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Dodd-Frank, Basel III and the Age of Uncertainty

WHITE PAPER

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The two-year anniversary of the passage of the Dodd-Frank Act is a good occasion to consider where we stand with respect to the proposals adopted in response to the financial crisis. Moreover, we do so in an environment of continued turmoil in the financial markets and banking industry.

It is a restatement of the obvious to observe that the 2007 to 2009 financial crisis has led to a fundamental re-ordering of the regulatory landscape for large banking institutions. Just like the Great Depression was the impetus behind the passage of landmark legislation, including the Glass-Steagall Act and the Securities Act of 1933, the perceived lessons of the recent financial crisis have provided the inexorable impetus behind the passage of the Dodd-Frank Act. While sweeping, however, the Dodd-Frank Act is but one component of this re-ordering of the U.S. and international bank regulatory environment. Aspects of these fundamental reforms include: the international adoption of significantly enhanced capital requirements and the implementation of mandated liquidity ratios; the introduction of effective floating, minimum capital requirements under stressed scenarios in the U.S.; increased efforts towards “ring-fencing” the local operations of internationally active banks; and the imposition of new analytical frameworks that seek to discourage the buildup of systemic risks through additional capital surcharges and limits on growth through acquisitions.

The emerging regulatory landscape is certainly more stringent and less forgiving. In many ways, this is rightly so—the crisis revealed deficiencies that needed to be fixed (although in the case of the Volcker Rule, one cannot readily identify a need for it in the 2007 to 2009 experience). One may debate the relative merits of some of the specific changes being made, at least in the case of measures that are in final enough form to permit evaluation. More crucially, however, it is proving very difficult to analyze how this new regulatory landscape will operate in practice to shape the very nature of the U.S. and international banking industry as a whole. Thus, in the short term at least, a dominant characteristic of the regulatory landscape emerging in the wake of the financial crisis is:

- uncertainty arising out of specific rules that require important clarifications, or actually remain to be written; and
- uncertainty as to how exactly all the rules will work (or not) together.

All of this uncertainty affects the banking industry which is understandably unsure about what the actual “rules of the road” will look like six months or one year or three years from now. Perhaps more importantly, it also creates real risks for financial markets and the U.S. and global economy.

In just the Dodd-Frank context, the uncertainty arising from statutory provisions and rules that require substantial clarifications or remain to be written is enormous. To name just a few of the most often debated open questions:

- Will the market-making exception to the Volcker Rule’s proprietary trading ban be broad enough to afford adequate market liquidity? Will it accommodate inter-dealer market activity adequately to permit firms to execute efficiently customer-driven business? Will it permit sufficient inventory to be carried to provide liquidity to customers, especially in illiquid markets?
- How far will the fund restrictions in the Volcker

Rule reach in terms of covering joint ventures, securitization vehicles, retail-oriented non-U.S. funds and other vehicles that technically may fall within the statutory or proposed regulatory definition of covered “hedge fund” or “private equity fund,” but are not the types of vehicles that readily spring to mind when one thinks of a private equity or hedge fund?

- How will many important aspects of the derivatives regulation provisions of Title VII of Dodd-Frank apply extraterritorially?
- Will there be a fix for the admittedly inadvertent drafting error that excluded the U.S. branches of foreign banks from the rates and currencies exception from the derivatives push-out provisions of the Lincoln Amendment?
- Will the rules regarding single counterparty exposure limits to be adopted pursuant to Section 165 of Dodd-Frank lead to extraordinary adjustments of relationships among market participants? What will be the effect of such adjustments on the banking system and the larger economy?

Each of these questions represents an important issue for the financial services industry in and of itself. There are unfortunately a plethora of other similarly unresolved Dodd-Frank related issues that could easily be included in this list.

