

Bank Capital Relief and Related Emergency Policy Measures

March 18, 2020

On March 17, 2020, the Federal Reserve Board (the “FRB”), Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation (collectively, the “Agencies”) adopted an interim final rule that adjusts the definition of “eligible retained income” under the Agencies’ regulatory capital rules by making the automatic limitations on capital distributions and other payments thereunder more gradual (the “Interim Final Rule”) and issued a Statement on the Use of Capital and Liquidity Buffers (the “Statement”).

The Interim Final Rule and Statement accompany the announcement of a series of emergency policy measures by the FRB intended as a response to the disruptions in economic and financial market conditions caused by the coronavirus disease 2019 (COVID-19), including the lowering of the target range for the federal funds rate to 0 to 0.25%, lowering the primary credit rate of the discount window to 0.25% and extending the potential term of such loans to up to 90 days, lowering the pricing on the standing U.S. dollar liquidity swap arrangements by 25 basis points, reducing bank reserve requirements to 0%, and establishing a Commercial Paper Funding Facility (“CPFF”) and Primary Dealer Credit Facility (“PDCF”).

Interim Final Rule

The Agencies’ regulatory capital rules require a banking organization to maintain certain buffers above its risk-based and leverage capital minima to avoid restrictions on capital distributions and certain discretionary bonus payments. In particular:

- A banking organization’s capital conservation buffer (“CCB”), most relevant for these purposes, is defined as the lowest amount by which its relevant capital ratio (common equity tier 1, tier 1 or total capital) exceeds its corresponding regulatory minimum (4.5%, 6% and 8%, respectively). Currently, all banking organizations are subject to a minimum capital conservation buffer (“CCB”) of 2.5% of risk-weighted assets.

- Certain larger and more complex banking organizations also are subject to a countercyclical capital buffer (“CCyB”) requirement.¹ In addition, the U.S. global systemically important bank holding companies are further subject to a risk-based capital surcharge (the so-called “GSIB surcharge”).² Both the CCyB and GSIB surcharge operate as extensions to the fixed CCB.
- If a banking organization’s CCB falls below 2.5% *plus* any required CCyB and GSIB surcharge, the firm becomes subject to increasingly stringent limitations on capital distributions and certain discretionary bonus payments.
- Currently, distribution limitations under the CCB are expressed as a percentage of “eligible retained income,” defined for a particular quarter as the net income *less* any distributions and associated tax effects not already reflected in net income for the four quarters preceding the current quarter. The percentage of distributable eligible retained income decreases as a banking organization’s CCB decreases.
- Historically, this framework has meant a banking organization that has had positive net income over the past calendar year, but has distributed a large portion of those earnings to shareholders, could be severely restricted in its ability to pay distributions if its CCB fell below 2.5% *plus* any required CCyB and GSIB surcharge (because the distributions during good quarters would reduce eligible retained income during bad quarters).
- This structural feature of the CCB strongly incentivizes banking organizations to scale back their lending and financial intermediation activities (maintaining capital ratios above the buffer amounts) during economic contractions rather than be subject to sudden and severe limitations on capital distributions.³
- The Interim Final Rule modifies the definition of eligible retained income by redefining it as the *greater* of: (1) net income for the four calendar quarters preceding the current calendar quarter, *net* of any distributions and associated tax effects not already reflected in net income (*i.e.*, the current definition); and (2) the *average* of net income for the four calendar quarters preceding the current calendar quarter.

¹ Category I, II and III firms are subject to a CCyB requirement. For more detail on the categorization framework, refer to our Debevoise In Depth [here](#).

² Category I firms also are subject to an enhanced supplementary leverage ratio, which is analogous to the CCB for the supplementary leverage ratio applicable to all Category I, II and III firms.

³ This change is similar to the revision to the definition of “eligible retained income” contemplated by the FRB’s recent stress capital buffer rule. To access a copy of the rule see the FRB’s website [here](#). Under the final stress capital buffer rule, the definition would have been bifurcated depending on whether a banking organization’s CCB is above 2.5% plus any applicable CCyB and GSIB surcharge. The revised definition in the Interim Final Rule would replace the previously contemplated revision in the FRB’s stress capital buffer rule once that rule is effective.

