Basel III Update: Federal Reserve Proposes New Bank Capital Framework

June 8, 2012

The Board of Governors of the Federal Reserve System (the "Federal Reserve") approved three notices of proposed rulemaking ("NPRs") that would revise the general risk-based capital rules to make them consistent with heightened international capital standards agreed to by the Basel Committee on Banking Supervision ("BCBS")[1] in a comprehensive reform package, known as Basel III, as well as certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Intended to strengthen the quality and quantity of capital of banking organizations of all sizes, the proposal was divided into three proposed rules, each of which is summarized below. Comments on the proposal are due September 7, 2012.

NEW RISK-BASED AND LEVERAGE CAPITAL REQUIREMENTS

The first NPR ("Basel III NPR") would revise the Board's risk-based and leverage capital requirements to be consistent with those in Basel III. It includes a more restrictive definition of regulatory capital, higher minimum regulatory capital requirements, and capital "buffers" designed to increase the resiliency of banking organizations during periods of financial stress. In addition, this NPR proposes a leverage ratio that incorporates certain off-balance sheet assets in the denominator (supplementary leverage ratio) and includes transition periods for the majority of the proposed requirements to give banking organizations ample time to adjust.

Introduction of CET1. The proposals in the Basel III NPR, which would apply to all depository institutions, top-tier bank holding companies with total consolidated assets of $500 million or more, and top-tier savings and loan holding companies[2] (collectively, banking organizations) would establish a new minimum common equity tier 1 capital to total risk-weighted assets ratio of 4.5%. Common equity tier 1 capital ("CET1") is a new regulatory capital component that is predominantly made up of retained earnings and common stock instruments (that comply with

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[1] The BCBS is a committee of banking supervisory authorities, which was established by the central bank governors of the G-10 countries in 1975. It currently consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

[2] The capital rule as proposed would apply to all top-tier savings and loan holding companies, which would include commercial companies that own grandfathered saving associations, once the rule becomes effective.

strict eligibility criteria), net of treasury stock, and net of certain regulatory capital deductions and adjustments.[3]

Additional Capital Buffers. The Federal Reserve proposes to apply limits on a banking organization's capital distributions and certain discretionary bonus payments to executive officers if the banking organization does not maintain a new "capital conservation buffer" of at least 2.5% of total risk-weighted assets (on a fully phased-in basis). The capital conservation buffer would be composed of CET1 capital and would be added to each of the minimum risk-based capital requirements.

For advanced approaches banking organizations,[4] which typically include the largest, most complex banking organizations, the capital conservation buffer may be expanded by up to an additional 2.5% upon activation of a new "countercyclical capital buffer" comprised solely of CET1. The countercyclical capital buffer may be triggered in the United States when the Federal Reserve and other federal banking agencies determine that a period of excessive aggregate credit growth is contributing to an increase in systemic risk. At the time the proposed rule becomes effective, the countercyclical buffer amount in the United States would initially be set to zero.

Basel III includes a CET1 capital surcharge of up to 3.5% for global systemically important banks ("G-SIBs").[5] The proposed rules do not address the G-SIB surcharge, although the agencies note that they plan to implement (on a phase-in basis) a surcharge for banks with $50 billion or more in total consolidated assets, in 2014.

Higher Capital Standards. In addition to these new capital measures, the proposed rule would raise the minimum tier 1 capital ratio from 4% to 6% of risk-weighted assets. These new and revised regulatory capital requirements also will be incorporated into the Prompt Corrective Action ("PCA") capital categories, which serve as a supervisory trigger as to inadequate capital for banks and thrifts (but generally not their holding companies). Banking organizations are generally expected, as a prudential matter, to operate well above their minimum regulatory ratios, with capital commensurate with the level and nature of the risks to which they are

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[3] CET1 capital may also include limited amounts of common stock issued by consolidated subsidiaries to third parties (minority interest).

[4] In general, the advanced approaches risk-based capital rule applies to those banking organizations with consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion (excluding insurance underwriting assets) and their depository institution subsidiaries. The market risk capital rule generally applies to those banking organizations with aggregate trading assets and trading liabilities equal to at least 10% of quarter-end total assets or $1 billion.

[5] Although undefined in the proposal, the BCBS identifies G-SIBs based on their size, interconnectedness, lack of substitutes for the services they provide, complexity, and global (cross-jurisdictional) activity.

exposed. These expectations are reflected, in part, in the ratios applicable to "well-capitalized" depository institutions under PCA.

Leverage Ratio: To constrain the degree to which a banking organization can leverage its equity capital base, all banking organizations under the Basel III NPR would remain subject to a 4% tier 1 leverage ratio. The leverage ratio is calculated by dividing an organization's tier 1 capital by its average consolidated assets (i.e. on-balance sheet assets as reported on the banking organization's regulatory report), minus amounts deducted from tier 1 capital. Advanced approaches banking organizations would also be required to maintain a supplementary leverage ratio of tier 1 capital to total leverage exposure of 3%. Total leverage exposure includes both on- and off-balance sheet assets.

The new capital and leverage requirements under the Basel III NPR, as compared to current requirements, are shown in Table 1, below:

Table 1: Current Minimum Requirements and Proposed Minimum Requirements Under the Basel III NPR (When Fully Phased-In by January 1, 2019)

	Current Minimum Requirement	**Proposed Minimum Requirement***	**Proposed Minimum for Well-Capitalized Under PCA**
Minimum CET1 capital ratio	N/A	4.5%	6.5%
Capital conservation buffer	N/A	2.5%	N/A
Minimum CET1 capital ratio plus capital conservation buffer	N/A	7.0%	N/A
Minimum tier 1 capital ratio	4.0%	6.0%	8.0%
Minimum tier 1 capital ratio plus capital conservation buffer	N/A	8.5%	N/A
Minimum total capital	8.0%	8.0%	10.0%
Minimum total capital plus capital conservation buffer	N/A	10.5%	N/A
Leverage ratio	4.0% (or 3%)	4.0%	5.0%

*For depository institutions, the proposed minimum is the same as "adequately capitalized" under the PCA.

New Capital Components. In addition to raising the minimum capital requirements, the proposed rule would establish more conservative standards for including an instrument in regulatory capital. Trust preferred securities, cumulative preferred stock and other hybrid instruments, for example, would not be included in tier 1 capital.[6] Common stock and noncumulative perpetual preferred stock would generally qualify, subject to a number of detailed criteria. These include, for preferred stock, a restriction on redemption within five years after issuance except for regulatory events, a prohibition on dividend step-ups, and a prohibition on purchase price resets or ratchets if new shares are subsequently issued at a lower price. The proposal also notes that while hybrid debt instruments could potentially be included in additional tier 1 capital under Basel III, for U.S. purposes an instrument that is classified as a liability for GAAP purposes would not qualify as tier 1 capital.

Capital Adjustments. Banking organizations would also be subject to stricter capital deductions (most of which are deducted from tier 1 capital) for assets such as mortgage servicing assets, deferred tax assets and certain investments in the capital of unconsolidated financial institutions.[7] Importantly, the proposal would remove the existing filter for unrealized gains and losses accumulated from available for sale securities recorded in accumulated other comprehensive income/loss ("AOCI") from regulatory capital measurements, with removal applied to CET1 capital.[8] Recognizing that this could discourage organizations from holding low-risk investment securities because of the potential capital volatility, the proposal requests comment on whether unrealized gains and losses from interest rate changes should be excluded from capital calculations.[9]

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6 Consistent with Basel III and the Collins Amendment of the Dodd-Frank Act, the Basel III NPR would require the phase-out from tier 1 capital of trust preferred securities and cumulative preferred stock over a 10-year period for all bank holding companies with total consolidated assets less than $15 billion as of December 31, 2009, permitting the inclusion in capital up to the percentage of the outstanding principal amount of such non-qualifying capital instruments as of December 31, 2013, until the instruments are fully phased-out on January 1, 2022; and a phase-out of those instruments over a 3-year period beginning on the same date for bank holding companies that had $15 billion or more in total consolidated assets as of December 31, 2009.

7 The Basel III NPR follows Basel III in requiring that banks deduct from CET1 any of the following assets to the extent that individually the asset category exceeds 10% of CET1 or, in the aggregate, 15% of CET1: (i) deferred tax assets arising from temporary differences that could not be realized through net operating loss carry-backs; (ii) mortgage servicing assets net of associated deferred tax liabilities; and (iii) significant investments in the capital of financial institutions in the form of common stock. In addition, significant investments in non-common stock capital instruments of such entities are to be deducted from the same tier of capital for which the instrument would qualify if issued by the bank itself.

8 Removal of the AOCI filter would be applied to CET1, with the impact of the filter's removal being phased-in 20% per year on an annual basis over five years commencing 2014.

9 The Agencies seek comment on an industry proposal that would exclude from the AOCI filter's removal unrealized gains and losses on debt securities whose valuations primarily change as a result of fluctuations in benchmark interest rates (for example, U.S. government and agency debt obligations, U.S. GSE debt obligations and other sovereign debt obligations that will qualify for a 0% risk weight under the Standardized Approach). The Agencies also seek comment on whether unrealized gains and losses on general obligations issued by states or political subdivisions of the

Effective Dates. While the rule would be effective as of January 1, 2013, full compliance with most aspects would not be required until January 1, 2019. Transition periods apply in several areas of the proposed rule, including the phase-out of certain non-qualifying capital instruments (like trust preferred securities), the new minimum capital ratio requirements, the capital conservation buffer, the regulatory capital adjustments and deductions, and the calculation of risk-weighted assets. The new minimum regulatory capital ratios and changes to the calculation of risk-weighted assets would be fully implemented by January 1, 2015.[10] The capital conservation buffer framework would phase-in between 2016 and 2018, with full implementation by January 1, 2019. Advanced approaches organizations would be required to calculate and report their supplementary leverage ratio beginning on January 1, 2015. However, it would not be a requirement until 2018.

The proposed changes to the minimum PCA capital requirements would take effect January 1, 2015. The proposed amendments to the current PCA leverage measure for advanced approaches depository institutions would take effect on January 1, 2018.

STANDARDIZED APPROACH FOR RISK-WEIGHTED ASSETS; MARKET DISCIPLINE AND DISCLOSURE REQUIREMENTS

The second NPR (the "Standardized Approach NPR") would apply to all banking organizations (other than small bank holding companies with $500 million or less in total assets) and includes proposed changes to the general risk-based capital requirements for determining risk-weighted assets (that is, the calculation of the denominator of a banking organization's risk-based capital ratios). The proposed rule would expand the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets. Generally ranging from 0% for U.S. government securities to 600% for certain equity exposures, the Standardized Approach NPR would apply higher risk weights for a variety of asset categories. Table 2, below, summarizes key provisions of the Standardized Approach NPR.

Table 2: Proposed Treatment for Different Categories of Risk-Weighted Assets Under the Standardized Approach NPR

Risk-Weighted Asset	Proposed Treatment
Residential mortgage exposures	Applies a more risk-sensitive treatment that would risk-weight an exposure based on certain loan characteristics and loan-to-value ratios

United States should receive similar treatment even though such gains or losses are more likely to result from credit risk and not primarily from fluctuations in a benchmark rate.

10 Consistent with the Dodd-Frank Act, a bank holding company subsidiary of a foreign banking organization that is currently relying on the Federal Reserve's Supervision and Regulation Letter (SR) 01-1 would not be required to comply with the proposed capital requirements until July 21, 2015.

