THE U.S. TREASURY DEPARTMENT PRESENTS ITS CORE PRINCIPLES FOR REGULATORY CAPITAL

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To Our Clients and Friends:

At the end of last week, the U.S. Treasury Department released "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms" (the "Principles"). The Principles, although lacking in many specifics, set forth the Treasury Department's vision for an international regulatory capital framework and are noteworthy in several respects:

- The Principles evidence a continued retreat from the market-based approach to regulation that had been favored prior to the financial crisis and is inherent in much of the architecture of the Basel II Capital Framework.
- The Principles emphasize the importance of voting common equity constituting a "large majority" of a banking firm's Tier 1 capital – an emphasis that has been particularly apparent since the Supervisory Capital Assessment Process (the so-called "stress tests").
- The Principles call for greater transparency regarding the capital and financial condition of banking firms, an approach that may signal a departure from the traditionally opaque supervisory and examination approach taken by U.S. bank regulators.
- The Principles reaffirm the use of a simple, non-risk based leverage ratio, to be applied on an international basis. Prior to the financial crisis, some in the U.S. banking industry had argued for the abandonment of the leverage ratio as a blunt and mis-designed instrument for capital assessment; now there appears to be support for an international leverage standard in the European Union and elsewhere among the G-20 nations.
- The Principles call for the creation of a "liquidity regime" that would complement the risk-based capital and leverage frameworks.

The Treasury Department issued the Principles to coincide with Secretary Geithner's visit to the G-20 Finance Ministers' summit in London this Labor Day weekend and to be part of the agenda for the G-20 leaders' summit in Pittsburgh later this month. As such, these Principles clearly are aimed at an international audience, and indeed the Finance Ministers included many of its concepts in the Banking Statement they published at the end of the London meetings. In addition, the Basel Committee on Banking Supervision ("Basel Committee") issued a statement yesterday generally supporting the Principles and promising

concrete proposals to implement them by the end of this year. Moreover, while the Principles are addressed to banking firms, they represent the Obama Administration's vision of the capital standards that would apply to all systemically significant financial firms (so-called "Tier 1 FHCs" in the Obama Administration's draft regulatory reform legislation), including those that do not own banks. As with other proposals by the Treasury Department, this one proceeds on an ambitious time frame. The Principles seek a "comprehensive international agreement on the new global framework" by December 31, 2010, with implementation of reforms effective internationally by December 31, 2012.

THE PRINCIPLES

The Treasury Department release identifies eight "Core Principles" focusing on the sufficiency of capital. These principles are designed to balance a number of factors: an individual bank's exposures, macro-economic and systemic issues, and the need to ensure that increased burdens on banks do not cause a re-emergence of an under-regulated nonbank financial sector.

Core Principle 1–Incorporating a Macro-Prudential View. The Treasury Department notes that, historically, the focus of bank capital requirements has been ensuring the solvency of individual banks. Core Principle 1 provides that the capital rules must be reoriented to incorporate a macro-prudential view that promotes the stability of the financial system as a whole. Core Principle 1 states that taking such a macro-prudential view means: (1) reducing the amount of risk that the capital and accounting frameworks permit banks to accumulate during strong economic times; (2) forcing banks to build larger capital cushions in strong economic times; (3) raising capital requirements for so-called "Tier 1 FHCs" and for systemically risky exposures; and (4) improving the ability of banks to withstand firm-wide and system-wide liquidity shortages.

Core Principle 2–Raising BHC Capital Requirements. Core Principle 2 calls on global capital requirements to be "higher across the board." In the United States, this core principle calls on imposing capital requirements on financial holding companies ("FHCs"). Currently, a bank holding company may qualify as an FHC so long as its subsidiary banks are and remain well-capitalized under the Prompt Corrective Action rules.

Core Principle 2 finds fault with this approach, saying that it allows an FHC to engage in many riskier activities, such as merchant banking, insurance underwriting and equity dealing, at the holding company level without endangering its FHC status. To address this perceived deficiency, Core Principle 2 promotes requiring FHCs to be "well capitalized" (and "well managed") on a consolidated basis. The core principle also calls on Tier 1 FHCs to have "substantially heightened" consolidated capital requirements to compel them to internalize the systemic significance of their actions.