- This revision is “intended to strengthen the incentives for a banking organization to use its capital buffers as intended in adverse conditions and serve as a financial intermediary and source of credit to the economy” by providing a more gradual phase-in of the CCB’s limitations based on a banking organization’s historical level of distributions.
- For example, a banking organization that has had positive net income over the past calendar year, but has distributed a large portion of earnings to shareholders, would be subject to limitations based on a percentage of average quarterly net income for the preceding calendar year without deducting distributions.

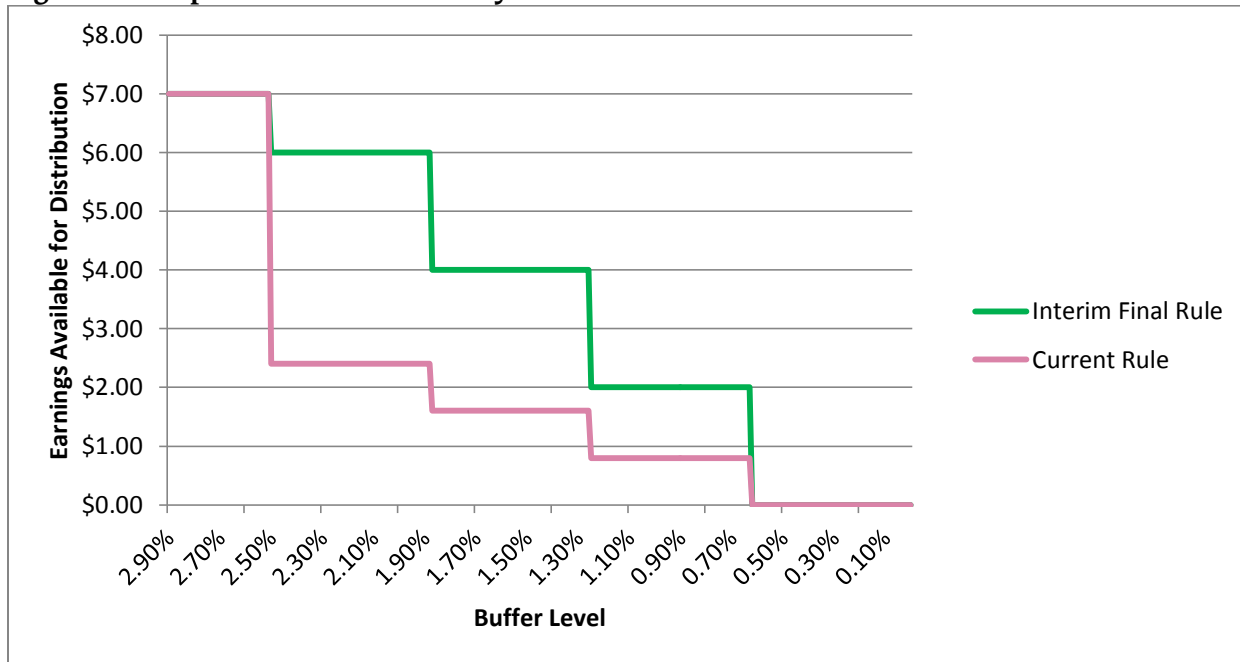
As an example of how the distribution limitations under the Interim Final Rule could be more graduated, consider the following (stylized) example for a hypothetical banking organization in the first quarter of 2020:

Table 1: Net Income and Distributions for Hypothetical Banking Organization (amounts in billions)

	1Q 2019	2Q 2019	3Q 2019	4Q 2019	1Q 2020	2019 Total	2019 Average
Net Income	\$12	\$11	\$9	\$8	\$3	\$40	\$10
Distributions	\$11	\$10	\$8	\$7	-	\$36	-
Retained Earnings	\$1	\$2	\$3	\$4	-		
Net Income less distributions	\$1	\$1	\$1	\$1	-	\$4	-

In 2019 this hypothetical banking organization had average quarterly net income of \$10, but only \$4 of net income (less distributions). For 1Q 2020, the banking organization had \$7 available for distribution (\$4 prior quarter retained earnings and \$3 current quarter net income). Assuming that the BHC is not a GSIB or subject to the advanced approaches, no CCyB or GSIB surcharge is applicable. The following graph compares the maximum payout amounts under the Interim Final Rule and current rule.

