Basel III for Community Banks

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Introduction

- On June 7, 2012, the OCC, Federal Reserve Board and FDIC (the “Agencies”) proposed significant changes to the U.S. regulatory capital framework:
  - U.S. version of the Basel III Proposal
  - The Standardized Approach Proposal
  - The Market Risk Proposal – not applicable to community banks
Introduction

• U.S. Basel III and Standardized Approaches
  • Far broader than Basel III itself
    • Basel III developed primarily to address the systemic risk presented by large, internationally active banks.

• Coverage
  • Banks and thrifts
  • All bank holding companies > $500 million
  • All thrift holding companies
  • Top-tier U.S. holding companies in FBO structure
Introduction

• Status:
  • Faced with extensive comments, Agencies will not meet the self-imposed deadline of Dec. 31, 2012 for a final rule.

• Other developments may affect timing
  • New capital rules may not be agencies’ highest priority
    • Volcker Rule
    • Systemic risk issues
  • Regulators can achieve most of their capital goals through supervisory process
  • Regulators already have pushed back by one year capital-related requirements (stress testing) for mid-size banks—between $10 and $50 billion.
Introduction

Recent agency developments

• Guidance and tools
  • Capital planning guidance, OCC Bull. 2012-16 (June 7, 2012).
  • Regulatory Capital Estimation Tools (Sept. 24, 2012).
  • Various federal regulators have indicated flexibility for community banks.

• Some leniency for community banks may be forthcoming.
  • Speeches by Comptroller Curry (Oct. 23 and Nov. 9) and Fed Governor Duke (Nov. 9).
  • Statements by federal regulators at House Fin. Serv. Comm. hearing (Nov. 29) and Sen. Banking Comm. hearing (Nov. 14).
Introduction

• Recent Congressional developments

• Letter from 53 Senators to Agencies expressing reservations about applying rules to community banks (Sept. 27, 2012).
• Senate Banking Committee hearing, questioning federal regulators about scope of rules (Nov. 14, 2012).
• House Financial Services Committee hearing (Nov. 29, 2012).
Introduction

• Structure of regulatory capital rules
  • Capital components
  • Risk adjusted assets
  • Ratios

• Purpose
  • Better loss absorption on a going-concern basis
  • Behavior modification

• Legal Foundation
  • Commitment to Basel III
  • Collins Amendment
  • New explicit authority to impose capital requirements
Three Broad Issues

• Capital Ratios

• Components of Capital

• Risk Weights
Capital Ratios
Minimum Capital Ratios

• Minimum Capital Requirements (fully phased-in):
  • 3 risk-based capital ratios.
    • Common equity Tier 1 capital ratio of 4.5 percent (new minimum).
    • Tier 1 capital ratio of 6 percent.
    • Total capital ratio of 8 percent.

• Tier 1 leverage ratio to average consolidated assets of 4 percent.
  • Similar to current rule for most U.S. banks.
  • Current favorable 3 percent requirement for CAMELS 1-rated U.S. banks and comparably ranked bank holding companies eliminated.
  • New definition of Tier 1 capital excludes some instruments currently included.

• Additional rules for U. S. banking organizations subject to the advanced Basel II capital framework, including an additional 3% Tier 1 leverage ratio.
Capital Conservation Buffer

- Capital Conservation Buffer (in addition to minimum capital)

- Capital conservation buffer: ratio of common equity Tier 1 capital to risk-based assets of 2.5%.
- Failure to meet buffer: restriction on payouts of capital distributions and discretionary bonus payments to executives.
- Maximum amount of restricted payout equals retained income times a specified payout ratio. Payout ratio is a function of the amount of the bank’s capital conservation buffer capital.
Capital Ratios

• Countercyclical Capital Buffer (not for community banks)
  • Not a concern for community banks.
  • A macro-economic countercyclical capital buffer of up to 2.5% of common equity Tier 1 capital to risk-weighted assets applicable only to advanced approaches banking organizations.
  • Countercyclical capital buffer, applied upon a joint determination by federal banking agencies, would augment the capital conservation buffer.
  • Unrestricted payouts of capital and discretionary bonuses would require full satisfaction of countercyclical capital buffer as well as capital conservation buffer.
# Capital ratio table

<table>
<thead>
<tr>
<th>Type of ratio</th>
<th>Current</th>
<th>New</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Minimum risk-based ratios</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 1 common equity risk-based</td>
<td>N/A</td>
<td>4.5%</td>
<td>7%</td>
</tr>
<tr>
<td>Tier 1 risk-based</td>
<td>4%*</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Total risk-based</td>
<td>8%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td><strong>Tier 1 common equity capital conservation buffer (risk-based)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N/A</td>
<td>+2.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Leverage ratio</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 1 leverage to average assets***</td>
<td>3% /4%</td>
<td>4%</td>
<td></td>
</tr>
</tbody>
</table>

*at least 50% of qualifying total capital

**Countercyclical conservation buffer (risk based) of an additional 2.5% for Basel II banks

***Supplemental leverage ratio for Basel II bank of an additional 3%
Supervisory Assessment of Capital

• Supervisory Assessment of Capital Adequacy
  • Banking organizations must maintain capital “commensurate with the level and nature of all risks” to which the banking organization is exposed.