Core Principle 3–Raising the Quality of Capital. Core Principle 3 states that voting common equity should constitute a large majority of a banking firm's Tier 1 capital, with deferred tax assets as well as hybrid and other innovative securities being subject to strict, internationally consistent limits.

The Federal Reserve's capital rules already provide an expectation that the majority of a bank holding company's capital will be voting common equity, an emphasis that, as indicated above, has grown since the stress tests. As a result, Core Principle 3 appears to focus on increasing the extent of a current approach rather than establishing a new direction for bank capital.

Core Principle 4–Adjusting Risk-Based Capital and Enhancing Capital Transparency. Core Principle 4 imports the macro-prudential view of Core Principle 1 explicitly into the risk-based capital rules. Core Principle 4 states that risk weights should be a function not only of asset-specific risk (as it is currently), but also the "systemic importance" of various exposure types. Explaining this approach, Core Principle 4 states that "[f]rom a macro-prudential perspective, exposure types that exhibit a high correlation with the economic cycle, or whose prevalence is likely to contribute disproportionately to financial instability in times of economic stress, should attract higher risk-based capital charges than other exposure types that have the same level of expected risk." As specific examples, Core Principle 4 provides that the key systemically important asset types currently include: (1) implicit and explicit exposures to bank-sponsored off-balance sheet vehicles; (2) trading positions; (3) equity investments; (4) structured asset-backed and mortgage-based securities, and (5) counterparty credit risk exposures to financial firms, including securities finance transactions and non-centrally cleared derivatives.

Core Principle 4 advocates reducing "excessive regulatory reliance" on internal banking models and ratings of credit rating agencies, which would seem to call into question the core underpinnings of the current Basel II capital framework. Moreover, given the significant volume of securities finance transactions, including securities lending and repo-style agreements, among custodial and other major banking firms, increasing the capital charge on such transactions could have a dramatic effect on these institutions in the future.

In addition, Core Principle 4 states that the financial position of banking firms needs to be more transparent, noting that in the current crisis governments often were hindered by the fact that the current capital framework provided a "lagging indicator" of a bank's health. As an example, Core Principle 4 cites that a banking firm's ratios generally do not reflect unrealized gains or losses on available-for-sale securities. Core Principle 4 notes that the Prompt Corrective Action framework focuses on capital, and suggests that other indicators, such as non-performing loan or liquidity levels, also should trigger some of the framework's protective provisions. The demand for greater transparency seems to depart from a

historical concern of regulators that too much fluctuation in the financials of a banking enterprise on a quarter-by-quarter basis could weaken investor confidence in the banking system, and the suggestion of other than capital-based triggers seems to indicate a lack of trust in the ability of the regulators to address such issues during their ongoing review and examination of these institutions.

Core Principle 5–Reducing Procyclicality. Core Principle 5 involves substantial discussion of the dangers of procyclicality — *i.e.*, the fact that banks are willing to lend more during good economic times and less during bad economic times, in each case further exacerbating the economic trend. Core Principle 5 recommends many initiatives to reduce procyclicality, including: (1) requiring banks to hold a capital buffer during good economic times so they do not face activity-inhibiting capital shortages during difficult times (with the buffer potentially determined by undefined macro-economic indicators); (2) modifying regulatory capital requirements to reflect longer term horizons and rely less on Value-at-Risk (VaR) models and internal rating systems (both of which, as discussed above, are core elements of Basel II); (3) requiring banks to evaluate loan loss reserves on factors other than historical experience, with the objective of banks recognizing higher provisions earlier in the credit cycle; (4) reducing capital disincentives (*e.g.*, only counting a portion of reserves toward capital) to holding greater loan loss reserves; and (5) encouraging Tier 1 FHCs and other banking firms to issue contingent capital instruments (*e.g.*, long-term debt that converts to equity in times of stress), although the Treasury Department recognizes that such instruments may not be sold on a cost-effective manner in the marketplace.