Figure 1: Comparison of Maximum Payout Amounts



Under the Interim Final Rule, maximum distributions allowable in the first quarter of 2020 decline more gradually, whereas the current rule has a significant cliff at 2.5%.

Statement on the Use of Capital and Liquidity Buffers. In a statement accompanying the Interim Final Rule, the Agencies explicitly encouraged banking organizations to use their capital and liquidity buffers “as they respond to the challenges presented by the effects of the coronavirus.” The Statement notes that the largest banking organizations hold \$1.3 trillion in common equity and \$2.9 trillion in high quality liquid assets, and goes on to explain that the buffers were “designed to provide banking organizations with the means to support the economy in adverse situations and allow banking organization[s] to continue to serve households and businesses,” implying that their usage would be appropriate in response to current market conditions, provided that banking organizations “continue to manage their capital actions and liquidity risk prudently.”

Commercial Paper Funding Facility and Primary Dealer Credit Facility

The FRB announced that it would establish a CPFF and PDCF, with the approval of the Treasury Secretary. The CPFF is intended “to support the flow of credit” by providing a “liquidity backstop to U.S. issuers of commercial paper,” while the PDCF is intended to “allow primary dealers to support market functioning and facilitate the availability of

credit to businesses and households.” The last time the FRB established a CPFF or PDCF during the 2007-2008 financial crisis (on October 27, 2008 and March 17, 2008, respectively).

- The CPFF and PDCF are established pursuant to Section 13(3) of the Federal Reserve Act, which provides the FRB the power to extend secured loans in “unusual and exigent circumstances,” to participants in a “program or facility with broad-based eligibility” that are “unable to secure adequate credit accommodations from other banking institutions,” subject to certain conditions.
- Prior to adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) the FRB could extend credit under Section 13(3) to any individual, partnership, or corporation. The Dodd-Frank Act limited the use of Section 13(3) authority to provision of liquidity through broadly-based facilities and by requiring Treasury Secretary approval before establishing any such program or facility.
- The CPFF will be structured as a credit facility extended by the Federal Reserve Bank of New York (“FRBNY”) to a special purpose vehicle (“SPV”) established to purchase commercial paper. Extensions of credit will be secured by assets of the SPV. The U.S. Treasury Department will provide \$10 billion of credit protection to the FRBNY in connection with the CPFF.
- The SPV will purchase from U.S. issuers of commercial paper three-month U.S. dollar-denominated commercial paper. To be eligible for purchase, commercial paper must be rated at least A-1/P-1/F-1 by a major nationally recognized statistical rating organization (“NRSRO”), and if rated by multiple NRSROs, rated at least A-1/P-1/F-1 by two or more major NRSROs.⁴ The SPV will cease purchasing commercial paper on March 17, 2021, unless extended by the FRB.
- The PDCF will be structured as a credit facility extended by the FRBNY to primary dealers. Extensions of credit will be made available to primary dealers for terms of up to 90 days at a rate equal to the Discount Window’s primary credit rate (0.25% as of March 16, 2020).
- Loans under the facility will be secured by collateral eligible for pledge in FRBNY open market operations, as well as investment grade corporate debt securities, international agency securities, commercial paper, municipal securities,

⁴ The SPV may make one-time purchases from issuers that meet these criteria as of March 17, 2020 and were rated at least A-2/P-2/F-2 as of the purchase dates.

mortgage-backed securities, certain asset-backed securities,⁵ and certain equity securities.⁶

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⁵ Commercial mortgage-backed securities, collateralized loan obligations and collateralized debt obligations must be AAA-rated. Commercial paper must be rated A1/P1 or A2/P2.

⁶ Exchange traded funds, unit investment trusts, mutual funds, rights and warrants will not be eligible.