Odessa Technologies®

Asset Finance & The Dodd-Frank Act

PART 2: MAIN BANKING CAPITAL RULES

Acknowledgements

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Odessa Technologies, Inc. is the developer of the LeaseWave® suite of products, a fully integrated browser-based lease and loan origination and portfolio management system designed to meet world-class standards of scalability and performance required by the largest equipment leasing and finance, vehicle leasing and fleet management companies. LeaseWave® is comprised of a suite of 120 configurable modules that fully automate leasing company operations while generating the accounting entries for every transaction. The company is headquartered in Philadelphia, Pennsylvania and employs a staff of 260 people exclusively focused on the global leasing industry.

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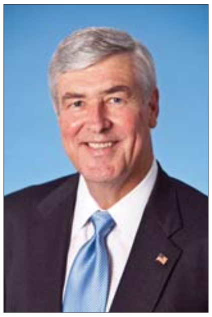
Foreword from William G Sutton, President and CEO, ELFA



The Equipment Leasing and Finance Association (ELFA) is the trade association representing over 500 financial services companies and manufacturers in the U.S. equipment finance sector, which includes financial services companies and manufacturers engaged in financing capital goods. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation.

Each year American businesses, nonprofits and government agencies invest over $1.2 trillion in capital goods and software (excluding real estate). Some 51%, or $628 billion, is financed through loans, leases and other financial instruments. America's equipment finance companies are the source of such financing, providing access to capital. Equipment finance companies also finance the export of U.S. manufactured products abroad.

Advocacy on behalf of the industry is a critical benefit of ELFA membership. With the Dodd-Frank Wall Street Reform and Consumer Protection Act now law and into the regulatory process, ELFA is fighting for sound rules that will continue to allow our industry to provide capital to businesses, governments and the non-profit sector for investment in capital plant and equipment.

ELFA's advocacy efforts on the Dodd-Frank law have focused on three main areas of interest for the equipment leasing and finance sector: risk retention rules on equipment finance securitization and syndications; the impact of Section 1071 loan data collection provisions and conflicts with the Equal Credit Opportunity Act (ECOA); and regulation of non-bank financial institutions. These three main issues were identified and prioritized through the efforts of the association's Financial Regulatory Reform Subcommittee of its Legal Committee. The committee is made up of employees at member companies that are experts in the field of regulatory enforcement, and as the implementation of Dodd-Frank continues, the committee members will continue to assess the impact of proposed rules on the industry and determine how involved ELFA will be in the regulatory process.

On risk retention, ELFA submitted two different comment letters during the comment periods in 2011 that requested regulators to create a workable framework for equipment finance securitizations. Equipment loans and securitized assets have significant variations and expected credit performance characterizations. In reviewing the proposed rules, ELFA raised concerns over the amount of detail provided in asset-level disclosures that raise privacy and competitiveness questions. The rules could undercut issuances in the market through group or asset level disclosure as it tries to create comparisons across a very heterogeneous industry. Altogether, the proposed rules could have adverse impacts on the ability of the equipment finance sector to access the capital markets.

Section 1071 of the Dodd-Frank law requires financial institutions to inquire if a commercial entity is a woman-owned, minority-owned or a small business. This provision seems to be in direct conflict with ECOA rules and would necessitate a separate and parallel system for information collection, maintenance, and dissemination in an attempt to comply with both legal requirements. ELFA worked successfully to get a delay in both the issuance of a regulatory framework and implementation of new rules and continues to advocate for the repeal of this provision in the commercial equipment finance space.

Finally, Dodd-Frank created provisions to require non-bank financial institutions that pose a risk to the stability of the U.S. to submit to regulation by the Federal Reserve Board. The law governs companies predominately engaged in financial activities, but exempts companies earning less than 85% of their revenues from financial services from regulation by the Federal Reserve. The Financial Stability Oversight Council in March 2011 defined a significant non-bank financial company as one with $50 billion or more in assets. A regulatory standard was also created through ELFA's advocacy and is governed by a series of considerations including the amount of leverage, amount and nature of the assets, amount and types of liabilities, off-balance sheet exposures, and the amount of credit provided to commercial and retail customers.

