Dodd-Frank Act: minimum capital requirements

The Dodd-Frank Act requires banking regulators to revise and/or establish the minimum leverage and risk-based capital requirements for bank holding companies and systemically important nonbank finance companies. These groups will now have to comply with the standards that are already in place for banks. In the future, new standards for risk based capital and leverage ratio cannot be set any lower than the requirements that were in force in July 2010 when the Dodd-Frank Act was passed.

At present the requirements are categorized as 'well capitalized' and 'adequately capitalized'. Banks which conduct plain vanilla banking activities only need to classified as 'adequately capitalized' while banks which engage in more complex activities such as securities trading need to be 'well capitalized' to reflect the additional risk undertaken.

		To be considered 'well capitalized'	To be considered 'adequately capitalized'
Minimum risk-based capital ratios	Tier 1 capital ratio	6%	4%
	Total capital ratio	10%	8%
Minimum leverage ratio		5%	4%

As well as increasing the amount of capital held, the Dodd-Frank Act also aims to increase the quality. Hybrid capital and Trust Preferred Securities are eliminated from Tier 1 capital.

The formula for risk-based capital requirement must include:

$$\text{Capital Adequacy Ratio} = \frac{\text{Regulatory Capital}}{\text{Risk Weighted Assets}}$$

Formula for leverage requirements must include:

$$\text{Leverage Ratio} = \frac{\text{Regulatory Capital}}{\text{Average Total Assets}}$$

The Dodd-Frank Act has a lot on common with the capital and leverage requirements outlined in Basel III as they seek to address similar risks and counter similar deficiencies exposed in the financial crisis. The U.S. has signed up to Basel III despite not fully adopting Basel II. However, with regard to minimum capital requirements, Dodd-Frank minimum ratios would take precedent over those in Basel III or any future Basel regulation.

Regulations must be issued no later than January 2012. There are phase ins and grandfathering for the exclusion from Tier 1 capital for hybrid debt or equity instruments issued before May 19, 2010.