure by cash posted, when margin is being used to offset liabilities and does not meet specified SLR criteria		Guarantee of client or CCP performance treated as single or netted derivatives
Effective notional					Include effective notional • Reduce by fair value change that is recognized in tier 1 capital • Reduce by purchase protection of same asset, etc.	

[6] Exposure to affiliates due to agency transactions, and the effective notional principal amount of sold credit protection cleared with a CCP on behalf of a client, can be excluded from total leverage exposure calculations

Repo-style exposures

Repo-style exposures	=	**Gross value of receivables**	-	**Netting benefits / offsets**	+	**Counterparty credit risk**	+	**Agent adjustments**

Key considerations for main components of repo-style exposures:

	Acting as a principal (single agreement)[7]	Acting as a principal (netted agreement)[7]	Acting as an agent (with bank acting as guarantor)[8]
Gross value of receivables	Gross fair value of receivables owed to the bank under repo-style transactions	Gross fair value of receivables owed to the bank under repo-style transactions	
On-balance sheet netting benefits/ offsets		Benefits due to on-balance sheet netting of repurchase and reverse repurchase agreements, if transactions meet specified criteria	
Counterparty credit risk	Max {0, [E - C]} Where: • E is the gross fair value of receivables • C is the associated received collateral (and uses collateral received value)	Max {0, [ΣE - ΣC]} Where: • E is the gross fair value of receivables • C is the associated received collateral (and uses collateral received value)	
Agent adjustments			Counterparty credit risk exposure to the counterparty of the customer, plus any additional guarantee provided as an agent

[7] Off-balance sheet repo-style transactions that are treated as a sale under generally accepted accounting principles (GAAP), will be treated as repo-style exposures and not as derivatives or other off-balance sheet exposures, for SLR calculation

[8] Counterparty credit risk for agency repo-style transactions only needs to be calculated when the bank indemnifies the customer

Other off-balance sheet exposures

Other off-balance sheet exposures (excluding derivatives and repo-style)	=	**CCF adjusted notional**	=	(**Gross notional**	X	**Basel III Standardized CCF %**)

Key considerations for main components of other off-balance sheet exposures:

	Other off-balance sheet exposures
Gross notional amount	Off-balance sheet amounts (excluding derivative and repo-style transactions): Off-balance sheet exposures generally include undrawn commitments, letters of credit, guarantees, forward agreements, reference asset for equity and sold credit derivatives etc.
CCF adjusted notional amount	Gross notional amount x CCF % Where: • CCFs based on Basel III standardized rules using maturity and exposure type subject to 10% floor

Off-balance sheet exposure	CCF
• Commitments that are unconditionally cancelable by the banking organization	10% (floor)
• Commitments with original maturity of ≤ 1 year that are not unconditionally cancellable by the banking organization • Self-liquidating trade-related contingent items that arise from the movement of goods with original maturity of ≤ 1 year	20%
• Commitments with original maturity of > 1 year that are not unconditionally cancellable by the banking organization • Transaction-related contingent items, including performance bonds, bid bonds, warranties and standby letters of credit	50%
• Guarantees, credit-enhancing representations and warranties that are not securitization exposures, financial standby letters of credit and forward agreements	100%

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