ELFA member company employees volunteer time and energy toward determining our industry's policy position, drafting comments and testimony, and even meeting with the appropriate regulators to ensure our industry is properly represented. Regulatory advocacy, in this case Dodd-Frank, is just one dimension of the benefits of ELFA membership.

For more information, please visit the Advocacy page on the ELFA website at www.elfaonline.org/Advocacy/Fed/.

William G. Sutton, CAE
President and CEO, ELFA

Introduction

This is the second in the series of White Papers on the implications of the Wall Street Reform and Consumer Protection Act, or the "Dodd-Frank Act", passed by the US Congress in July 2010, which are being produced by Asset Finance International in association with Odessa Technologies.

This report concentrates on the main changes in bank solvency rules, following the first one focused on the changes affecting securitization deals. Later reports will cover:

- other aspects of banking regulation, including the Dodd-Frank proposals for orderly wind-up of insolvent banks and protecting taxpayers from exposures to bank bailouts; and
- proposals affecting the credit rating agencies and their reports on banks and their commercial customers.

The main focus of interest for AFI and Odessa is the impact of these changes on leasing and asset finance. Banks are of course important in the leasing market, both as large scale funders of non-bank lessors and in many cases as lessors in their own right. In the main the bank solvency rules apply equitable treatment to bank leasing and lease funding activities, compared with comparable bank exposures in analogous lending facilities.

The changes noted below affecting banks in general will therefore nearly all be pertinent to the banks' various types of involvement in the leasing market. Where there are specific implications for leasing, these are noted.

As detailed below, more stringent capital regulations under Dodd-Frank are concentrated on various defined categories of larger institutions. These are the ones thought to pose the greatest systemic threat of instability. Pre-existing prudential rules for smaller banks are generally left unchanged.

Regulation of non-banks

Under Sections 113-115 of Dodd-Frank, the new Financial Stability Oversight Council (FSOC) established by Section 111 of the Act may determine that a non-bank financial company (NBFC) shall be supervised by the Federal Reserve. This would make the company subject to similar prudential rules to those applied to regulated banks. Under Section 113 (a) (1), a two thirds majority of FSOC including its Chairperson (i.e. the Treasury Secretary) is required for such a decision.

Such a decision can be made if the FSOC determines that any "material financial distress" of such a company, or "the nature, scope, size, scale, concentration, inter-connectedness or mix of [its] activities" could pose a threat to US financial stability. Section 113 (a) (2) sets out a number of criteria that must be considered by the FSOC in deciding whether to designate a US NBFC for banking-type supervision. These include:

- the extent of the company's leverage;
- its off-balance-sheet exposures;
- its transactions and relationships with other significant NBFCs, and/ or with significant bank holding companies (BHCs);
- the extent to which the company may already be regulated by any financial regulation agencies;
- the amount and nature of its financial assets; and
- the amount and type of its liabilities, including the extent of reliance on short term funding.

Similar considerations are laid down in Section 113 (b) for the possible regulation of a foreign NBFC with significant US activities.

Under Section 113 (d), all determinations for the Federal Reserve regulation of NBFCs must be re-evaluated by FSOC at least once every year. Each one can be rescinded, though this again requires a two thirds majority vote in FSOC.

Section 115 allows for some NBFCs to be subjected to more stringent regulatory parameters than others. Under sub-section (a) (2) (A), such differentiation can be determined by FSOC either on an individual basis or by category of company. These decisions must have regard to such criteria as "capital structure, riskiness and complexity" of the relevant companies.

Section 115 (a) (20 (B) permits FSOC to recommend a minimum asset level threshold of $50 bn for the application of any specific prudential rule to NBFCs.

To date, no designations of NBFCs have been made under the Act. The principle of bringing non-banks into the scope of banking-type regulation has been criticized by some commentators, who suggest that it may dilute the essential focus of banking supervisors on the deposit takers already subject to regulation.

