Revised Capital Rules for Banking Organizations

"…the most substantial revisions to the capital rules since the adoption of risk-based capital in 1988"

Southeast Banker Outreach Forum

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Setting the Context - the Four "W's"…

Why?

- Address weaknesses in capital standards
- Implement parts of Basel III framework and sections of Dodd-Frank Act

What?

- Higher quality and quantity of capital
- Enhanced risk coverage and disclosures

Who?

- Applies to all banking organizations, except for small BHCs < $500 million in assets, and certain SLHCs

When?

- Becomes effective Jan 1, 2015 for community banking organizations
- Extended transition period with most requirements fully phased in by Jan 2019

Regulatory Capital Framework

- **On July 2, 2013, the Board published the Final Regulatory Capital Rule to enhance regulatory capital requirements.**
- **Key Elements of the Final Rule:**
  - Introduces a new definition of capital with a focus on voting common equity as the predominant form of a banking organization's capital structure.
  - Revises the Prompt Corrective Action (PCA) framework by introducing a new Common Equity Tier 1 (CET1) ratio and higher regulatory capital minimums.
  - Introduces higher capital charges for various risk exposures to better reflect banking organizations' risk profiles.

Regulatory Capital Framework

- The Final Rule retains key elements of the three NPRs released in June 2012, with a few significant changes made in response to public comments:

	NPR Proposed Rules	Final Rule

Risk-Weighted Assets	• Residential mortgages would have been assigned risk weights between 35 – 200% based on borrower characteristics and loan features	• Residential mortgage risk weights remain <u>unchanged</u>
		  • 50% for first lien 1-4 family
		  • 100% for all other mortgage exposures

AOCI	• Unrealized gains/losses would have been *included* in capital • Introduces potential volatility to capital ratios	• BHCs <$250 billion in assets have a <u>1-time option to opt-out</u>
Phase-out of TruPS	• TruPS phased-out from Tier 1 over 10-years for banking organizations < $15 billion	• Permanent grandfathering of TruPS for banking organizations < $15 billion in total assets

Revisions to Capital Ratio Requirements

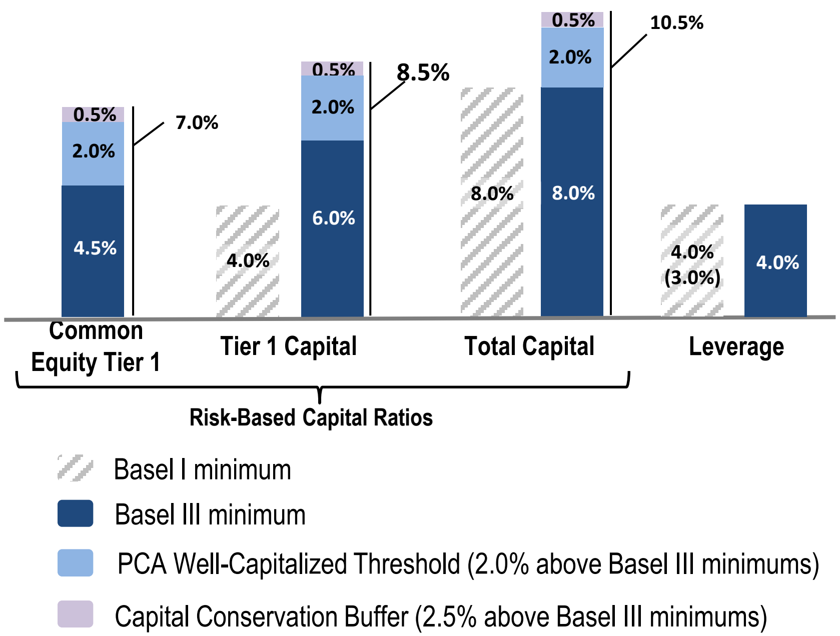
$$\text{Capital Ratio} \uparrow = \frac{\text{Eligible Capital} \downarrow}{\text{Risk-Weighted Assets} \uparrow}$$

Capital Ratios

Capital Ratio = $\frac{\text{Eligible Capital}}{\text{Risk-Weighted Assets}}$

- New Common Equity Tier 1 ratio (4.5%)
- Higher Tier 1 Capital Ratio (6%)
- No change to Total Capital Ratio (8%)
- Elimination of 3% Leverage ratio for “1” rated institutions
- New Capital Conservation Buffer (2.5%)

Basel III Minimum Capital Requirements



Revised PCA Framework

$$\text{Capital Ratio} = \frac{\text{Eligible Capital}}{\text{Risk-Weighted Assets}}$$

- The revised PCA thresholds will become effective January 1, 2015, and apply to all insured depository institutions
- Note: The capital conservation buffer is <u>NOT</u> part of the revised PCA framework.

