U.S. Prepares to Place
Stricter Rules on 8 Biggest Banks

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JPMorgan Chase & Co. (JPM), Wells Fargo & Co. (WFC) and Goldman Sachs Group Inc. are among eight U.S. banks facing a new round of domestic rules on capital and debt that would be even stricter than global standards approved today.

Regulators will push banks to maintain a leverage ratio of capital to assets that exceeds the 3 percent minimum set by the Basel Committee on Banking Supervision, Federal Reserve Governor Daniel Tarullo said today, and the Federal Deposit Insurance Corp. said a proposal may be published next week. Another measure "in the next few months" would compel banks to hold a set amount of equity and long-term debt to help regulators dismantle failing lenders, Tarullo said.

The remarks show U.S. regulators plan to ratchet up demands for bigger buffers against losses to prevent a repeat of the 2008 credit crisis, brushing aside protests from bankers who say lending and profit will be hurt. The Fed's board unanimously approved new global rules known as Basel III today even as Tarullo said key parts are too weak.

"We're in the first few chapters of a horror story for the big banks, with the worst to come," said Coryann Stefansson, a director at PricewaterhouseCoopers LLP. "It's clear that U.S. is willing to push for stronger capital, even without the support of the Basel committee."

People with knowledge of the matter have said U.S. regulators may want to double Basel's 3 percent capital threshold, known as the leverage ratio.

New Restraint

“If the leverage ratio is raised to six, that would be a major tightening by the U.S. above and beyond the global agreement,” said Stefan Walter, the Basel committee’s secretary general until October and now a principal at Ernst & Young LLP. “In Basel, the leverage ratio was seen as a backstop, but at such a high level, it can become a new restraint on banks.”

The measures under consideration would affect the eight U.S. institutions already tagged as being “of global systemic importance,” according to Tarullo. The Financial Stability Board has identified those as JPMorgan, Wells Fargo, Goldman Sachs, Bank of America Corp. (BAC), Citigroup Inc. (C), Morgan Stanley (MS), State Street Corp. (STT) and Bank of New York Mellon Corp.

Other changes may include higher capital requirements for banks that rely on short-term market funding, and capital surcharges that the Basel panel is preparing to impose on firms whose failure might threaten the entire system, according to Tarullo. Spokesmen for the banks declined to comment or didn’t respond to inquiries about Tarullo’s remarks.

The U.S., along with 26 other members of the Basel Committee, must enact local regulations to carry out a 2010 revision of how minimum capital levels are set for the world’s banks. Those funds serve as a buffer against losses that might cause a global lender to collapse and bring down the entire financial system. The FDIC and Office of the Comptroller of the Currency are scheduled to vote on the Basel standards by July 9.

Profit Impact

When finalizing the rule, the U.S. eased requirements for some of the smallest firms while tightening for the biggest ones. Bankers have argued that new regulations and capital ratios will inhibit lending and erode profit.

The leverage ratio proposed by Basel represents a stricter standard for measuring capital than in the past. Traditional rules allowed bankers to sort their assets according to risk and set aside less money to cover the ones they judged to be less dangerous. Regulators became skeptical of the complex formulas behind those risk weightings after the financial crisis and instead demanded a minimum amount of capital to back assets regardless of the perceived risk.

Narrow Definition

Doubling Basel’s leverage ratio for banks “will put even those that view themselves as very well-capitalized under heavy pressure to raise still more tangible equity,” said Karen Shaw Petrou, managing partner of Washington-based Federal Financial Analytics. “The capital heat’s far from off for the biggest U.S. banks.”

The U.S. rules published today also narrow the definition of what counts as capital, in line with Basel’s revisions after the 2008 crisis, and reclassify derivatives and mortgage-based securities as more risky than in previous versions.

“This framework requires banking organizations to hold more and higher-quality capital, which acts as a financial cushion to absorb losses, while reducing the incentive for firms to take excessive risks,” Fed Chairman Ben S. Bernanke said in prepared remarks. “Banking organizations will be better able to withstand periods of financial stress, thus contributing to the overall health of the U.S. economy.”

Community Banks

Regulators surprised banks and analysts last year by imposing the new Basel framework on most community lenders. Lawmakers and lobbyists said the smallest companies shouldn’t be included because they didn’t cause the 2008 crisis, couldn’t raise capital as easily and might have to reduce lending.

Some of the rules, such as the non-risk-based leverage threshold, apply only to the biggest institutions or a smaller sub-group of the top six.

“Community (CBNK) and regional banks don’t pose systemic risks when they fail,” said Stefansson at PricewaterhouseCoopers. “So it’s easier to soften the rules on them without undermining the commitment to Basel or tougher capital rules.”

The final version released today allows almost all but the biggest firms to opt out of requirements that they take capital charges as the market valuation of their trading assets fluctuates. It also simplifies the risk calculation for mortgages, a process that community banks had argued was too cumbersome and expensive.

The original proposal had called for eight categories of risk for home loans and would assign 200 percent risk weights to the worst ones. The final version goes back to two categories and 100 percent risk weighting for the worst.

Hybrid Holdings

Banks with less than $15 billion in assets were also allowed to retain some hybrid securities that otherwise would no longer count as capital under Basel III.

About 90 percent of bank holding companies with less than $10 billion in assets already meet the new minimum capital requirements, the Fed said in a staff memo today. The rest would need about $2 billion in added capital to comply. That shortfall was $3.6 billion in June 2012 when the rules were announced.

Almost 95 percent of firms with assets of more than $10 billion meet the requirements and the shortfall is $2.5 billion, down from $6 billion last year. The Fed didn’t say which banks fell below the standard. The almost decade-long transition period should give banks enough time to comply, the Fed said.

Staggered Timetable

The rules go into effect Jan. 1 for the largest banks that use internal risk models to calculate capital needs while others get an extra year before starting to comply. The Basel framework has a stage-by-stage compliance schedule, with the requirements for capital going up every year until full levels are reached.

The Basel rules were created in 2010 by a committee of central bankers and regulators to improve and standardize safety guidelines that govern the world's lenders. Regulators in member nations have since customized the rules to reflect conditions in their own markets. Only half of the Basel members have completed their local rules so far.

The European Union, which has accused the U.S. of dragging its feet, just completed its internal approval process last week. Banks have eight more years to fully comply.

"On Basel III, the banks either meet or are very close to meeting the requirements," said Luigi De Genghi, a partner at Davis Polk & Wardwell LLP in New York and a member of the firm's financial institutions group. "Arguably they've gotten there through the stress-testing and capital planning process, which requires them to show how they'll meet Basel III."