Alluding to the recent major hedging losses in the London investment office of J P Morgan, Richard Breeden, chairman of Breeden Capital Management and a former chairman (1989-93) of the Securities and Exchange Commission (SEC), wrote recently: "If the Fed could not stop the 'London whale' inside a bank it knows intimately, what reason is there to think it will do any better spotting, let alone controlling, the risks at General Electric, Fidelity or whatever other companies are ultimately determined to be systemically important [NBFCs]?" (Financial Times, June 1 2012)

Certain types of NBFC, such as insurance or fund management groups, are perhaps more likely than others to remain outside the scope of banking regulation through the above quoted criterion concerning other financial regulatory regimes in Section 113 (a) (2). However, General Electric, which has significant equipment leasing and asset finance activities, has often been mentioned as a possible candidate for regulation under this Dodd-Frank provision.

There are a number of US manufacturer-captives or other non-bank lessors whose main holding companies and leasing operations are not currently within the scope of banking supervision, Some of these groups have certain subsidiaries which for various reasons do have banking charters, but do not undertake the group's leasing business. Potentially their holding companies could be viewed as candidates for NBFC designation.

Fed Proposals For Certain Large Groups

Sections 165-166 of Dodd-Frank mandated the Federal Reserve to develop a package of enhanced prudential standards for:

- existing regulated BHCs with consolidated assets of $50 bn or more;
- foreign banking organizations, treated as BHCs for the purposes of the Bank Holding Company Act 1956 pursuant to Section 8 (a) of the International Banking Act 1978, and subject to the same $50 bn threshold; and
- any NBFCs that might be designated pursuant to Section 113 of Dodd-Frank (see above), whether or not the permitted $50 bn threshold were applied to these for any or all such prudential standards.

In accordance with these requirements, the Federal Reserve issued Proposed Rules (PRs) for most of these institutions on January 5 2012 ("Enhanced prudential standards and early remediation requirements for covered companies"), for which the response deadline for comments expired on March 31 2012.

The "covered companies" subject to these proposals will be BHCs and any NBFCs that may in future be designated by FSOC. Foreign banking organizations within this Dodd-Frank mandate will be subject to a separate set of proposals due from the Federal Reserve later, which are likely to follow similar lines. However, foreign-owned US BHCs which are themselves above the $50 bn threshold will be within the scope of the initial proposals.

As detailed below, and as mandates in general terms by Dodd-Frank, the proposals included:

- enhanced standards for risk based capital and leverage requirements;
- enhanced liquidity requirements;
- enhanced risk management rules;
- single counterparty credit exposure limits (which are not an existing requirement for BHCs as such, though they are so in the regulatory regimes for individual banks, whether regulated by the Federal Reserve or by other agencies);
- stress testing requirements;
- new debt-to-equity limits (separate from the existing leverage rules) for those covered companies that may be designated by FSOC to pose a "grave threat to financial stability"; and
- "early remediation" proposals for covered companies considered dangerously close to their minimum prudential requirements.

Most of these PRs would be implemented from 12 months after the date when they are finalized. The finalization date is not yet known, but is likely to be later this year.

In addition to these mandated standards, in related areas Dodd-Frank authorizes, but does not require, the Federal Reserve to apply additional new standards to the covered companies, including:

- contingent capital (i.e. possible requirements for minimum levels of loss-absorbing debt instruments); and
- limits on totals of short term debt.

The Federal Reserve is not proceeding with any of those non-mandated proposals at this stage, but is committed to keeping them under review.

Capital ratios etc

Section 165 (b) (1) (A) (i) of Dodd-Frank requires enhanced risk-based capital and leverage ratios for covered companies. As with many other provisions in the Act, the mandate is not quantified beyond the requirement to “enhance” pre-existing requirements.

In its PRs statement, the Federal Reserve suggested that the first stage of this mandate had been satisfied in respect of BHCs by a recent tightening of the capital rules for those above the $50 bn threshold.

All regulated banks have to show an ability to meet current minimum requirements – tier 1 capital at 4% of risk-weighted assets (RWAs), total capital at 8% of RWAs, and a leverage ratio of tier 1 capital to unweighted assets of 4% – on a forward-looking time horizon over nine quarters, under both “baseline” and “stressed” conditions.