Prompt Corrective Action Threshold	Risk-Based Capital Ratios			U.S. Leverage Ratio
	Total Capital (unchanged)	Tier 1 Capital	Common Equity Tier 1 Capital	
Well-capitalized	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%
Adequately Capitalized	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%
Significantly Undercapitalized	< 6%	< 4%	< 3%	< 3%
Critically Undercapitalized	Tangible equity (defined as Tier 1 capital plus non-Tier 1 perpetual preferred stock) to total assets ≤ 2%			

Eligible Capital

Capital Ratio ↑ = Eligible Capital ↓ / Risk-Weighted Assets ↑

- Stricter eligibility requirements

- Additional deductions & adjustments
  - Common Equity Tier 1 primarily composed of common stock, retained earnings, and limited recognition of minority interests
  - Deductions from CET1 of goodwill and other intangibles (except MSAs), gain on securitization sales, certain defined benefit pension fund assets, and investment in own shares
  - **10% and 15% threshold deductions:** deferred tax assets, MSAs, and investments in unconsolidated financial institutions

- Key Changes Relevant to Community Banking Organizations
  - Phase out of certain tier 1 capital instruments (e.g., TruPS, cumulative instruments) – **permanent grandfathering of TruPS issued prior to May 19, 2010**
  - Inclusion of unrealized losses and gains (AOCI) – **1-time option to opt-out by January 1, 2015 regulatory filing**

Risk-Weighted Assets (RWA)

$$\text{Capital Ratio} \uparrow = \frac{\text{Eligible Capital} \downarrow}{\text{Risk-Weighted Assets} \uparrow}$$

- More risk sensitive RWA calculations, including:
  - **Risk weights for residential mortgages will remain unchanged**
  - Higher risk weight for High Volatility Commercial Real Estate[1] (150%)
  - Higher risk weight for exposures more than 90 days past due (generally 150%)
  - Higher risk weights for other exposures such as short-term commitments, and equity investments
- Removal of external credit ratings from the securitization framework

[1] High volatility commercial real estate is a subset of CRE, and defined as a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction of real property. Certain exceptions apply: 1) 1-4 family residential properties, 2) certain community development projects 3) the purchase or development of agricultural land, 4) CRE projects that meet the criteria in the rule.

Timeline and Transition Period

2015 | 2016 | 2017 | 2018 | 2019

- New PCA minimums in effect
- Begin phase-in of capital conservation buffer to 2019
- Begin phase-in of deductions to CET1 to 2018

As of January 1					
CET1	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer	N/A	0.625%	1.25%	1.875%	2.5%
CET1 + Conservation Buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1	40%	60%	80%	100%	100%
Min Tier 1	6.0%	6.0%	6.0%	6.0%	6.0%
Tier 1 + Conservation Buffer	N/A	6.625%	7.25%	7.875%	8.5%
Min Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%
Total Capital + Conservation Buffer	N/A	8.625%	9.25%	9.875%	10.5%

Summary

Impetus for Capital Rule Making	• Address weaknesses in regulatory capital standards to strengthen the banking sector • Implement parts of the Basel III framework and sections of the DFA
Key Themes	• Higher quality and quantity of capital • Enhanced risk coverage • Tailored requirements for smaller institutions
Implementation	• Most institutions meet the requirements or are making steady progress • Extended transition allows accretion of capital

Additional References : ***FRB Community Bank Guide*** (http://www.federalreserve.gov/commbankguide20130702.pdf), ***Interagency New Capital Rule Community Bank Guide*** (http://www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf)