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Cabinet News and Views

Informed analysis for the financial services industry

Capital News from the Capital

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Let the capital discussions begin.

If Fed Vice Chair Michael Barr's announcement earlier this week of preliminary recommendations for risk-based capital rules was intended to set in motion increased conversation and to prepare big banks for some analysis and introspection, then that's exactly what has occurred.

My colleague Nikita Cotton and I take a close look at Vice Chair Barr's speech at the Bipartisan Policy Center and analyze his preliminary recommendations on capital and risk exposure.

If you'd like to start the discusion at your organization, we'd be happy to participate. Just reach out to me here.

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Fed Vice Chair Barr Delivers Results of Holistic Capital Review


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In a speech made at the Bipartisan Policy Center ("BPC") on Monday, the Federal Reserve's Vice Chair for Supervision, Michael S. Barr, communicated preliminary recommendations stemming from the holistic review of capital requirements for large banks that he has undertaken since being appointed. The results of Vice Chair Barr's review have been widely anticipated in the wake of the banking turmoil earlier this year, and, as expected, are largely referential to how Silicon Valley Bank ("SVB") and others could have been more resilient in the face of market stress. While Vice Chair Barr noted that this holistic review began well before the market stress that occurred related to SVB's failure, he pointed to the SVB review in May and his speech on the importance of capital from December as important background for the recommendations he made in his BPC speech.

Depending on a bank's size, most banks over $100 billion in assets are today subject to a combination of risk-based regulatory capital minimums, leverage capital ratios and capital buffer requirements. Vice Chair Barr's recommendations are largely in line with the latest set of recommendations for risk-based capital rules for globally active banks set by the Basel Committee that were finalized in 2017, largely known as "Basel III Endgame" by the regulators, but often referred to as Basel IV by the industry. Basel III Endgame standards have already begun to go into effect in the UK and the EU. While the U.S.'s proposal for their implementation has not yet been released, the industry expects U.S. implementation to be more stringent than other jurisdictions. Monday's remarks provide a preview of what's to come in that respect.

Of most significance is that Vice Chair Barr's recommendations, if instituted, would apply heightened standards to and increase capital requirements for banks and bank holding companies ("BHCs") with at least $100 billion in total assets – currently, the most stringent U.S. capital requirements and reliance on internal models only apply to banks with over $700 billion in total assets. A broad overview of the reforms Vice Chair Barr recommends for banks and BHCs with more than $100 billion in assets includes:

- Stress testing, which forms the basis for a bank's Stress Capital Buffer requirements, should test for a wider array of risks.

- Technical changes made to the G-SIB surcharge, including measuring system indicators throughout the year instead of just at year-end and lowering the surcharge calculation to increase in 0.1 percentage point increments instead of 0.5 percentage point increments to reduce cliff-effects.

- Banks should no longer be allowed to rely on their internal models and should instead use standardized approaches to model their counterparty credit risk and operational risks, as well as certain market risks that are too difficult to model. Operational risk charges should be based on a firm's activities and historical losses, and market risk should be modeled at the level of individual trading desks for particular asset classes, as opposed to at the firm level.

- Banks should have to account for unrealized losses and gains in their available-for-sale securities when calculating their regulatory capital requirements (no AOCI opt-out).
- A new long-term debt requirement framework similar to the current requirement for the largest BHCs should be adopted for all BHCs with more than $100 billion in assets.

However, any proposals to institute Vice Chair Barr's recommendations will still need to be voted on by the Federal Reserve Board and then go through the standard notice-and-comment rulemaking process. In particular, Vice Chair Barr indicated that the Fed will seek comments on whether the recommended reforms to the risk-based capital framework and stress testing regime would result in double counting risks for minimum capital requirements. The Bank Policy Institute ("BPI"), a leading trade association for the largest banks, didn't wait for the comment period to open – the BPI released a statement on Monday that Vice Chair Barr's speech did not seem to adequately consider the costs of additional capital requirements.

Separately from the proposals set forth above, additional reforms related to liquidity, interest rate risk and executive incentive compensation are likely to be pursued at a later date. However, Vice Chair Barr indicated that he will not recommend changes to the Counter-cyclical Buffer ("CCyb"), nor to the Enhanced Supplementary Leverage Ratio ("eSLR"), as his proposed risk-based capital requirement reforms (and the accompanying estimated additional $2 in capital for every $100 in risk-weighted assets) would make it so that the eSLR should be less likely to be the binding constraint, and thus lessen the likelihood Treasury market intermediation would be affected, as critics of the eSLR have warned against.

While Vice Chair Barr asserted that "most banks already have enough capital today to meet the new requirements," banks should begin to undertake analyses of how the heightened capital requirements might apply to them and their level of risk exposure.

CFPB Amicus Brief Emphasizes Strength of Truth In Lending Act Anti-Evasion Precedent

By **Mercedes Kelley Tunstall**
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The Consumer Financial Protection Bureau ("CFPB") yesterday filed an amicus brief in *Franklin Savings Bank v. Bordick*, a case before the Supreme Court of Maine.