• General authority for regulatory approval, on a joint consultation basis, of other Tier 1 or Tier 2 instruments on a temporary or permanent basis.

• The regulators can also invalidate/modify capital instruments and risk-weighting charges on a case-by-case basis.
Capital Components
Capital Components

- Three buckets
  - Common equity Tier 1
  - Additional Tier 1
  - Tier 2
Common Equity Tier 1 Components

• Common Equity Tier 1 (less applicable deductions—some of which are set forth on following slides):
  
  • Common stock (satisfying specified criteria).
  • Retained earnings.
  • Accumulated other comprehensive income (‘‘AOCl’’).
  • Qualifying common equity Tier 1 minority interest.

• Can include nonvoting common, but the Agencies continue to expect that voting common should be the dominant element within common equity Tier 1 capital.
Common Equity Tier 1 Deductions

• Deductions from common equity Tier 1 capital

  • Goodwill + all other intangibles (except mortgage servicing assets), net of associated deferred tax liabilities ("DTLs").
  • Deferred tax assets ("DTAs") arising from operating loss and tax credit carryforwards (net of DTA valuation allowance and net of DTLs).
  • Gain-on-sale associated with a securitization exposure.
  • Defined benefit plan net assets net of deferred tax liability (excluding those of depository institutions with their own plans).
Common Equity Tier 1 Deductions

- Investments in financial subsidiaries.
- Savings association impermissible activities.
- For advanced approaches banks, expected credit losses exceeding eligible credit reserves.
- Items exceeding common equity Tier 1 capital thresholds (certain DTAs, MSAs, significant unconsolidated financial institution common stock investments).
- Others.
Additional Tier 1 Capital

• Noncumulative perpetual preferred stock.
• Other capital instruments that satisfy specific criteria.
• Tier 1 minority interests that are not included in a banking organization’s common equity Tier 1 capital.
• Qualifying TARP and Small Business Jobs Act preferred securities that previously were included in Tier 1 capital.
Significant exclusions from Tier 1 Capital

• Cumulative preferred stock would no longer qualify as Tier 1 capital of any kind.

• Certain hybrid capital instruments, including trust preferred securities, no longer will qualify as Tier 1 capital of any kind.
Tier 2 Capital Components

• Tier 2
  • Qualifying instruments (including cumulative preferred) that satisfy specified criteria.
  • Qualifying total capital minority interest not included in Tier 1 capital.
  • Allowance for loan and lease losses (“ALLL”) up to 1.25% of risk-weighted assets excluding ALLL.
  • Qualifying TARP and Small Business Jobs Act preferred securities that previously were included in Tier 2 capital.
Deductions from Tier1/Tier2 capital

- Direct and indirect investments in own capital instruments.
- Reciprocal cross-holdings in financial institution capital instruments.
- Direct, indirect and synthetic investments in unconsolidated financial institutions. Three basic types:
  - Significant Tier 1 common stock investments.
  - Significant non-common-stock Tier 1 investments.
  - Non-significant investments (aggregate 10% ceiling.)
- The “corresponding deduction” approach for reciprocal cross holdings, significant non-common stock investments and non-significant investments.
- Volcker Rule covered fund investments (from Tier 1).
- Insurance underwriting subsidiaries.
Minority Interests

• Minority Interests
  • Limits on type and amount of qualifying minority interests that can be included in Tier 1 capital.
  • Minority interests would be classified as a common equity Tier 1, additional Tier 1, or total capital minority interest depending on the underlying capital instrument and on the type of subsidiary issuing such instrument.
  • Qualifying common equity Tier 1 minority interests are limited to a depository institution (“DI”) or foreign bank that is a consolidated subsidiary of a banking organization.
  • Limits on the amount of includable minority interest would be based on a computation generally based on the amount and distribution of capital of the consolidated subsidiary.
## Prompt Corrective Action (PCA)

