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BASEL III ENDGAME PROPOSAL COULD UNDERMINE U.S. CLEAN ENERGY AND INFRASTRUCTURE POLICY

On July 27, 2023, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC" and, together with the Federal Reserve and the FDIC, the "Agencies") issued a notice of proposed rulemaking that would implement the remaining elements of the Basel III Accord (colloquially known as the "Basel III Endgame") into the U.S. bank capital framework[1]. The Proposal revises the capital requirements applicable to large banking organizations (those with total assets of $100 billion or more) and banking organizations with significant trading activity[2]. Among the proposed revisions is a significant increase in the risk weight assigned to non-publicly traded equity exposures, including certain tax equity investments. This change, if adopted, would make it prohibitively expensive for banks to make certain tax equity investments, which, given the substantial participation of banking organizations in this market, is certain to have a harmful, albeit likely unintended, impact on the financing of clean energy and infrastructure projects.

In this briefing, we discuss the current treatment of tax equity investments under U.S. bank capital rules and how such investments would be treated if the Proposal is adopted by the Agencies without modification. Additionally, we assess the likely impact that the adoption of the Proposal would have on the tax equity financing of clean energy and infrastructure projects.

BACKGROUND

Under the Agencies' existing bank capital rules, banking organizations (with certain limited exceptions) are required to hold minimum regulatory capital

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[1] OCC, Federal Reserve and FDIC, Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity, 88 Fed. Reg. 64028 (Sept. 18, 2023) (the "Proposal").

[2] For purposes of the rule, "significant trading activity" means aggregate trading assets and trading liabilities in excess of (i) $5 billion or (ii) 10% of total assets. Banking organizations with significant trading activity but less than $100 billion in net assets would only be subject to the Proposal's revised market risk capital requirements.

against various categories of risk-adjusted assets (known as "risk-weighted assets"). Risk-weighted assets for equity exposures (other than equity exposures to an investment fund) must be calculated pursuant to the simple risk-weight approach ("SRWA")[3]. Under the SRWA, a bank's total risk-weighted assets for equity exposures are calculated by multiplying the adjusted carrying value of each equity exposure by a specified risk-weight percentage.[4]

Banking organizations may currently apply a 100% risk weight to "non-significant" equity investments, which include the aggregate amount of non-publicly traded equity exposures below 10% of the bank's total capital.[5] An identical risk weighting (or 100%) applies to community development equity exposures, such as low-income housing tax credit investments ("LIHTC Investments").[6]

While the rules do not generally distinguish between types of "non-significant" equity exposures, the Agencies have recognized the particular benefits of tax equity investments. In December 2020, the OCC implemented a rule which codified the authority of national banks to engage in tax equity finance ("TEF") transactions under its general lending powers.[7] The OCC authorized national banks to engage in TEF transactions that are "the functional equivalent of a loan," subject to certain additional requirements.

According to the American Council on Renewable Energy ("ACORE"), domestic banks represent over 80-90% of the approximately $20 billion annual market of tax equity financing.[8] In a typical TEF transaction, a bank funds a project via an equity investment in an entity that generates tax credits, and such credits are subsequently passed onto the bank through the equity ownership as an investment return. In a "partnership-flip" TEF transaction, the most prevalent tax equity investment structure, tax equity investors typically receive as consideration cash and the allocation of U.S. federal income tax credits on their equity investments in a partnership, which owns energy and infrastructure projects that generate federal income tax credits.

TEF transactions primarily rely on tax credits generated by energy and infrastructure projects to further the federal government's clean energy and climate policies. For example, the Inflation Reduction Act ("IRA"), signed into law by President Biden in 2022, incentivized large taxpayers to enter into TEF transactions by extending clean energy and infrastructure tax credits such as the investment tax credit and production tax credit, establishing new credits, and substantially updating the Internal Revenue Code to make certain tax credits transferable and/or eligible for "direct pay."