In addition, BHCs above the $50 bn threshold must now go beyond the tier 1 capital rule for other regulated banks by demonstrating an ability to keep “tier 1 common equity” (after deducting certain types of preference stock and minority interests in subsidiaries permitted within basic tier 1 capital) above 5% of RWAs.

The PRs proposed that any designated NBFCs would have to meet the current capital and leverage rules for all banks, rather than those now required for the large BHCs.

The PRs suggested that the Federal Reserve can complete a second and final phase of compliance with the Dodd-Frank mandate on enhanced capital for large institutions, through additional capital surcharges for the very largest BHCs, in compliance with the Basel III international proposals for global systemically important banks (G-SIBs).

For a target group of around 30 G-SIBs at the global level, to be determined according to criteria of size, inter-connectedness, complexity and the extent of cross-border activity, the Basel Committee of Banking Supervisors (BCBS) finalized its requirements in November 2011, for phasing in over the three years from January 2016. There will be five graded categories for G-SIBs, where surcharges of “common equity tier 1 capital” (a similar aggregate to the above mentioned Federal Reserve definition of common equity) to RWAs, above the minimum ratio to apply to all banks, will range from 1 to 3.5%.

The Federal Reserve plans to formulate and adopt rules during 2014 for US compliance with the Basel III G-SIB requirements.

Liquidity rules

Section 165 (b) (1) (A) (ii) of Dodd-Frank mandates enhanced liquidity requirements for covered companies.

The PRs proposed a multi-stage process. Initially, there would be a requirement for these institutions to conduct monthly internal stress tests to measure their liquidity needs over three distinct time frames (30 days, 90 days and 12 months), at times of instability. They would be required to hold liquid assets sufficient to cover 30-day outflows in stressed conditions.

Later, for “internationally active banks” (IABs) which will include at least a sub-set of the covered companies addressed by the Dodd-Frank mandate (together with some other US banks), there will be further liquidity rules in compliance with Basel III.

From January 2015 BCBS requires IABs to adopt a “liquidity coverage ratio” (LCR). This will be similar to the above US rule which should by then be already adopted, except that the required holdings of liquid assets under LCR will be of higher minimum quality.

Then in addition from January 2018 BCBS requires IABs to adopt a more sophisticated “net stable funding ratio” (NSFR). This extends the forward time frame out to 12 months, and measures a range of quality-weighted liquid assets to be required against a risk-weighted measure of potential cash outflows.

Large exposures

Section 165 (e) of Dodd-Frank mandates a general credit limit of 25% of total capital, for covered companies' exposures to single counterparties (including single groups of connected parties). It authorizes the Federal Reserve to reduce this limit if such is judged necessary to mitigate risks to US financial stability. This statutory provision allows exemptions from the general rule that are judged to be in the public interest, and consistent with the purposes of the legislation.

The 25% rule is equivalent to that already applied to US banks in general – but, as noted above, not previously at consolidated level for BHCs. The PRs have now proposed a general 25% limit for covered companies.

A tighter 10% limit (for the same ratio of the maximum single counterparty exposure in relation to the capital of the lender or lessor) was proposed for cases where each party - i.e. both the lender/lessor and its customer - either has assets of over $500 bn or is a non-bank covered company (a category not yet brought into operation, as noted above).

The proposals would take account of risk mitigation through collateral, guarantees or credit derivative hedges. Among firmly proposed exemptions in the PRs were;

- exposures to US government agencies;
- intra-day exposures on payment and settlement of transactions; and
- a catch-all category to add any other exemption that the Federal Reserve may consider to be in the public interest.

The PRs raised the possibility of exempting some foreign sovereign exposures, e.g. to central banks arising from foreign banking operations.

In relation to exposures to securitized transactions, the PRs also raised the possibility of requiring covered company investors to “look through” a special purpose vehicle (SPV) structure so as to aggregate the exposure with other exposures to the originating lender or sponsor. This might be required only where the SPV failed a specified diversity test (e.g. requiring coverage of 20 or more underlying exposures).