<table>
<thead>
<tr>
<th>Category</th>
<th>Total RBC</th>
<th>Tier 1 RBC</th>
<th>Common Equity Tier 1 RBC</th>
<th>Tier 1 Leverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well capitalized</td>
<td>10%</td>
<td>8%</td>
<td>6.5%</td>
<td>5%</td>
</tr>
<tr>
<td>Adequately capitalized</td>
<td>8%</td>
<td>6%</td>
<td>4.5%</td>
<td>4%</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>&lt;8%</td>
<td>&lt;6%</td>
<td>&lt;4.5%</td>
<td>&lt;4%</td>
</tr>
<tr>
<td>Significantly undercapitalized</td>
<td>&lt;6%</td>
<td>&lt;4%</td>
<td>&lt;3%</td>
<td>&lt;3%</td>
</tr>
<tr>
<td>Critically undercapitalized</td>
<td></td>
<td></td>
<td>Tangible equity/total assets (\leq 2%)</td>
<td></td>
</tr>
</tbody>
</table>
Risk-Weights

Risk-Weighted Assets
Risk-Adjusted Assets

- Eleven broad asset classes
  - Residential mortgages
  - Commercial lending – “high volatility” CRE loans
  - Corporate exposures
  - Off-balance sheet exposures
  - OTC derivatives
  - Cleared transactions
Risk-Adjusted Assets

- Eleven broad asset classes (cont’d)
  - Unsettled transactions
  - Securitization exposures
  - Equity exposures
  - Sovereign, public sector entities ("PSEs") and foreign bank exposures
  - Other assets
Residential First Mortgages

1. Residential first mortgages
   • Generally higher risk weights.
   • Category 1 (traditional) vs. Category 2 (non-traditional).
     • Duration.
     • Regular periodic payments.
     • Underwriting requirements.
     • Limits on rate adjustments.
     • Income documented and verified.
   • Loan-to-value ratio.
1. Residential first mortgages (cont’d)

<table>
<thead>
<tr>
<th>LTV</th>
<th>Category 1</th>
<th>Category 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;60%</td>
<td>35%</td>
<td>100%</td>
</tr>
<tr>
<td>&gt;60, &lt;80</td>
<td>50%</td>
<td>100%</td>
</tr>
<tr>
<td>&gt;80, &lt;90</td>
<td>75%</td>
<td>150%</td>
</tr>
<tr>
<td>&gt;90</td>
<td>100%</td>
<td>200%</td>
</tr>
</tbody>
</table>
Residential First Mortgages

1. Residential mortgages (cont’d)
   • Government supports continue to be recognized.
     • FHA/VA: 0%.
     • Fannie Mae/Freddie Mac: 20%.
   • Private mortgage insurance has no effect on LTV calculation.
   • Restructured or modified loans: newly risk-weighted after restructuring or modification.
   • Mortgage-servicing assets now risk-weighted at 250% (after appropriate deduction from common equity Tier 1 capital).
Commercial Loans

2. Commercial loans
   • Current 100% default weight still applies.
   • Commercial real estate loans are presumptively “high volatility” and risk-weighted at 150%, unless
     • LTV equal to or less than maximum supervisory ratio (65% acquisition; 75% development; 80% construction);
     • Developer contributes up front capital of at least 15% of appraised “as completed” value; and
     • Capital remains in project through the life of the project.
   • Financing of 1- to 4-family properties exempt from rule.
3. Corporate exposures

- 100%.
- Includes exposures to securities firms.
- Essentially a default category where the corporate exposure does not fall into another category.
4. Off-balance sheet exposures – credit conversion factors (CCFs)
   • 0% CCF-- only unconditionally cancelable commitments.
   • [10% CCF -- short-term ABCP facilities – eliminated.]
   • 20% CCF -- short-term commitments (and trade-related contingent claims).
   • 50% CCF -- no change (long-term commitments and transaction-related contingent claims).
   • 100% CCF -- “repo-style” transactions now subject to conversion, in addition to guarantees, financial standby letters of credit, and forward agreements.
5. OTC derivatives

• Risk weight is a function of counterparty’s credit risk.
  • Current 50% cap is eliminated.

• Capital impact depends on measurement of exposure – current credit exposure plus probability of future exposure.

• Multiple contracts subject to “qualifying master netting agreement.”
  • Agreement must be enforceable in insolvency.
Cleared Transactions

6. Cleared transactions

• Qualifying central clearing party (“QCCP”).
  • QCCP – must be designated FMU.
  • Only eight FMUs designated to date.
  • If bank is clearing member of QCCP: 2% of trade exposure amount (value plus any posted collateral that is not bankruptcy remote).
  • If bank is client of QCCP member: 2-4% of collateral posted by bank.

• Default fund contributions by clearing member.
  • If QCCP, complex calculation.
  • If non-QCCP, 1,250%.
Unsettled transactions

7. Unsettled transactions
• New asset class not addressed in current rules.
• Risk of delayed settlement or delivery—settlement outside the market standard.
• Simultaneous performance
  • DvP (securities/commodities) and PvP (forex) transactions.
  • Net exposure risk-weighted at 100% begins after 5 day.
  • Risk weight escalates, up to 1,250% after 45 days.
• Performance by bank as prerequisite to performance by counterparty
  • 1 day after settlement date, counterparty risk weight.
  • After 5 days, 1,250%.
Securitization exposures

8. Securitization exposures
   • New due diligence requirement to demonstrate understanding of risks of particular transaction.
   • Detailed quarterly analysis of each position.
   • Risk-weighting alternatives
     • Credit ratings eliminated.
     • Simplified supervisory formula approach – borrowed from Basel II.
     • Gross-up approach.
     • Other – 1,250%.
     • 20% minimum risk weight.
8. Securitization exposures (cont’d)
   • Gain-on-sale – full deduction from common equity Tier 1.
   • Credit-enhancing interest-only strips – 1,250%, to extent not deducted in connection with gain on sale.
   • Non-credit enhancing interest-only strips – 100%.
Equity Exposures

9. Equity exposures – unconsolidated entities

- Current rule – 100%
- Exposure baseline – adjusted carrying value
- Simple risk weight approach

Sovereigns, international funds, MDBs 0%
Public sector entities, FHLBs, Farmer Mac 20%
Community development, effective hedge pairs 100%
Significant investments in capital of unconsolidated financial institutions and not deducted from capital 250%
Publicly traded equities; ineffective hedge pair 300%
Non-publicly traded equities 400%
Investments in certain investment firms 600%
Equity Exposures

9. Equity exposures – investment funds

- Look-through approaches for investment fund exposures
  - Full look-through: investment risk-weighted based on assets owned by fund.
  - Simple modified look-through: investment risk-weighted based on highest risk weight of permissible fund investment under prospectus or other offering document.
  - Alternative modified look-through: investment risk-weighted based on proportions of risk weights of permissible fund investments under prospectus or other offering document.
- Special rules for assets for nonbanking exposures that are unique to insurance underwriting activities.
Sovereign, PSE, foreign bank exposures

10. Sovereign, public sector entities (PSEs) and foreign bank exposures

• Sovereign exposures
  • Current rule – OECD membership.
  • Proposal – OECD country risk classification (“CRC”).
  • Risk weights range from 0% to 150%.

• PSE exposures
  • CRC-based scale for general obligation bonds, from 20% to 150%.
  • CRC-based scale for revenue bonds, from 50% to 150%.

• Foreign bank exposures
  • CRC-based scale, from 20% to 150%. 
11. Other assets

- Cash – 0%.
- Own-vault gold bullion, and conditionally other-vault bullion – 0%.
- Certain cash-settled transactions with a CCP – 0%.
- Items in process of collection – 20%.
- DTAs – 100% for realizable NOL carrybacks, and 250% for non-realizable NOL carrybacks.
- MSAs – 250% if not deducted from capital.
- Any asset not otherwise assigned a risk-weight – 100%.
Credit Risk Mitigants

Credit risk mitigants

• Government guarantees of residential mortgages
• Guarantees and credit derivatives
  • Protection providers now include investment-grade companies.
  • Terms: unconditional and uncancellable.
  • Certain adjustments for maturity and foreign currency mismatches.
• Collateral
  • Simple – 20% minimum risk weight (with some exceptions).
  • Collateral haircut allowed for certain exposures; assessment of market volatility of collateral.
Effective Dates
Effective Dates

• Components of Capital
  • Non-qualifying capital instruments
    • BHCs of $15 billion + in assets: 2013-2016.
    • BHCs under $15 billion and all depositories: 2013-2022.

• Risk-Adjusted Assets
  • All new risk weights are effective Jan. 1, 2015.

• Capital Ratios
  • Minimum total capital: no change and therefore no phase-in.
Pro Forma Effect (Fed staff)

- 90% of bank holding companies under $10 billion would meet the 4.5% minimum common equity Tier 1 ratio

- 80%+ would meet the capital conservation buffer (4.5% + 2.5%)

- Shortfall for those bank holding companies under $10 billion that don’t meet these ratios would be roughly $3.6 billion in the aggregate.

- Regulatory capital estimation tool: www.federalreserve.gov/bankinfo/foreg/basel/basel3tools.htm
Criticisms from Community Banks

- Too complex.
- Will impact ability of small banks to lend.
- Risk weights on mortgages will adversely affect mortgage market.
- Proposed loan-to-value ratios on mortgages (for risk-weights) impose recordkeeping burden.
- Inclusion of unrealized gains and losses on AFS debt securities introduces volatility into capital—and hard to manage.
- Accelerated phase out of trust preferred from Tier 1 capital.
- ICBA: exempt all banks under $50 billion (unlikely).
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