Table 2: Proposed Treatment for Different Categories of Risk-Weighted Assets Under the Standardized Approach NPR	
Risk-Weighted Asset	**Proposed Treatment**
High volatility commercial real estate	Assigns a higher risk weight (150%) for certain commercial real estate facilities that finance the acquisition, development, or construction of real property
Past due exposures	Assigns a higher risk weight (150%) for exposures that are more than 90 days past due or on nonaccrual (excluding sovereign and residential mortgage exposures)
Credit exposures to foreign sovereigns, foreign banks, and foreign public sector entities	Bases the risk weight for each exposure type on the country risk classification of the sovereign
Derivative contracts	Removes the risk weight cap regardless of counterparties and provide preferential capital treatment for centrally-cleared derivatives and repo-style transactions

While the current risk-based capital requirements recognize guarantees and collateral as credit risk mitigants to a limited extent, the Standardized Approach NPR would expand the scope of (i) eligible guarantors (to include, for example, investment grade corporate entities, subject to certain limitations), and (ii) eligible collateral (to include, for example, corporate debt securities that are investment grade, equity securities that are publicly traded and convertible bonds that are publicly traded).

In the Standardized Approach NPR, the Federal Reserve also proposes alternatives to credit ratings for calculating the risk-weighting assets for certain assets, consistent with Section 939A of the Dodd-Frank Act.[11] The proposed rule would also introduce disclosure requirements for top-tier banking organizations domiciled in the United States with $50 billion or more in total assets, including disclosures related to regulatory capital instruments.

The changes in the Standardized Approach rule are proposed to take effect on January 1, 2015, with an option for early adoption.

11 For determining the risk weight of certain exposures to non-U.S. sovereigns and non-U.S. public sector entities, the proposed rule uses the Organization for Economic Co-operation and Development's (the "OECD") country risk classification model (or "CRCs"). And for determining the risk weight of corporate exposures, adopting a definition of "investment grade" that is based on an approach that the OCC implemented in its investment securities regulations; namely, treating an exposure as investment grade if the obligor "has adequate capacity to meet financial commitments for the projected life of the asset or exposure," with the "adequate capacity" test being met if "the risk of [the obligor's] default is low and the full and timely repayment of principal and interest is expected."

ADVANCED APPROACHES RISK-BASED CAPITAL RULE; MARKET RISK CAPITAL RULE

The third NPR (the "Advanced Approaches and Market Risk NPR") would generally apply only to advanced approaches banking organizations and proposes to revise the existing advanced approaches risk-based capital rule to incorporate certain aspects of Basel III and the Dodd-Frank Act. The changes are designed to increase the risk sensitivity of internationally active banks to counterparty risk and interconnectedness among financial institutions. These revisions also include replacing references to credit ratings with alternative standards of creditworthiness consistent with Section 939A of the Dodd-Frank Act.

The Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation are also expected to propose that the market risk capital rule be applicable to federal and state savings associations, and the Federal Reserve is proposing that the advanced approaches and market risk capital rules apply to top-tier savings and loan holding companies domiciled in the United States that meet the applicable thresholds.

FUTURE RULEMAKINGS?

While lauding the proposal as "major progress on the way to overhauling capital requirements," Governor Daniel K. Tarullo, the governor largely responsible for the proposal, cautioned that the proposal does not signify the end of that effort. In particular, Governor Tarullo identified two areas for future reform. First, depending on the results of the fundamental review of the trading book currently underway in the BCBS, he would like to see revisions made to the market risk capital requirements to standardize capital requirements for market risk, as a "back-up" for model-derived risk weights. And, second, with regard to contingent capital, which is part of Basel III but was not addressed in the proposal, Governor Tarullo noted that regulators should consider changes in capital requirements to ensure that there would be adequate subordinated debt or similar liabilities on the balance sheets of the largest banking organizations to help ensure they could be successfully resolved through the conversion of debt to equity.

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This memorandum serves only to highlight certain key features of the proposed rules. For more information regarding the Federal Reserve's proposal and its implications, please contact any member of the Firm's Financial Institutions Group.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

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