PROPOSED TREATMENT OF EQUITY EXPOSURES IN BASEL III ENDGAME

The Agencies have proposed to replace the SRWA with an expanded simple risk-weight approach ("ESRWA") for equity exposures. Under the ESRWA, the Agencies would eliminate the current 100% risk weight bucket for "non-significant" equity exposures on the basis that doing so will "improve the risk

[3] "Advanced Approaches" institutions are also permitted to use an internal models-based approach as an alternative to the SRWA.
[4] 12 CFR § 217.52(a) (Federal Reserve); 12 CFR § 3.152(a) (OCC); 12 CFR § 324.152(a) (FDIC).
[5] 12 CFR § 217.52(b)(3)(iii) (Federal Reserve); 12 CFR § 3.152(b)(3)(iii) (OCC); 12 CFR § 324.152(b)(3)(iii) (FDIC).
[6] 12 CFR § 217.52(b)(3)(i) (Federal Reserve); 12 CFR § 3.152(b)(3)(i) (OCC); 12 CFR § 324.152(b)(3)(i) (FDIC).
[7] OCC, Commercial Lending: Tax Equity Finance Transactions Pursuant to 12 CFR 7.1025, OCC Bulletin 2021-15 (March 25, 2021).
[8] ACORE, ACORE Letter on the Impact of Proposed Bank Regulatory Capital Requirements on Tax Equity Investment in Clean Energy (Aug. 22, 2023).

sensitivity and robustness" of a bank's equity exposures.[9] Consequently, the risk weight assigned to non-publicly traded equity exposures, including TEF transactions, would increase **from 100% to 400%,** a quadrupling of the amount of capital that banks must hold in order to meet regulatory minimums.[10] Rather than increasing the risk sensitivity of a bank's equity exposures, the elimination of the risk weighting for "non-significant" equity exposures amounts to a flat capital surcharge on non-publicly traded equity exposures more generally, which is particularly impactful for sponsors and developers of clean energy and infrastructure projects that enter into TEF transactions to monetize federal income tax credits.

The change is made more troublesome by the fact that the Agencies proposed to retain the 100% risk weight for community development investments (including LIHTC Investments) and investments in small business investment companies under ESRWA on the basis that such investments "generally receive favourable tax treatment and/or investment subsidies that make their risk and return characteristics different than equity investments in general."[11] In maintaining this treatment for such investments, the Agencies also "recogniz[e]… the importance of these investments to promoting important public welfare goals…." Such rationale would appear to apply equally to clean energy and infrastructure tax equity investments.

Despite the substantial impact that this change is likely to have on the participation of banks in the tax equity market, the Agencies provide no explanation in the Proposal as to why a "one-size-fits-all" treatment of non-publicly traded equity investments under the capital rules is appropriate. Moreover, smaller banks will remain subject to the SRWA and retain a "non-significant" equity exposure bucket, meaning only the larger banks that are significant investors in these markets will be penalized by the new rules.

In light of the Agencies' prior acknowledgement of the importance of tax equity investments, the comparability of such investments' risk/return profile to community development investments, and the Agencies' recognition that investments that further public welfare goals should be given more favourable treatment under the U.S. capital rules, we can only assume that this was an oversight and that the Agencies did not specifically consider tax equity investments when crafting the Proposal.

IMPACT ON TAX EQUITY INVESTMENTS IN CLEAN ENERGY AND INFRASTRUCTURE PROJECTS

Due to the array of federal tax incentives for clean energy and infrastructure projects, tax equity financing is an essential funding source for those projects, and ACORE noted that many banks increased tax equity investments following the adoption of the OCC rule discussed above.

However, if adopted, the new ESRWA may make such investments uneconomical for banks, significantly undermining the federal government's public policy goals underlying the IRA. Specifically, in order to account for the increased risk weight associated with their tax equity investments, banks would almost certainly be compelled to increase their pricing to a degree that would be prohibitive for project sponsors.

[9] Proposal, supra note 1, at 64074.
[10] Id. at 64076.
[11] Id. at 64077.

The Agencies have extended the comment period for the Proposal until January 16, 2024,[12] and we expect the clean energy industry to continue to advocate for changes to the treatment of tax equity investments in advance of a final rulemaking. We will continue to keep an eye on these developments and encourage you to reach out to us with any questions.

[12] Federal Reserve, Press Release: Agencies extend comment period on proposed rules to strengthen large bank capital requirements (Oct. 20, 2023).

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CONTACTS

Jeff Berman
Partner

T +1 212 878 3460
E jeffrey.berman
@cliffordchance.com

Alexander Leff
Partner

T +1 713 821 2804
E alexander.leff
@cliffordchance.com

Young Kim
Counsel

T +1 212 878 4902
E young.kim
@cliffordchance.com

Hannah Richard
Counsel

T +1 212 878 8458
E hannah.richard
@cliffordchance.com

Eric Bernstein
Associate

T +1 212 878 3411
E eric.bernstein
@cliffordchance.com

Henry Myers
Associate

T +1 212 878 4951
E henry.myers
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

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