Federal Reserve Adopts Final U.S. Bank Capital Standards Under Basel III

July 8, 2013

The Federal Reserve Board has approved a final rule (the "Final Rule") implementing the revised capital standards of the Basel Committee on Banking Supervision, commonly known as "Basel III,"[1] and addressing various requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). It replaces the general risk-based capital rules of the different banking agencies that currently apply to banking organizations with a single integrated regulatory capital framework that emphasizes not only higher capital cushions for banks to absorb losses but also more stringent criteria for what qualifies as regulatory capital.

As discussed in this summary, the Final Rule makes important changes to the proposed rules issued by the Federal Reserve Board and other banking agencies last summer (collectively, the "Proposed Rule").[2] According to Governor Daniel K. Tarullo, who leads the Federal Reserve Board's bank regulatory reform efforts, the Final Rule marks the end of major modifications to capital rules for the "vast majority of banks," but there remain a number of other capital-related initiatives for the eight U.S. banking organizations that have already been identified as having global systemic importance (Bank of America, The Bank of New York Mellon Corporation, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo).

A. SCOPE OF APPLICATION

The Final Rule generally applies to all U.S. banking organizations (including national and state-chartered banks, federal and state-chartered thrifts, bank holding companies, and savings and loan holding companies), subject to the following notable exceptions:

- *Insurance Companies and Grandfathered Unitary Thrift Holding Companies*—The Final Rule does not apply to top-tier savings and loan holding companies

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1 Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010; revised June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.

2 The Proposed Rule, as published by the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, 77 Fed. Reg. 52792 (Aug. 30, 2012), comprised three separate proposals: (i) one relating to minimum capital ratios, capital buffers, and items in the "numerator" of the regulatory capital ratios; (ii) another relating to risk-weighted assets used in calculating the "denominator" for banking organizations; and (iii) another relating to risk-weightings applicable only to internationally active banking organizations with significant trading activities. The FDIC and OCC are expected to approve the Final Rule this week.

("SLHCs") that: (i) have more than 25% of their consolidated assets derived from insurance underwriting activities (other than credit risk insurance), (ii) are "insurance underwriting companies" (*i.e.*, companies that engage in insurance underwriting activities and are subject to state insurance regulation), or (iii) are grandfathered unitary SLHCs with 50% or more of their revenues on an enterprise-wide basis derived from nonfinancial activities.[3] All other SLHCs are covered by the Final Rule ("covered SLHCs"). The Federal Reserve Board was generally sympathetic to arguments by the insurance industry that the Proposed Rule's capital requirements were "bank-centric" and inconsistent with insurance companies' business models and risk profiles. A separate, "appropriate" capital framework applicable to SLHCs not covered by the Final Rule is expected to be implemented by the time covered SLHCs must comply with the Final Rule in 2015. The Federal Reserve Board also noted that it plans to release a proposal "in the near term" relating to the transfer by grandfathered unitary SLHCs of their financial activities to an intermediate holding company and the capital requirements for such intermediate holding companies.

- *Bank Holding Companies Relying on "SR 01-1"*—U.S. bank holding company subsidiaries of foreign banking organizations that are currently relying on Supervision and Regulation Letter 01-1 are exempt from compliance until July 21, 2015.
- *Small Bank Holding Companies*—Top-tier bank holding companies that have consolidated assets of less than $500 million and are subject to the Federal Reserve Board's Small Bank Holding Company Policy Statement are exempt. There is no comparable exemption for covered SLHCs that have consolidated assets of less than $500 million.

B. GENERAL TIMING

There are two main start dates:

- *January 1, 2014*—For advanced approaches banking organizations (generally those with consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion), this is the start date for compliance with the revised minimum regulatory capital ratios and for determining risk-weighted assets under the "advanced approach."

[3] The calculation of total consolidated assets for this purpose is generally based on GAAP, although the Federal Reserve Board recognizes that many SLHCs substantially engaged in insurance activities do not calculate assets in such manner and, therefore, they will be permitted to use estimated calculations (subject to possible review and adjustment). Calculations must be as of June 30 of the previous calendar year.

- _January 1, 2015_—For non-advanced approaches banking organizations and covered SLHCs, this is the start date for compliance with the revised minimum regulatory capital ratios and for determining risk-weighted assets under the "standardized approach."

The Final Rule also provides transition periods for the phase-out of certain capital instruments that no longer will be included in regulatory capital, as well as for certain required regulatory capital deductions and adjustments, with the start date for such transition periods commencing in 2014 or 2015, depending on whether the banking organization is subject to the advanced approaches rules or not. Regardless of the size or complexity of a banking organization, the transition period for the two special capital buffers under Basel III—the conservation buffer and the countercyclical capital buffer, as discussed below—begins on January 1, 2016.

C. HEIGHTENED CAPITAL RATIOS AND NEW BUFFERS

Consistent with Basel III and the Proposed Rule, the Final Rule sets out new minimum regulatory capital requirements for U.S. banking organizations.

1. Minimum Risk-Based Capital Ratios

All advanced approaches banking organizations, non-advanced approaches banking organizations, and covered SLHCs (which are generally referred to as "banking organizations" in this memorandum) will need to meet the following minimum capital ratios, expressed as a percentage of risk-weighted assets, by January 1, 2015:

- _Common Equity Tier 1 Capital Ratio_—a common equity Tier 1 ("CET1") capital ratio of 4.5% (a new concept and requirement).
- _Tier 1 Capital Ratio (CET1 capital + Additional Tier 1 capital)_—a Tier 1 capital ratio of 6.0% (increased from 4.0% under the current capital rules).
- _Total Capital Ratio (Tier 1 capital + Tier 2 capital)_—a total capital ratio of 8.0% (unchanged from current capital rules).

For the year 2014 only, advanced approaches banking organizations that are not covered SLHCs will need to have CET1 capital, Tier 1 capital, and total capital ratios of 4.0%, 5.5%, and 8.0%, respectively.

As is the case under the existing capital rules, most banking organizations will be expected to maintain capital levels well above the minimum capital ratios. In addition, for a bank holding company to have the expanded activity authority attendant to "financial holding company" status, it needs to be "well capitalized." The Final Rule does not establish standards for determining whether a bank holding company is well capitalized, which under the current rules are the same as the risk-weighted ratios required for well capitalized status under the prompt corrective action rules.

By 2019, all banking organizations will effectively be required to hold a minimum of 7% CET1 capital against total risk-weighted assets (taking into account the 4.5% CET1 capital ratio plus the 2.5% capital conservation buffer). For the eight U.S. bank holding companies that have been identified by the Financial Stability Board as being global systemically important banks ("G-SIBs"), an additional common equity surcharge will apply on top of the 7% CET capital ratio (the highest G-SIB capital surcharge bucket has been set at 2.5% and will apply to Citigroup and JPMorgan Chase).[4] The Final Rule does not address the G-SIB capital surcharge, but as noted in Section G of this memorandum, the Federal Reserve Board is expected to issue a proposal later this year to implement this additional capital requirement for the eight U.S. G-SIBs.

2. Minimum Leverage Ratios

Under the Final Rule, all banking organizations will be subject to a leverage ratio of 4% (as before). The ratio is generally calculated by dividing Tier 1 capital by an organization's average total on-balance consolidated assets.

In addition, commencing January 1, 2018, advanced approaches banking organizations will be subject to a minimum supplementary leverage ratio of 3%, although they will be required to calculate and report this ratio beginning on January 1, 2015. This ratio is calculated as the simple arithmetic mean of the ratio of a banking organization's Tier 1 capital to total leverage exposure as of the last day of each month in the reporting quarter. The term "total leverage exposure" incorporates, among other things, the notional amount of certain off-balance sheet exposures (such as 10% of the notional amount of unconditionally cancellable commitments made by the banking organization and the potential future exposure amount for derivative contracts) in addition to on-balance sheet assets.

It is important to note that the Final Rule implements the minimum leverage ratio requirement under Basel III. As discussed in Section G of this memorandum, the Federal Reserve Board has indicated it regards Basel III's minimum leverage ratio as too low for the eight U.S. bank holding companies that have been identified as G-SIBs and, accordingly, may soon issue a proposal to increase it.

3. Capital Conservation Buffer and Countercyclical Capital Buffer

Consistent with Basel III and the Proposed Rule, the Final Rule adopts a "capital conservation buffer" for all banking organizations, as well as another buffer, known as a "countercyclical capital buffer," for advanced approaches banking organizations. Because noncompliance will

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[4] *See* Financial Stability Board, *Update of Group of Global Systemically Important Banks (G-SIBs)* (Nov. 1, 2012), *available at* http://www.financialstabilityboard.org/publications/r_121031ac.pdf. On July 3, 2013, the Basel Committee announced that it is in the process of updating its assessment methodology for G-SIBs and that it intends to finalize its framework for assessing and identifying G-SIBs by November 2013. *See* Basel Committee, *Globally Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (July 2013), *available at* http://www.bis.org/publ/bcbs255.pdf.

result in limitations on distributions and discretionary bonus payments, there are strong incentives for banking organizations to hold more than the minimum required capital.

As noted above, the transition period for these two buffers begins on January 1, 2016. The preamble to the Final Rule indicates that the maximum capital conservation buffer and the maximum *potential* countercyclical capital buffer will each be 0.625% for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019. This phase-in is consistent with both Basel III and the Proposed Rule.

(i) *Capital Conservation Buffer*

The capital conservation buffer will be composed exclusively of CET1 capital and would be added on top of each of the minimum risk-based capital ratios discussed above. A banking organization's buffer will be calculated by taking the lowest of the following three ratios (as calculated as of the last day of the previous calendar quarter): (i) its CET1 capital ratio minus its minimum CET1 capital ratio requirement, (ii) its Tier 1 capital ratio minus its minimum Tier 1 capital ratio requirement, and (iii) its total capital ratio minus its minimum total risk-based capital ratio requirement. Under the Final Rule, if any one of these ratios is less than or equal to the applicable minimum requirement, then the capital conservation buffer is 0%.