At the same time, there are numerous other fundamental regulatory reforms underway affecting banking institutions. Many of these changes also pose significant uncertainties. Some of the most important arise out of the Basel Committee process:

- Basel III will significantly increase the amount of capital banking institutions must hold. By some estimates, U.S. banking institutions will be required to hold over 100 percent more Tier 1 Common Equity capital in the aggregate as compared to the amount held at December 31, 2007.
- Similarly, its other prescribed quantitative, qualitative and risk-weighting requirements result in the 7 percent minimum Common Equity Tier 1 ratio under Basel III being equivalent to a 14 percent Tier 1 Capital Ratio under the pre-

crisis Basel I rules for U.S. banks. Basel II.5 also dramatically increases—often by 400 percent or more—the capital charge on trading positions held by large banking institutions.

- For the first time, formal liquidity related ratio requirements are being imposed—the Liquidity Coverage Ratio and the Net Stable Funding Ratio. By some estimates, the implementation of the Liquidity Coverage Ratio alone could require the U.S. banking industry in the aggregate to hold an additional \$1.4 trillion to \$2 trillion of highly liquid assets which meet the relevant Basel III definitions.
- An additional Common Equity Tier 1 capital surcharge of up to 3.5 percent on global systemically important banks is being imposed. This G-SIB surcharge is based on a multi-factored test which attempts to measure relative size, substitutability, interconnectedness, complexity and cross-border activities among large internationally active banking institutions in order to mitigate and reduce systemic risk.

The base documents comprising the international Basel II.5 and Basel III accords and the proposed U.S. regulations implementing these accords are each extremely complex. In light of their intricate nature, important details will need to be worked through as the actual binding rules are adopted and come into effect in the U.S. and elsewhere.

In addition to the increased Basel III capital requirements, the interplay between annual supervisory stress tests in the U.S. and the Federal Reserve's capital plan rules creates further enhanced and variable de facto minimum capital requirements. The stress tests in effect set the true minimum capital. That minimum will also change from year to year as the stress scenarios change. Banking institutions subject to the stress tests are effectively required to maintain minimum 5 percent Tier 1 Common Equity under highly adverse macro-economic scenarios or else face limitations on capital distributions. Moreover, the supervisory models and underlying assumptions by which the regulators judge whether an institution has passed or failed the stress test have thus far proven to be opaque "black boxes." This combination of

factors will inherently introduce uncertainty with respect to minimum capital requirements and capital planning. Unlike regulatory capital floors pursuant to the Federal Deposit Insurance Act's and related regulations' "prompt corrective action" provisions or the Basel minimums, the amount of capital required by this floating 5 percent minimum will necessarily depend in any given year on the models and on the severity of the macro-economic assumptions used for the stress tests.

Furthermore, there is also a trend for regulatory authorities in many jurisdictions, including the U.S., to examine more carefully the operation of large international banking institutions operating within their respective territory, and to insist that these operations be more free standing. In the U.S., this trend is exemplified by the so-called "Collins Amendment" provision of Dodd-Frank which requires U.S. bank holding company subsidiaries of foreign banks to meet capital requirements on a stand-alone basis by 2015. This provision reverses the Federal Reserve's historical position that it would look to the capital adequacy of the foreign banking institution as a whole. Whether the Collins Amendment is the first or last step in ring-fencing U.S. subsidiaries of foreign banking institutions remains to be seen.

Finally, the Federal Reserve's recent decisions with respect to the PNC/Royal Bank of Canada and Capital One/ING transactions raise fundamental issues and uncertainties as to the ability of the largest banking institutions to grow and more moderately sized firms to expand into the next tier. Those orders involved PNC and Capital One's acquisition of some of the U.S. banking operations of Royal Bank of Canada and ING, respectively. The orders approving those applications were the first occasion for the Federal Reserve to apply the new systemic risk impact requirement imposed under Dodd-Frank.

