The Ideas and Analysis Letter: The Sanchez "Take"
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The Capital Conservation Buffer

The business banking community cries out against regulations. Corporate management, especially banking managers, say they are overregulated. They complain about choke holds put on them by regulators. They scream about excesive overhead and regulatory buden. They want to be taxed less. They want to be left alone to do whatever they do best – make money.

Their cries to be less regulated; to be left alone; are loud and clear. We hear them. We also see their actions, which cry out for more regulations. It is hard to understand how one takes a position for less regulation in face of greed-driven business disasters of recent years such as the:

- Dot.com Bubble
- Asian Contagion
- Subprime Lending Fiasco
- Libor-Rigging Scandal
- Financial Engineering Abuses
- S&L Crisis
- Foreign Currency Manipulations
- Derivative Scandals (particularyl credit default swaps)
- Bank Involvement with Electricity and other Esoteric Derivatives
- FASB 105 OBS Accounting Scandal

Scandals are initially revealed. Then, they are fully understood. Then, monetary punishments are imposed on institutions. The punishments are dollar penalties that seem to be payments in exchange for engaging in the "crooked," (as in "not straight") behavior. The penalties are "peanuts" in relation to the big prizes –

the extra money drained out of the economy by strange, esoteric, unseemly dealings. No individual in a position of power ever seems to get hurt. No “Big Shot” is penalized and has to give up illbegotten profits. Rarely, is the perpretator of the “not straight” activity incarcerated. The “crook” (person behind the “not straight” activity) has the corporate entity pay the fine and then moves on to the next profit seeking venture – straight or otherwise.

In recent years, after the second great contraction of American capitalism, lawmakers have tried to re-set the rules to punish the “crooks.” One new attempt, born, it seems, out of the spirit of the not-favorably-thought-of Dodd-Frank legislation, is the idea of preventing bailouts of funds from depository institutions when they have serious capital shortages.

The new Capital Ratio rules that are part of Basel III of the OECD include a provision that requires conservation of capital. A certain minimum amount of capital must be on hand before executive bonus payments or dividends can be paid out. This capital conservation buffer is a breath of fresh air. It is a move in the right direction for regulators.

Capital Conservation Buffer

The Basel III rule requires that the minimum amount of Capital (the buffer) set aside functions as a cushion before a bank can pay executive bonuses or dividends. The rule comes into play on 1/1/16.

New Ratios

Firstly, Basel III requires the following new, higher than before, minimum ratios for four new metrics.

	Adequatley Capitalized	Well Capitalized
Common Equity Tier 1 (CET1) Capital Raio	≥ 4.5%	≥ 6.5%
Tier 1 Risk-Based Capital Ratio	≥ 6.0%	≥ 8.0%
Total Risk-Based Capital Ratio	≥ 8.0%	≥ 10%
Leverage Ratio	≥ 4.0%	≥ 5%

Limitations on Cash Bailouts

By calendar year 2019 a banking organization must maintain a capital conservation buffer of common equity Tier 1 Capital in an amount greater than 2.5 percent of total risk-weighted assets to avoid being subject to limitations on capital distributions and discretionary bonus payments to executive officers.

Mechanics

A banking organization’s capital conservation buffer is the **lowest of** the following:

(i) The banking organization’s common equity Tier 1 Capital Ratio minus its adequately capitalized minimum common equity Tier 1 Capital ratio of 4.5%
(ii) The banking organization’s Tier 1 Capital Ratio minus its adequately capitalized minimum Tier 1 Capital Ratio of 6.0%; and
(iii) The banking organization’s Total Capital Ratio minus its adequately capitalized minimum Total Capital Ratio of 8.0%

A banking organization's maximum payout amount for each of its current calendar quarters is equal to the banking organization's eligible retained income, multiplied by the applicable maximum payout ratio, in accordance with the table on the next page.

A banking organization with a capital conservation buffer that is greater than 2.5 percent is not subject to a maximum payout

limitation. Such a banking organization, however, may still be subject to limitations on capital distributions as a result of supervisory actions or other laws or regulations.

Capital Conservation Buffer and Maximum Payout

Capital Conservation Buffer (as a percentage of risk-weighted assets)	**Maximum Payout** (as a percentage of eligible retained income)
Greater than 2.5 percent	No payout limitation applies
Less than or equal to 2.5 percent and greater than 1.875 percent	60 percent
Less than or equal to 1.875 percent and greater than 1.25 percent	40 percent
Less than or equal to 1.25 percent and greater than 0.625 percent	20 percent
Less than or equal to 0.625 percent	0 percent

The table above illustrates the relationship between the capital conservation buffer and the maximum payout ratio. The maximum dollar amount that a banking organization is permitted to pay out in the form of distributions or discretionary bonus payments during the current calendar quarter is equal to the maximum payout ratio multiplied by the banking organization's eligible retained income.

The calculation of the maximum payout amount is made as of the last day of the previous calendar quarter and any resulting restrictions apply during the current calendar quarter.