The Final Rule provides a "maximum payout ratio" for distributions[5] and discretionary bonuses[6] to executive officers[7] that increases in stringency as a banking organization dips further into its buffer above the minimum ratios. As illustrated in the table below, the maximum dollar amount that a banking organization is permitted to pay during a calendar quarter is equal to the maximum payout ratio multiplied by the banking organization's eligible

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[5] The term "distribution" is defined generally as a repurchase or redemption of a Tier 1 or Tier 2 capital instrument or a dividend or interest payment on such instrument (except in the case of a Tier 2 instrument on which the banking organization does not have full discretion to suspend such payments without triggering an event of default). Significantly, the Final Rule provides that a redemption or repurchase of a capital instrument is *not* a "distribution" if the banking organization fully replaces that capital instrument by issuing another capital instrument of the same or better quality (that is, equally or more subordinate), based on the Final Rule's eligibility criteria for capital instruments, and provided that such issuance is completed within the same calendar quarter the banking organization announces the repurchase or redemption.

[6] The term "discretionary bonus" is defined relatively narrowly to include only payments where the banking organization has discretion as to whether to make such payment and in what amount. Payments pursuant to any contract or promise (express or implied) or prefunded bonus pool would not be considered discretionary bonuses. In addition, non-cash payments that do not affect capital or earnings would also be excluded.

[7] The term "executive officer" means a person who holds the title or performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line, and other staff that a banking organization's board of directors deems to have equivalent responsibility.

retained income (generally, net income for the prior four calendar quarters, net of any capital distributions).

Capital Conservation Buffer	Maximum Payout Ratio for Distributions and Discretionary Bonus Payments
Greater than 2.5%	No payout limitation applies
Less than or equal to 2.5% and greater than 1.85%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

To avoid these quantitative limits, a banking organization must hold a capital conservation buffer in an amount *greater than* 2.5% of its total risk-weighted assets (plus, for advanced approaches banking organizations, whatever is required under a countercyclical capital buffer then in effect).

(ii) *Countercyclical Capital Buffer*

The countercyclical capital buffer, also consisting of CET1 capital, applies only to advanced approaches banking organizations. It would be on top of the capital conservation buffer and would range from 0% to 2.5% of risk-weighted assets. For purposes of both buffers, advanced approaches banking organizations will not be required to calculate them based on their advanced approaches total risk-weighted assets, as the Proposed Rule would have required. Instead, they will generally calculate their buffers by using the lower of the standardized approach and advanced approaches risk-based capital ratios.[8]

Initially, the countercyclical capital buffer will be set to 0%, but the banking agencies have the discretion to make upward adjustments, on a country-by-country exposures basis, based on a range of "macroeconomic, financial, and supervisory information" (such as the ratio of credit to GDP, a variety of asset prices, funding spreads, credit condition surveys, and indices based on CDS spreads) indicating an increase in systemic risk. An upward adjustment would generally be announced 12 months prior to its effectiveness and remain in effect for 12 months unless extended or adjusted by the banking agencies.

[8] This approach may be used by advanced approaches banking organizations that have completed the so-called "parallel run" process under Basel II. Basel II was never comprehensively implemented in the United States, but a portion of it (relating to the "advanced approach") was applied to the largest, most complex U.S. banking organizations.

4. Updated Prompt Corrective Action Framework for Insured Depository Institutions

The Final Rule updates the prompt corrective action ("PCA") framework applicable to insured depository institutions (but not their holding companies) under Section 38 of the Federal Deposit Insurance Act. The general structure of the PCA framework—"well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized"—remains the same, but the Final Rule makes necessary adjustments to account for changes to the required capital levels made by the Final Rules, such as the new CET1 capital requirement and the supplementary leverage ratio.

Effective January 1, 2015, all insured depository institutions must comply with the revised PCA thresholds, as depicted below.

PCA Category	Total Capital	Tier 1 Capital	Common Equity Tier 1	Leverage Measure	
				Leverage Ratio	Supplementary Leverage Ratio
Well Capitalized	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%	Not applicable
Adequately Capitalized	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%	≥ 3%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%	< 3%
Significantly Undercapitalized	< 6%	< 4%	< 3%	< 3%	Not applicable
Critically Undercapitalized	Tangible Equity (defined as Tier 1 capital plus non-Tier 1 perpetual preferred stock) to Total Assets ≤ 2%				Not applicable

D. OTHER CHANGES TO THE NUMERATOR: REDEFINING THE COMPONENTS OF REGULATORY CAPITAL

A central theme of Basel III, and of post-crisis capital regulatory reform in general, is that new capital standards must not only address the *quantity* of capital but also the *quality* of capital held by banking organizations. In the financial crisis, the U.S. banking agencies identified significant weaknesses in the loss-absorbency of certain capital instruments, such as trust preferred securities ("TruPS"), that ultimately led them to view such instruments as inappropriate for inclusion in Tier 1 capital. In the Proposed Rule from last summer, the banking agencies sought to address these weaknesses. The Final Rule largely follows the Proposed Rule's eligibility criteria for the various components of capital, as well as the general approach to regulatory adjustments and deductions, but with some notable differences.