As for the measurement of capital for the purposes of these rules, the PRs tentatively suggested basing it on total regulatory capital. However, they also raised the possibility of narrowing it to tier 1 common equity.

The new single counterparty rules for covered companies will not come into operation before October 1 2013, should this be later than the general PR implementation date of 12 months from finalization of the rules.

Qualitative risk management

Section 165 (h) of Dodd-Frank requires all publicly quoted banking companies with over $10 bn of assets to establish a risk committee with oversight of enterprise-wide risk management, made up of independent directors including at least one risk management expert.

Though mainly otherwise concerned with a narrower range of large banks, and with quantitative rules, the PRs addressed this Dodd-Frank mandate. For the covered companies, the Federal Reserve made proposals for robust enterprise-wide risk management procedures, overseen by a risk committee at board level and a chief risk officer with an appropriate level of independence. The risk committee proposal was extended to all quoted BHCs above the $10 bn threshold.

Stress testing

For covered companies, Section 165 (i) (1) of Dodd-Frank requires the Federal Reserve to impose rules for stress testing capital against adverse economic conditions, and to publish a summary of the results. In addition, Section 165 (i) (2) requires internal company-run stress tests annually for all regulated banks above a $10 bn assets threshold, and semi-annually for covered companies.

Prior to the enactment of Dodd-Frank, the Federal Reserve had been overseeing stress test exercises across major banks since early 2009 in response to the previous year's credit crisis, and has been publishing some results from late 2010. The PRs outlined how these will be adapted to the statutory mandates in Dodd-Frank,

For the supervisory stress tests (i.e. those to be carried out by the Federal Reserve annually at the covered companies) the PRs set out a range of proposed parameters. They will be based on a threefold range of economic scenarios (baseline, adverse and severely adverse). These will incorporate a range of assumed macroeconomic variables such as GDP, unemployment rates, house prices and equity prices.

For those tests, the Federal Reserve proposes to publish company-specific results, covering each quarter-end over the forward planning horizon, to include:

- estimated losses, including broad portfolio breakdowns;
- net revenue before provision for losses;
- allowances for loan losses;
- pro forma regulatory and other capital ratios.

For the company-run stress tests, there are broadly similar proposed ground rules for both the methodology and the results, to be published in this case within 90 days of being communicated to the Federal Reserve.

Debt-to-equity ratios

While all regulated banks are subject to a general leverage rule, requiring tier 1 capital to be at least 4% of weighted risk assets, Section 165 (j) of Dodd-Frank mandates an additional new leverage-type ratio for those covered companies considered to pose particular systemic risks. This is to be based on a 15-1 ratio of total debt to equity.

Cross-referring to the criteria for NBFCs in Section 113, the Act mandates FSOC to apply the risk criteria to individual companies based on the following factors:

- the extent of leverage (under the existing regulatory rule);
- the scale, concentration and inter-connectedness of the company's activities; and
- its importance as a source of credit to US households and businesses.

As this particular mandate includes a specified numerical rule (in contrast with most other Dodd-Frank provisions), it leaves relatively little discretion to the regulator. However, the PR made proposals for procedures to notify the relevant identified companies and give them time to comply where necessary by either raising additional capital or liquidating assets.

It was proposed that companies should always have 180 days to comply, and should be given permission to request up to two further extensions of 90 days each.

It was proposed that for the purposes of this rule, “debt” and “equity” would have the same respective meanings as total liabilities and total equity capital.