Core Principle 6–Imposing an Enhanced Leverage Constraint. Core Principle 6 cites the benefits of incorporating a leverage ratio, in addition to risk-capital ratios, into the regulatory framework. According to the Treasury Department, a leverage framework limits "regulatory arbitrage activities" whereby bank firms will engineer assets and risk taking toward the weak spots in the risk capital framework.

Presumably this principle is principally directed toward the international community, as the U.S. Prompt Corrective Action framework already includes a leverage requirement. However, Core Principle 6 also would extend the scope of the leverage requirement (including in the U.S.), at a minimum, to incorporate off-balance sheet items. As is described below, the G-20 finance ministers and central bankers appear to agree, at least in concept, with the Treasury Department's view of the need for an international leverage standard.

Core Principle 7–Adding a Liquidity Standard. In Core Principle 7, the Treasury Department asserts that, while the regulatory framework has focused largely on the asset side of a banking firm's balance sheet, the manner in which a firm funds its assets is no less important. As a result, Core Principle 7 calls for the introduction of an explicit liquidity

regulatory regime to complement the asset-based capital regime, and perhaps even affect a bank's capital requirements.

These liquidity regulations should be structured to accomplish two goals: (1) requiring banks to hold sufficient liquid assets to overcome an acute liquidity stress scenario (including collateral calls by derivative counterparties, draws on lines of credit by borrowers, and bank support for off-balance sheet vehicles), and (2) reducing longer-term structural asset-liability mismatches. The Treasury Department also suggests that the regulatory framework should address macro-economic issues by reflecting cross-funding between banks, between banks and nonbanks, and concentrations in funding sources across the financial sector.

In response to the financial crisis, the Basel Committee published extensive guidance on liquidity in September 2008, "Principles for Sound Liquidity Risk Management and Supervision." These Treasury Department principles appear to go further than the Basel Committee's efforts by advocating imposing specific numerical regulatory requirements on banking institutions and expressly tying those requirements to acceptable bank capital levels.

Core Principle 8–Considering Industry Migration to Non-Bank Lenders. In part in response to the additional capital, liquidity and other requirements described above that Treasury Department wishes to impose on the banking industry, Core Principle 8 focuses on concerns that lending and certain other traditional banking activities will migrate to non-bank lenders, which would not be subject to these requirements. Although not specifying how, Treasury Department says that the demands of a stronger capital and regulatory regime must occur in a "balanced fashion" that minimizes incentives for this migration. Core Principle 8 then goes on to detail the Treasury Department's proposals to limit the activities of other components of the financial services sectors, including designating Tier 1 FHCs, which will be subject to regulation whether or not they own banks, increased regulation of money market mutual funds, and requiring central clearing and trading of many derivative transactions. Core Principle 8 does not, however, address how to maintain a competitive balance with large, but not Tier 1 FHC-sized, mortgage and commercial lenders with which banks traditionally have competed.

CONCLUSION

As with many of its other proposals, the Treasury Department's Principles are broad in scope and, if implemented in their current form, would have a significant impact on the banking industry. But what effect the Principles will have remains to be seen, particularly since the Treasury Department has no direct role in setting capital standards for banking institutions.

To a significant degree, the Principles appear to be founded on the belief that, if revenues can be generated, banks will assume risk at the expense of safe and sound behavior unless

there are express, detailed rules to prevent such behavior. Regardless of the validity of this belief, creating these detailed rules on an international level from the concepts above will present a significant challenge, and developing them in a way that does not unduly debilitate the role of banks in the financial services sector will prove harder still. Finally, given that it required almost a decade to implement the Basel II capital rules, achieving those objectives while making even more fundamental changes to the oversight of the banking sector in the one to two year time frame specified by the Treasury Department will require unprecedented effort and international coordination among regulators and the financial services sector.

Please contact us if you have any questions.

Gregory J. Lyons
+1 212 909 6566
gjlyons@debevoise.com

Satish M. Kini
+1 202 383 8190
smkini@debevoise.com

Paul L. Lee
+1 212 909 6955
pllee@debevoise.com