1. Capital Components

The Final Rule establishes the qualification criteria for the following three components that comprise a banking organization's "regulatory capital":

- _Common Equity Tier 1 Capital_—As noted previously, CET1 capital is a new concept under Basel III. CET1 capital is predominantly comprised of retained earnings and common stock instruments (that meet strict delineated criteria), net of treasury stock, and after making necessary capital deductions and adjustments. It will also include AOCI (for organizations that do not make opt-out elections) and CET1 minority interests, which are subject to restrictions described below. Under the Final Rule, CET1 capital will be the largest capital component for most banking organizations.
- _Additional Tier 1 Capital_—Additional Tier 1 capital consists of non-cumulative perpetual preferred stock and similar instruments meeting specified eligibility criteria, related surplus, Tier 1 minority interests that are not included in a banking organization's CET1 capital,[9] and "TARP" preferred stock and other instruments issued under the Emergency Economic Stabilization Act of 2008. Among the eligibility criteria for both CET1 capital and Additional Tier 1 capital instruments is the requirement (which beyond what Basel III required) that any paid-in amount be classified as equity under GAAP before the instruments may be included in regulatory capital. As such, the banking agencies believe it will likely be difficult for any contingent capital instrument to qualify prior to its conversion into an equity instrument.
- _Tier 2 Capital_—Tier 2 capital includes instruments such as subordinated debt that has a minimum original maturity of at least five years and is subordinated to the claims of depositors and general creditors.[10] It will also include total capital minority interest not included in Tier 1 capital and limited amounts of a banking organization's allowance for loan and lease losses (ALLL), less applicable regulatory adjustments and deductions. The Final Rule removes the existing limit on how much Tier 2 capital will count as regulatory capital and also removes the sublimit on the portion of Tier 2 capital that may be comprised of subordinated debt.

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[9] With respect to capital instruments issued by real estate investment trusts ("REITs"), which can count toward Tier 1 capital under the current capital rules, the preamble to the Final Rule notes that the banking agencies do not expect REIT preferred stock to qualify as a Tier 1 minority interest under the new capital framework, particularly if the issuer does not have the ability to declare a consent dividend or otherwise cancel cash dividends. Also, the Final Rule clarifies that certain REITs currently used by banking organizations will not qualify as "operating subsidiaries" under the rule and, as a result, minority interests in such entities will not qualify as regulatory capital. For REITs to be treated as operating subsidiaries, they must be actively managed for earning a profit in their own right.

[10] The Final Rule clarifies that for a subordinated debt instrument to qualify as Tier 2 capital, it must also be subordinated to the claims of trade creditors. Accordingly, subordinated debt issued by banking organizations on or after May 19, 2010 with a carve-out for these creditors will not qualify as Tier 2 capital.

2. Limitations on Minority Interests

During the recent financial crisis, the banking agencies found that minority interests in a banking organization's consolidated subsidiaries were generally available to absorb losses at the subsidiary level, but not always available to absorb losses at the consolidated parent organization level. Under the Final Rule, minority interests in a parent banking organization's subsidiaries will be subject to limitations on their inclusion in the parent banking organization's regulatory capital based generally on the amount of capital held by the subsidiary and of the type of interest held.

As a threshold matter, a minority interest in a consolidated subsidiary cannot be included in a banking organization's regulatory capital if the subsidiary's capital ratios are equal to or below the level of capital necessary to meet the minimum capital requirements plus the capital conservation buffer (or the equivalent standards of the subsidiary's home country supervisor). In other words, a subsidiary must have "surplus" capital for the banking organization to be able to include its minority interest in such subsidiary as regulatory capital. However, the surplus capital itself, to the extent it is attributable to third party investors, cannot be counted toward the parent banking organization's regulatory capital. For subsidiaries that are not subject to the capital requirements of the Final Rule, or equivalent home country rules, the banking organization will be required to make these calculations as if the subsidiary were subject to the Final Rule.

As for the type of interest held, the particular capital instrument related to the minority interest must satisfy the eligibility criteria for such instrument to be included in a particular class of regulatory capital. Most importantly, only CET1 capital issued by a consolidated U.S. depository institution subsidiary or foreign bank subsidiary of a parent banking organization to third party investors may count under the Final Rule toward such parent's CET1 capital.

3. Phase-Out of Non-Qualifying Capital Instruments

As under Basel III, Dodd-Frank's Collins Amendment, and the Proposed Rule, the Final Rule generally requires the phase-out of non-qualifying capital instruments—notably, TruPS and cumulative perpetual preferred stock—that were issued prior to a cut-off date and included in Tier 1 capital. However, the Final Rule differs substantially from the Proposed Rule with respect to timing and the treatment of certain instruments issued by smaller banking organizations.

- *Depository Institution Holding Companies with Less than $15 Billion in Total Consolidated Assets as of December 31, 2009*—These companies may permanently include non-qualifying instruments that were issued and included in Tier 1 or Tier 2 capital prior to May 19, 2010 in Additional Tier 1 or Tier 2 capital until they redeem such instruments or until the instruments mature. This is a major change from the Proposed Rule, which would have imposed a 10-year phase-out of these instruments and which disregarded the permanent grandfathering treatment that Congress explicitly authorized under the Collins Amendment.

- _Depository Institution Holding Companies with $15 Billion or More in Total Consolidated Assets as of December 31, 2009_—These companies may include non-qualifying instruments that were issued and included in Tier 1 or Tier 2 capital prior to May 19, 2010 in Additional Tier 1 or Tier 2 capital, subject to a specified phase-out schedule. The Proposed Rule would have phased out these instruments over a three-year period by capping the maximum amount includible in Tier 1 and Tier 2 capital at 75% in 2013, 50% in 2014, 25% in 2015, and then 0% thereafter. The Final Rule effectively maintains the same schedule once the Final Rule becomes effective: the Additional Tier 1 capital phase-out schedule commences January 1, 2014 for advanced approaches banking organizations (excluding SLHCs), when a 50% cap will apply, and on January 1, 2015 for non-advanced approaches banking organizations and covered SLHCs, when a 25% cap will apply. By January 1, 2016, all non-qualifying instruments must be phased out of Additional Tier 1 capital. Non-advanced approaches banking organizations may permanently include non-qualifying capital instruments in Tier 2 capital that have been phased out of Additional Tier 1 capital pursuant to the schedule above. However, advanced approaches banking organizations may include non-qualifying capital instruments in Tier 2 capital that have been phased out of Additional Tier 1 capital pursuant to the schedule above up to a 60% cap for 2016, with the cap declining progressively by 10% each year thereafter until the phase-out is completed at year-end 2021.

4. Capital Deductions and Adjustments

As a general matter, the revised capital framework imposes stricter regulatory capital deductions from and adjustments to capital, with most deductions and adjustments taken against CET1 capital. The Final Rule generally provides lengthy transition periods, except as otherwise noted below.

The following is a summary of how the Final Rule treats certain key deductions and adjustments:

- _Mortgage Servicing Assets ("MSAs"), Deferred Tax Assets ("DTAs"), and Significant Investments in Unconsolidated Financial Institutions_—Consistent with Basel III and the Proposed Rule, the Final Rule requires banking organizations to deduct the following assets from CET1 capital to the extent they individually exceed 10% of CET1 capital or, in the aggregate, 15% of CET1 capital: (i) DTAs that cannot be realized through net operating loss carrybacks, net of any related valuation allowances and net of deferred tax liabilities ("DTLs"); (ii) MSAs, net of associated DTLs; and (iii) "significant investments" (*i.e.*, 10% or more ownership) in the capital (in the form of common stock, net of associated DTLs) of unconsolidated "financial institutions" (defined broadly to include banking organizations; nonbank banks, such as credit card banks and industrial banks; insurance companies; nonbank companies designated as systemically important by the Financial Stability Oversight Council (so-called "nonbank SIFIs"); and any

other company, of which the banking organization owns $10 million of GAAP equity or more than 10% of the common stock, that is predominantly engaged in certain lending, securities underwriting, or certain insurance activities).

- *Unrealized Gains and Losses in Accumulated Other Comprehensive Income ("AOCI")*—Under the Proposed Rule, unrealized gains and losses on AOCI (other than with respect to certain cash flow hedges) would have been required to be included in the CET1 capital of all banking organizations. Notably, the Final Rule gives significant relief to community banks and many regional banks that had voiced concerns during the comment period that the inclusion of unrealized gains and losses on available-for-sale debt securities would have resulted in large and volatile changes in their capital levels. Non-advanced approaches banking organizations will be permitted to make a one-time election to opt-out of this requirement (and, in effect, retain the AOCI treatment under the current capital rules) when they file their first call report after becoming subject to the Final Rule (*i.e.*, the first quarter of 2015). If a top-tier depository institution holding company makes an AOCI opt-out election, any subsidiary insured depository institution that is consolidated by the depository institution holding company also must make an AOCI opt-out election.

  In the event of a merger or similar business combination between a banking organization that has made an opt-out election and one that has not, the surviving organization (if it is a non-advanced approaches banking organization) will be permitted to make a new opt-out election by the first regulatory reporting date after the completion of the transaction. This permitted election is not dependent upon the respective sizes of the merging organizations or which is the surviving entity (assuming it is not an advanced approaches banking organization). If a banking organization acquires less than substantially all of the assets or voting stock of a banking organization which had made a different opt-out election, the applicable banking agency may in its discretion allow the acquiror to make a new opt-out election.

- *Defined Benefit Pension Fund Assets*—Depository institution holding companies (but not their bank or thrift subsidiaries) will need to deduct any defined pension fund asset, net of any associated DTLs, from capital unless they have "unrestricted and unfettered access" to the assets of a particular fund.

- *Goodwill and Other Intangibles (other than MSAs)*—Goodwill and other intangible assets of a banking organization (other than MSAs) are to be deducted from CET1 capital. No transition period is provided for goodwill deductions.

- *Investments by a Banking Organization in its Own Regulatory Capital Instruments*—As in the Proposed Rule, the Final Rule requires a banking organization to deduct the amount of its investments in its own capital instruments—including direct, indirect, and synthetic exposures—to the extent such instruments are not already excluded from regulatory capital. To avoid any double-counting of

capital, a banking organization would have to look through its holdings of an index security to deduct investments in its own capital.

- *Equity Investments in Financial Subsidiaries*—National banks and insured state banks that establish financial subsidiaries (generally subsidiaries that engage in activities that are "financial in nature" for purposes of Section 4(k) of the Bank Holding Company Act) will be required to deduct their equity investments in such subsidiaries from CET1 capital. This is consistent with the deductions from a depository institution's Tier 1 and Tier 2 capital and from its risk-weighted assets under the current capital rules. There is no transition period.

5. Treatment of Permitted Fund Investments Under the Volcker Rule

The Final Rule does not address the capital requirements that will apply in respect of investments in private equity and hedge funds that are permitted under the Volcker Rule. We expect this issue to be addressed in the long-awaited final regulations under the Volcker Rule.

E. CHANGES TO THE DENOMINATOR: DETERMINING RISK-WEIGHTED ASSETS

Basel III generally gives banking organizations a choice between two methods for calculating risk-weighted assets, which comprise the denominator of a banking organization's risk-based capital ratios. One is a "standardized approach" that permits them to measure credit risk using metrics and risk-weightings prescribed by regulation. Another is an "advanced approach" (or internal ratings-based approach) that allows banking organizations to use their internal models and ratings systems to measure credit risk, subject to regulatory approval. The Final Rule reflects changes in both approaches that are designed to address perceived shortcomings in risk-based capital requirements identified by the U.S. banking agencies during the financial crisis. To address criticisms that the advanced approach, which is generally used by the largest, most complex financial institutions, could result in such institutions having lower capital requirements than smaller institutions, the standardized approach will serve as the "floor" mandated by the Collins Amendment with respect to any leverage and risk-based capital requirements that the Federal Reserve Board may impose on banking organizations and nonbank SIFIs.

1. The Standardized Approach

The standardized approach for calculating risk-weighting goes into effect on January 1, 2015 and will apply to all banking organizations. Until then, non-advanced approaches banking organizations and covered SLHCs will remain subject to the current general risk-based capital rules. From January 1, 2014 to December 31, 2014, advanced approaches banking organizations will be required to use the current general risk-based capital rules, including the current market-risk rule (which governs the market risk adjustment to the denominator), to calculate their standardized total risk-weighted assets under the Final Rule.

The following is a summary of the key features of the standardized approach.

- *Expansion of Risk-Weight Categories*—In general, the Final Rule changes the risk-weights used for certain on- and off-balance sheet asset categories to more appropriately reflect their associated credit risks. The number of risk-weighting categories is expanded from four (0%, 20%, 50%, and 100%) to a much larger and more risk-sensitive number of categories that generally range from 0% (for U.S. government and certain other sovereign exposures) to 600% (for certain equity exposures).

- *On-Balance Sheet Assets*—Among other things, the Final Rule revises the methodologies for determining risk-weighted assets for certain on-balance sheet items, such as:
  - certain commercial real estate credit facilities that finance the acquisition, development, or construction of real property, by assigning a higher risk-weight (150%);
  - exposures that are more than 90 days past due or on nonaccrual (excluding sovereign and residential mortgage exposures), by assigning a higher risk-weight (150%); and
  - exposures to foreign sovereigns, foreign banks, and foreign public sector entities, by basing the risk-weight for each exposure type on the Organization for Economic Co-operation and Development's ("OECD") country risk classification ("CRC"), rather than simply on the basis of OECD membership.[11]

- *Residential Mortgage Exposures*—Notably, the Final Rule did not adopt proposed changes in the Proposed Rule on the risk-weightings for residential mortgage exposures that would have applied a more granular, risk-sensitive treatment to such exposures based on loan characteristics such as loan-to-value ratios. Instead, the Federal Reserve Board opted to leave unchanged the current risk-weightings for residential mortgages, which generally are 50% for performing, secured first-lien mortgage loans, and 100% for all other first-lien residential mortgage loans. The Federal Reserve Board rejected the earlier proposal in view of potential implementation burdens, particularly for community banks, as well as concerns regarding the cumulative impact of other, recently-implemented residential mortgage regulations on U.S. housing markets.

- *Off-Balance Sheet Exposures* – The Final Rule also establishes risk-weights, by means of a credit conversion factor ("CCF"), for certain off-balance sheet items, including guarantees and commitments. The Final Rule includes "credit enhancing representations and warranties" that are not securitization exposures among the list of off-balance sheet exposures that will be subject to

[11] Since the release of the Proposed Rule, the OECD ceased rating certain high-income jurisdictions. Accordingly, the Final Rule reflects this so that those OECD member countries, foreign banks domiciled in OECD countries, or public sector entities that no longer receive a CRC are assigned to the lowest applicable risk-weight (generally 0% to 20%).

a CCF of 100%. However, the Federal Reserve Board retained the safe harbor from capital requirements in the current risk-based capital rules for assets sold with representations and warranties that contain certain early default clauses or premium refund clauses that apply within 120 days of the sale. Additionally, the Final Rule stipulates that banking organizations apply a CCF of 20% to all short-term commitments of one year or less that are not unconditionally cancellable, as initially proposed.

- *OTC Derivatives* – The Final Rule applies risk-weights to over-the-counter ("OTC") derivative contracts. Exposure calculation methodologies vary, depending upon whether the contracts are single OTC contracts or multiple contracts subject to qualifying master netting arrangements. The rule generally recognizes credit risk mitigation benefits of financial collateral that secures an OTC derivative contract. In addition to off-balance sheet exposure related to the underlying contracts, counterparty credit risk for OTC credit risk derivatives are addressed in the Final Rule, with regard to both protection purchasers and protection providers. In the case of counterparty credit risk for OTC equity derivatives, banking organizations generally must treat an OTC equity derivative contract as an equity exposure and compute a risk-weighted asset amount for the OTC equity derivative contract. In addition, the organization must calculate a risk-based capital requirement for the counterparty credit risk of an OTC equity derivative contract, as provided in the Final Rule.

  The Final Rule specifies applicable risk-weightings for a clearing bank's exposure for OTC derivative contracts, which apply whether the bank is acting as direct financial intermediary or guarantor on behalf of its client. The Final Rule introduces capital requirements for cleared transactions with central counterparties and for default fund contributions to central counterparties ("CCPs") by clearing member banking organizations, as initially proposed. In general, the Final Rule recognizes that CCPs help improve the safety and soundness of the derivative and repo-style transaction markets through the multilateral netting of exposures, establishment and enforcement of collateral requirements, and the promotion of market transparency, and the Final Rule provides preferential capital treatment for centrally-cleared derivatives and repo-style transactions. Finally, the Final Rule specifies the methodologies to be used by banks that are clearing member clients to calculate risk-weighted assets for cleared OTC derivative transactions.

- *Credit Risk Mitigants* – The current capital rules recognize, to a very limited extent, guarantees and collateral to mitigate credit risk. The Final Rule specifies alternative methodologies for calculating such offsets and expands 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).

- *Securitizations* – Consistent with Basel III, the Final Rule specifies the methodologies for calculating risk-weighted assets for unsettled transactions and for securitization exposures. Under the Final Rule, a banking organization would determine the risk-based capital requirement for securitization exposures by applying either (1) the gross-up approach from the general risk-based capital rules based on the subordination of a securitization exposure; or (2) a simplified supervisory formula approach ("SSFA"), which is a simplified version of the supervisory formula approach in the advanced approaches rule and has been adopted by the agencies in the market risk rule. The Final Rule modifies the SSFA to recognize common deferral features associated with student and consumer loans unrelated to credit risk.

- *Equities* – Equity exposures are subject to alternative methods for calculating risk-weighted assets. Generally, banks must use a "simple risk-weight approach," which establishes risk-weights ranging from 0% to 600%, depending upon the credit quality of the issuer, that are applied to the adjusted carrying value of the investment, in the case of on-balance sheet equity exposures. Generally, non-significant equity exposures the carrying value of which in the aggregate does not exceed 10% of a bank's total capital are subject to risk-weights of 100%, subject to certain exceptions. Equity purchase commitments and other off-balance sheet equity exposures are subject to conversion factors ranging from 20% to 100%, depending on the term and conditionality of the commitments.

- *Fund Investments*—With regard to investments by banking organizations in or through investment funds, or separate accounts, the Final Rule offers three options (*i.e.*, full look-through, simple look-through, or alternative modified look-through), each of which looks through the fund and establishes risk-weights according to the types of investments permitted to be made by the fund or through the separate account.[12] Thus, the risk-based capital requirement for equity exposures to investment funds that hold only low-risk assets would be relatively low, whereas high-risk exposures held through investment funds would be subject to a higher capital requirement, with a minimum risk-weight for any equity exposure to an investment fund at 20%.

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[12] On July 5, 2013, the Basel Committee proposed further revisions to the treatment of banks' equity investments in funds. Among other things, the revisions address risks associated with banks' interaction with so-called "shadow banking entities," or those credit intermediaries operating outside the regular banking system, particularly where there are successive layers of funds (so-called "funds of funds"). In using the "look-through" approach, banks will be required to apply a risk-weight of 1,250% to a fund's exposure to other funds. *See* Basel Committee, *Consultative Document: Capital Requirements for Banks' Equity Investments in Funds* (July 2013; comment period expires Oct. 4, 2013), *available at* http://www.bis.org/publ/bcbs257.htm.

An exposure to an investment fund that generally would meet the definition of a "traditional securitization"[13] (as defined in the Final Rule) and that has "greater than immaterial leverage" (a phrase that is not defined) will be subject to a risk-weight of 600%. Accordingly, investments in funds with material amounts of leverage and that otherwise meet the definition of a traditional securitization may be subject to higher capital requirements. Most private equity funds should have immaterial leverage, particularly if debt under so-called "subscription line facilities" (which involve debt that is collateralized by uncalled capital commitments and eventually repaid out of capital calls) is excluded from the analysis.

- *Alternatives to Credit Ratings*—Consistent with the mandate of Dodd-Frank, the Final Rule adopts alternatives to credit ratings for calculating the risk-weighting for certain assets.[14] This is a significant departure from the reliance on credit ratings that had been sanctioned previously by regulators.