In that case, the borrowers took out a loan that they used to finance the short-sale of their residential property. The loan was characterized as a “commercial loan” and provided for payments to be made over a four-year period, with a balloon payment due at the end of those four years. The borrowers made the payments for four years but could not make the balloon payment and defaulted, and the bank sued. Because the bank characterized the loan as “commercial” in purpose, instead of being made for “personal, family, or household purposes,” the borrowers did not receive consumer disclosures required by the Truth In Lending Act and Regulation Z (both “TILA”), and the loan also was made regardless of their ability to pay (*i.e.*, TILA would have required the loan terms to reflect the borrowers’ actual ability to pay the loan). During the trial phase of the case, the court agreed that because the loan was made as a commercial loan, the borrowers could not claim protections under TILA.

The CFPB argues in the amicus brief that the “trial court erred in concluding that TILA does not apply whenever a contract labels a loan ‘commercial’ for three reasons,” including that the loan in question was clearly made primarily for a “personal, family or household purpose”; that it is necessary for the court to determine whether there is a “covered purpose” for the loan under TILA due to the status of the borrowers, regardless of how the loan was labeled; and that “allowing creditors to evade TILA merely by stamping the loan documents with the term ‘commercial’ is at odds with the statute’s remedial purpose.” Referencing several cases as precedent and usual practice during supervision, the CFPB explains that courts regularly apply a five-factor test that is described in TILA’s Official Commentary to determine whether the true purpose of a loan to finance an acquisition is commercial. Those factors are: the relationship of the borrower’s primary occupation to the acquisition; the degree to which the borrowers will personally manage the acquisition; the ratio of income from the acquisition to the total income of the borrower; the size of the transaction; and the borrower’s statement of purposes for the loan. In conclusion, the CFPB urged the court to protect the borrowers, and Maine consumers generally, by adopting a “substance-over-form approach to determining TILA coverage is necessary to effectuate TILA’s consumer-oriented purposes” and ensuring that TILA’s consumer protection requirements cannot be readily evaded by simply labeling a loan as “commercial.”

The UK Proposes Changes to Short Selling Regime

By Alix Prentice
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The UK Government has published its response to a call for evidence for a review of the Short Selling Regulation. The review was initiated as part of the UK's aim to deliver a "Smarter Regulatory Framework" for financial services by repealing and replacing EU law retained after Brexit with firm-facing regulations made by regulators under a framework set by the government.

The FCA will consult on a short selling regime to replace the current version and will take into account responses to the call for evidence and the views of the government. The government is also making two key changes to the UK's short selling regulatory framework at this stage – namely:

1. The replacement of the current public disclosure requirements based on individual net short positions with an aggregated net position disclosure regime.
2. An increase to the current disclosure threshold net short position reporting requirements from 0.1 to 0.2%.

The government considers that short selling is an essential tool to facilitate effective market function and support liquidity, and considers that these changes support this facilitation and protect against the risks of short selling. To that end, restrictions on uncovered short selling will remain in place, as will the market maker exemption.

Global Banking Regulators Plan to Develop Short-Term Climate Scenarios


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The Network of Central Banks and Supervisors for Greening the Financial System ("NGFS") is assembling a team of modelling experts to develop short-term climate scenarios that capture the adverse implications in the near term of disorderly climate transition efforts and natural disasters. In a Call for Expression of Interest published on May 24, the NGFS observed that short-term climate scenarios are intended to complement the NGFS's existing framework of long-term climate scenarios, and will be based on detailed narratives and recommendations around scenario design, shocks, calibration and model implementation. The NGFS plans to commence developing scenarios in the third quarter of 2023.

Launched in 2017, the NGFS is a group of 125 central banks and supervisors based on five continents that share best practices and contribute to the development of environment and climate risk management in the financial sector, and seek to mobilize mainstream finance to support the transition toward a sustainable economy. NGFS members themselves are responsible for the supervision of all global systemically important banks and 80% of internationally active insurance groups.

Experts will be charged with creating macroeconomic models that can simulate various shocks related to transition and acute physical risks. In addition, these experts will guide the NGFS in understanding the modelling output and making the data available to a wider audience.

Since 2020, the NGFS has used climate scenarios to help central banks and supervisors explore the possible impacts of climate change on the economy and the financial system. These climate scenarios explore a range of plausible outcomes:

- "Orderly" scenarios assume climate policies are introduced early and become gradually more stringent, with relatively subdued physical and transition risks.
- "Disorderly" scenarios explore higher transition risks due to delayed or divergent policies across countries and sectors.
- "Hot house world" scenarios assume some climate policies are implemented in some jurisdictions, but that global efforts are insufficient to halt significant global warming, leading to severe physical risks and irreversible impacts such as rising sea levels.

- “Too little, too late” scenarios assume that a late transition fails to limit physical risks.

Taking the Temperature: As we have observed, the European financial sector has been using climate scenarios, including those developed by NGFS, to assess the implications of unchecked climate change and “stress test” financial institutions through various time periods. U.S. financial regulators have undertaken similar assessments.

The NGFS joins the UN Environment Programme Finance Initiative (“UNEP FI”), for example, which has been using short-term scenarios for some time. In May 2022, the UNEP FI released a report exploring three climate-driven macroeconomic shock scenarios for financial institutions – a sudden rise in carbon price, a spike in oil price and a trade war.

(This article originally appeared in Cadwalader Climate, a twice-weekly newsletter on the ESG market.)