Proposed levels for early remediation		
Defined level	**Regulatory capital requirement**	**Restrictions**
Level 1 (Heightened supervisory review)	Well capitalized (tier 1 capital >6%, total capital >10%, and tier 1 leverage ratio > 5%), but company has demonstrated capital structure or capital planning weaknesses	Fed to produce initial report on elements evidencing deterioration within 30 days of level 1 trigger breach, and determine possible move to higher level
Level 2 (Initial remediation)	Fails to meet any one of Level 1 criteria, but maintains tier 1 capital > 4%, total capital > 8%, and tier 1 leverage ratio > 4%	Capital distributions (dividends or share buybacks) restricted to 50% of net income in previous two quarters. Growth restrictions: no more than 5% growth in either total assets or RWAs per quarter or per annum; and company cannot acquire control of another. Non-public memorandum of understanding to be agreed with Fed.
Level 3 (Recovery)	Either (i) fails to meet any one of level 2 criteria, but maintains tier 1 capital >3%, total capital > 6% and leverage ratio > 3%; or (ii) remains below 6% tier 1 capital, 10% total capital, or 5% tier 1 leverage ratio, for more than two complete consecutive quarters.	Written agreement prohibiting all capital distributions, and any quarterly growth in total assets or RWAs, and all material acquisitions. Requirement to raise additional capital to come above regulatory minimums; and divestiture requirement if agreed timetable not met. Supervisors may remove culpable senior managers. Prohibition on discretionary bonus payments, and restrictions on all pay increases.
Level 4 (Recommended resolution)	Below any of 3% tier 1 capital, 6% total capital, or 3% tier 1 leverage ratio	Fed to consider recommendation to Treasury and Federal Deposit Insurance Corporation (FDIC) for orderly liquidation under Title II of Dodd-Frank

Early remediation

Section 166 of Dodd-Frank mandates the Federal Reserve to produce regulations for early remedial action for covered companies in a distress position, to minimize the probability of their insolvency. For this purposes, it specifies the use of certain types of trigger measure; and that the remedies required should progressively increase in stringency for specified levels of deterioration in the financial condition of the relevant company.

However, most of the formulation of the criteria was delegated to the Federal Reserve. The PR proposed four graded levels of remedial requirement. Each level could be triggered by either regulatory capital numbers being close to the minimum solvency criteria, or by weaknesses measured against the proposed liquidity requirements or qualitative risk management standards (see above), or by either of two forward-looking triggers, based on:

- results of supervisory stress tests (see above); or
- additional market based indicators (see below), providing third party assessments of a company's position.

These market based indicators would include four separate “equity based” factors, including the expected default frequency (EDF) which aims to measure the probability of a company's default in the next 12 months using Moody's KMV RISKCALC model; and other widely used indicators assessing such factors as expected volatility of the company's share price.

There are also “debt based” factors, in the shape of credit default swap (CDS) rates for protection against the financial company's default on a 5-year maturity, and its subordinated bond spreads over the Treasury rate on the same maturity or the LIBOR swap rate.

The table on page 11 illustrates the proposed rules for each successive degree of assessed distress, by reference to the regulatory capital triggers (though as noted above, there would be several other triggers that could operate independently) and the type of restrictions applied at each level.

For those covered companies subject to Basel rules (see above), the PR envisaged subsequent changes conforming with Basel III changes during the 2016-2019 period. For phased implementation over that period, BCBS requires a range of “capital conservation buffer” zones, similar to the Fed's remediation categories, and with similar types of restrictions. However, the metrics of the two systems are not identical.

"Advanced Approach" And Collins Amendment

Some of the largest banks face an additional complication from a separate Dodd-Frank provision. These are "internationally active banks" (IABs), subject to what is termed the "advanced approach" to risk capital measurement under the Basel rules. They will include some of those "covered companies" subject to the changes described above, but also some other institutions not within the definition of BHCs,

The advanced approach provides for RWAs to be determined by risk modelling techniques to be overseen by bank supervisors, as opposed to the limited range of standardized risk asset weightings (RAWs) under the "generally applicable" (GA) approach to capital measurement applied to the majority of banks.

Those US banks for whom IAB status is mandatory are called "core banks". They are those which have either:

- total assets above $250 bn; or
- total on-balance-sheet foreign exposures above $10 bn.

Some other banks, termed the "opt-ins", have chosen to operate under the advanced approach although they are below the above size thresholds. For the advanced approach generally results in lower minimum capital requirements compared with the GA approach, due to lower RAWs.

Within leasing portfolios of regulated banks, the comparatively lower RAWs under the advanced approach will be pertinent to the lease receivables. The weightings of residual value (RV) exposures, however, will be at the same level under either approach, and generally below the receivables weighting in the case of the advanced approach.