The Final Rule also introduces new quantitative and qualitative disclosure requirements for top-tier banking organizations domiciled in the United States with $50 billion or more in total assets. The required disclosures would be both quantitative and qualitative in nature, with quantitative disclosures to be made quarterly and qualitative disclosures to be made annually. Banking organizations would have some flexibility in determining the appropriate medium and location of disclosure, but management is encouraged to provide all of the required disclosures in one place on an entity's public website.

The precise quantitative and qualitative disclosures to be made are outlined in 10 tables that are included in the Final Rule. Among other things, banking organizations would need to summarize the main terms and conditions of their regulatory capital instruments, provide details on capital adequacy (including specific capital ratios and disclosure of any limitations on distributions and discretionary bonus payments resulting from the capital conservation buffer), make disclosures related to counterparty risk and credit mitigation, and provide information on securitization transactions and the management of interest rate risk.

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13 The definition of "traditional securitization" specifically excludes exposures to an "investment fund," which is defined as a company (i) where all or substantially all of the assets of the fund are financial assets and (ii) that has no material liabilities.

14 For example, in determining the risk-weight of certain exposures to non-U.S. sovereigns and non-U.S. public sector entities, the Final Rule uses the OECD's CRC model. And for determining the risk-weight of corporate exposures, it adopts a definition of "investment grade" that is based on an approach that the OCC implemented in its investment securities regulations; namely, it treats 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.

2. The Advanced Approach

The advanced approach for calculating risk-weighted assets is revised under the Final Rule to incorporate certain aspects of Basel III and Dodd-Frank, including those related to the securitization framework,[15] treatment of counterparty credit risk,[16] and disclosure requirements regarding capital instruments and securitization exposures. These modifications are designed to ensure that advanced approaches banking organizations hold higher levels of capital for these exposures and are more transparent about such exposures. To recognize the higher correlation of financial institutions' creditworthiness due to sensitivity to common risk factors, and consistent with Basel III, the Final Rule increases capital requirements for exposures to non-regulated financial institutions and to regulated financial institutions with consolidated assets greater than or equal to $100 billion. The changes are designed to increase the risk sensitivity of internationally active banks to counterparty risk and interconnectedness among financial institutions.

F. MARKET RISK CAPITAL RULE AND PROPOSED AMENDMENTS

The Final Rule also would integrate the banking agencies' existing market risk capital rule into the comprehensive capital framework and implement the market risk capital rule for savings associations and covered SLHCs whose trading activity (the gross sum of its trading assets and trading liabilities) is equal to 10% or more of its quarter-end total assets or $1 billion or more.

Contemporaneous with the release of the Final Rule, the Federal Reserve Board issued a proposal to amend the market risk capital rule by (i) revising the treatment under the current market risk rule of the specific risk-weights for sovereign exposures, non-publicly traded mutual funds, and certain student loans that are securitized and traded; and (ii) clarifying the timing of disclosures required under the current market risk rule to better align the rule with transition provisions of the new comprehensive capital framework.

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[15] These revisions also include replacing references to credit ratings with alternative standards of creditworthiness consistent with Section 939A of Dodd-Frank. The Final Rule removes the ratings-based and the internal assessment approaches for securitization exposures from the rules currently applicable to advanced approaches banking organizations. Instead, an advanced approaches banking organization will calculate its capital requirement for securitization exposures using either the supervisory formula approach (SFA) or the simplified supervisory formula approach (SSFA) under the Final Rule.

[16] To address shortcomings revealed by the financial crisis, the Final Rule includes a higher counterparty credit risk capital requirement, consistent with Basel III, to account for credit valuation adjustments ("CVA"). The CVA is the fair value adjustment that reflects counterparty credit risk in the valuation of an over-the-counter derivative contract. The Final Rule also would make changes to the internal models methodology under the advanced approach, requiring banking organizations to consider stressed inputs when calculating their capital requirements for counterparty credit risk.

G. ADDITIONAL CAPITAL-RELATED INITIATIVES AROUND THE CORNER

In his prepared remarks at the Federal Reserve Board's meeting on July 2, 2013, Governor Tarullo highlighted four additional capital-related initiatives, in "various stages of development," that will apply to the eight U.S. G-SIBs:

- *G-SIB Capital Surcharge*—A notice of proposed rulemaking, possibly "late this year," to implement the G-SIB surcharge applicable to the eight U.S. banking organizations identified as having global systemic importance.
- *Heightened Leverage Ratio*—A notice of proposed rulemaking, which is "very close to completion," that will establish a leverage ratio threshold above the required minimum under Basel III. Governor Tarullo said the minimum leverage ratio "seems to have been set too low to be an effective counterpart to the combination of risk-weighted capital measures that have been agreed internationally."
- *Total Equity and Long-Term Debt*— A notice of proposed rulemaking "in the next few months" concerning the combined amount of equity and long-term debt that very large banking organizations should maintain in order to facilitate orderly liquidation in appropriate circumstances.
- *Capital Charge Related to Short-Term Wholesale Funding*—An advance notice of proposed rulemaking that would require "additional measures that would directly address risks related to short-term wholesale funding, including a requirement that large firms substantially dependent on such funding hold additional capital."

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