Under this provision, the federal banking regulators must consider "the extent to which [the] proposed acquisition, merger, or consolidation would result in greater or more concentrated risks to the stability of

the United States” in evaluating related applications. The Federal Reserve engaged in a detailed analysis of the likelihood that the RBC and ING transactions—which many observers believed not to present any significant systemic risk issues given the respective size and relatively simple business models of the institutions involved—increased U.S. systemic risk using, in part, the Basel Committee’s criteria for imposing the G-SIB surcharge. While these two transactions were ultimately approved, the Federal Reserve’s analytical requirements in this area raise serious uncertainties with respect to future applications by larger financial institutions, and most certainly increase the burden of the approval process for all applicants.

Individually, many of the major reform initiatives arising out of the financial crisis—Dodd-Frank, Basel, stress testing, ring-fencing, systemic risk evaluations—are rife with significant questions, ambiguities and uncertainties. That uncertainty is magnified, however, by the interplay among the individual reform initiatives being undertaken. It is extremely unclear how the various new rules and other reforms will interact in the aggregate to reshape the financial services industry and affect the ability of banking institutions to perform their crucial financial intermediation role in the U.S. and global economy.

By way of illustration, in a ring-fenced financial system, capital and liquidity requirements must be separately met in each jurisdiction. The Collins Amendment to Dodd Frank, which required U.S. intermediate bank holding companies owned by foreign banks to meet separately Federal Reserve capital requirements exemplifies this development. If a banking institution needs not only to meet capital and liquidity standards on a consolidated level, but now must also separately meet those standards at each subsidiary, the aggregate real capital and liquidity requirements for the banking institution as a whole intuitively must be greater than the levels nominally applicable to it on a consolidated basis. This result is driven by the institution no longer being able to dynamically allocate capital and liquidity as needed among different business units or subsidiar-

ies. Thus, the new higher nominal capital levels being imposed may in fact be further increased by structural changes in the industry.

In other instances, individual reforms could work at cross-purposes to each other. On the one hand, Title VII of Dodd-Frank generally mandates (and the Basel accords encourage) the migration of the execution and clearing of many derivatives transactions on to central clearing entities that are viewed as systemically safer due to regulation and capital requirements. On the other hand, the proposed single counterparty exposure rules under Title II of Dodd-Frank appear to simultaneously limit individual banking institutions exposures to central clearing entities. Thus, the uncertainties created by the interrelationship among the various regulatory reform efforts can have significant unintended consequences. We note that Federal Reserve Chairman Ben Bernanke has himself acknowledged that the aggregate impact of the current financial services regulatory reforms efforts in the United States, including Dodd-Frank and Basel III, have not yet been comprehensively analyzed.

These two aspects of uncertainty—uncertainty in connection with rules that require important clarifications or actually remain to be written and uncertainty as to how exactly all the rules will work (or not) together—creates real risks for financial markets and the U.S. and global economy. The aggregate uncertainty in the emerging fundamental re-ordering of the regulatory environment:

- impedes management’s ability to develop and implement strategies to effectively deploy capital and increase lending in the face of unclear rules of the road,
- hinders efforts by banking institutions to retain talented employees given questions as to the future of their respective business units, and
- diminishes the ability of investors to understand the business models in which they are being asked to invest.

If anything, the sluggish pace of economic growth over the past three years seems to suggest that these are not trivial concerns which may be papered over in a quixotic quest for a perfectly fail safe financial system.

The lessons learned from the 2007 to 2009 financial crisis have significantly improved regulators', banking institutions' and market participants' knowledge about what can go wrong and the limits of previous regulatory approaches. However, our collective experience with the specifics of the fundamental reform being adopted in the wake of the crisis and interplay between these various individual reform efforts remains limited. Certainly significant regulatory change was necessary following the financial crisis, and there is no way to avoid uncertainty arising from the process of change. Uncertainty, however, can and should be managed and controlled. We need to proceed in a deliberate and even cautious manner.

The experience and additional knowledge gathered as new rules and other initiatives are being designed, implemented and holistically analyzed should constantly inform an iterative regulatory reform process in a way that carefully addresses uncertainty risk.