US banks subject to the advanced approach are not yet benefiting from its regulatory capital advantages, due to transition provisions still running from the time when the advanced approach was first adopted. Their prospects of benefiting from it at an early date have now been dealt a blow by Section 171 of Dodd-Frank.

This Section was a late addition to the Dodd-Frank Bill shortly before its final enactment, sometimes known as the Collins amendment after its sponsor Senator Susan Collins. Reportedly unwelcome to the banking authorities, it nevertheless provided a firm mandate which is now reflected in implementing regulations.

Section 171 (b) provides for minimum regulatory capital and leverage ratios to be no lower than the GA requirements as at the date of Dodd-Frank enactment in 2010. In the case of capital requirements (as opposed to leverage, which is not subject to separate rules in the advanced approach), this had very significant implications for IABs.

The US banking regulators adopted the advanced approach in December 2007, following the finalization of the Basel II regime which currently remains in force pending the transition to Basel III from January 2013. However, they provided for 3-year transition periods, to smooth the adjustments from the GA rules to the advanced approach.

For each IAB that transition period would not begin until there had been a satisfactory period of parallel running, during which the bank would file regulatory reports under both sets of rules but would remain governed by the GA rules. At the time that the regulators needed to implement Section 171, all of the IABs were still in parallel running, and none had moved into their intended transition periods.

The regulators' solution

In June 2011 the Federal Reserve, Office of the Comptroller of the Currency (OCC) and FDIC adopted a final rule for implementing the Section 171 (b) requirement. This confirmed the relevant proposal issued for consultation in December 2010. The GA rules are now to remain in place as a “permanent floor”, for those banks applying the advanced approach.

Thus the IABs will continue to have to compute their capital requirements according to both sets of rules (GA and advanced). The lower of the resulting two tier 1 capital levels, and the lower of the two total capital levels, as derived under this dual computation, will each have to be compared with the respective minimum ratios of 4% for tier I and 8% for total capital.

This arrangement will remove the advantages that the IABs could have expected to accrue from around the current year, as the previously proposed transition periods began to take effect. Those lost advantages would have applied both in operational terms, through the ending of the parallel running periods, and in competitive terms since in most cases the advanced approach would have appreciably reduced capital requirements.

Although the regulators describe the resulting arrangements for IABs as permanent, they will in fact be superseded at some point through the transition from Basel II to Basel III. For the Basel III rules, most of which will be phased in through gradual changes over the six years up to 2019, will in fact raise both the GA and advanced versions of capital requirements substantially above the GA base point required as a floor by Section 171 (b).

At the same time it is likely to remain the case that the advanced approach will generally require less regulatory capital compared with GA levels. For the global changes this time are concentrated on common equity tier 1 capital requirements, rather than RAWs. Therefore it is possible that ultimately the IABs will be able to realize some advantage from the advanced approach under the Basel III regime.

In their final notice, the regulators say that they will undertake quantitative analysis of the evolving regulatory framework to ensure that, for all banks so far as possible, minimum capital rules will be floated off from the GA floor set by Section 171 (b). Although higher capital rules are of course never welcomed by the regulated banks, it has long been clear that they will be coming into force across the board in varying degrees. By making this commitment the US regulators intend to ensure that banks in future do not have to face a new form of parallel reporting (under both current and historic rules) as a consequence of the static floor built into the statute.

IABs in general were highly critical of the “permanent floor” solution adopted by the regulators, although some accepted that the terms of Section 171 (b) left them little choice. In a comment on the initial proposals in February 2011, the American Bankers Association (ABA) argued that the proposed approach would unfairly penalize firms subject to the advanced approach and would "significantly undermine the progress made towards a more risk-sensitive approach".

Referring to the opt-in banks, the ABA added: "Imposing a floor that is tied to Basel I rules approach raises the question of why any bank would want to undertake the expense and effort to convert to the advanced approaches rules if it has the option not to do so.”

Current US banking regulations for non-IASBs are in conformity with the pre-2005 international Basel I requirements, before the introduction of the advanced approach under Basel II – hence the above ABA reference to Basel I.