How to Subsequently Avoid Maximum Payout

A banking organization that becomes subject to a maximum payout ratio remains subject to restrictions on capital distributions and certain discretionary bonus payments until it is able to build up its capital conservation buffer through retained earnings, raising additional capital, or reducing its risk-weighted assets.

Additionally, a banking organization cannot make distributions or certain discretionary bonus payments during the current calendar quarter if the banking organization's eligible retained income is negative and its capital conservation buffer was less than 2.5 percent as of the end of the previous quarter.

Compliance with the capital conservation buffer is determined **prior to** any distribution or discretionary bonus payment. Therefore, a banking organization with a capital buffer of more than 2.5 percent is not subject to any restrictions on payments even if such distribution or payment would result in a capital buffer of less than or equal to 2.5 percent in the current calendar quarter. However, to remain free of restrictions for purposes of any subsequent quarter, the banking organization must restore capital to increase the buffer to more than 2.5 percent prior to any distribution or discretionary bonus payment in any subsequent quarter.

Examples

The 2.5% buffer is fully effective on 1/1/19. However the capital conservation buffer must be calculated starting on 1/1/16 and the following table must be used in the interim between 1/1/16 and 1/1/19.

Transition Provisions for the Capital Conservation Buffer

Transition Period	Capital Conservation Buffer Percentage above which Institutions Avoid Limitations on Distributions and Certain Discretionary Bonuses
Calendar year 2016	0.625
Calendar year 2017	1.250
Calendar year 2018	1.875
Calendar year 2019 and thereafter	2.500

Starting on January 1, 2016, institutions must complete their Call Report Schedule RC-R, Part I, lines 47 ("Eligible retained income") and 48 ("Distributions and discretionary bonus payments during the quarter") if the amount on line 46a (the institution's own Capital Conservation buffer) is less than or equal to the applicable minimum capital conservation buffer.

Institutions must complete Schedule RC-R, Part I, lines 47 and 48, if the amount reported in Schedule RC-R, Part I, line 46a is less than or equal to the applicable capital conservation buffer described in the above table.

The ratio on line 46a must equal the lesser of:

Line 41 (CET1 Capital Ratio minus 4.5%)

Line 42 (Tier 1 Capital Ratio minus 6.0%)

Line 43 (Total Capital Ratio minus 8.0%)

Line 46a, "institution specific buffer," must be greater than the capital conservation buffer to avoid limitations (see above table) on paying dividends or paying bonuses.

Lines 47 and 48 are completed only if line 46a is less than the capital conservation buffer.

Example

For example, assume the following two insured depository institutions had the following capital ratios.

	Bank A at 2016	Bank B at 2016
CET1 (Line 41)	10.65%	7.00%
Tier 1 (Line 42)	10.65%	7.00%
Total (Line 43)	11.53%	7.90%
Leverage (Line 44)	8.03%	3.00%

Bank A at 2016

Line 46a institution specific capital buffer:

Lesser of: Line 41 less 4.50% = 10.65% - 4.50% = 6.15%
Line 42 less 6.00% = 10.65% - 6.00% = 4.65%
Line 43 less 8.00% = 11.53% - 8.00% = 3.53%

The lesser ratio is 3.53% ; the amount for Line 46a.

Lines 47 and 48

Nothing is reported on Lines 47 or 48 because Line 46a with 3.53% is greater than 0.625%, the 2016 buffer percentage above which there are no limits on distributions and discretionary executive bonuses.

Limitations

In this case Bank A would have no limitation on distributions and discretionary bonuses.

Bank B at 2016

Line 46a

Institution specific capital buffer:

Lesser of Line 41 less 4.50% = 7.00% - 4.50% = 3.00%
Line 42 less 6.00% = 7.00% - 6.00% = 1.00%
Line 43 less 8.00% = 7.90% - 8.00% = **Minus 0.10%**

The lesser ratio is **minus 0.10%**; the amount on line 46a.

Lines 47 and 48

The **minus 0.10%** on line 46a is les than the 2016 0.625% capital buffer percentage above which there are no limits on distributions and discretionary executive bonuses. Lines 47 and 48 must be completed and payout can not avoid limitations.

The maximum payout would be **zero** because the capital conservation buffer of minus 0.10% on line 46a is less than 0.625%.

Relief to Avoid Raiding the Bank's Capital

Although January 1, 2016 is the first time that banks are required to present on their Call Reports the determination about whether there are limitations, many banking organizations have already done so, informally. They want a "sneak preview" about their ability to pay dividends and/or executive bonuses in light of their capital situation.

The Basel III capital buffer is keeping banks on the "straight and narrow."

The cushion serves as a regulation that prevents corporate managers from raiding the capital when it is at a dangerously low level.

This new regulation follows a sensible approach. It will prevent unjustified bailouts at crucial times that, if made, would decimate the bank and make it a "ward" of the regulators.

The new regulation will avoid losses being absorbed by other than those who put the organization into a sorry state in the first place – the management.

Those who mismanage a bank should not be allowed to bail out money, put the bank in violation of minimum capital requirements and then leave what is remaining to others to deal with.

The buffer, obviously not very well-liked by mangagement, seems to be a rarely seen step in the right direction.

We need more intelligent regulation such as the capital conservation buffer.

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