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News Bulletin

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They're Here: The Final Interagency Regulatory Capital Rules

The Federal Reserve Board today approved the publication of the long-awaited final regulatory capital rules ("Final Rules"), which were proposed one year ago (the "Proposed Rules").[1] While today's action was taken by the Federal Reserve Board, the OCC and the FDIC are expected to announce their approval of the Final Rules by no later than July 9. Therefore, rather than just referring to the actions of the Federal Reserve Board in this discussion, we will refer hereinafter to the actions of all three federal banking agencies (the "Agencies").

As adopted, the Final Rules make major changes to the U.S. regulatory capital framework in a regulatory effort to strengthen the regulatory capital of U.S. banking organizations and bring the U.S. into compliance with the Basel Committee's current international regulatory capital accord ("Basel III"). The Final rules will replace the Agencies' general risk-based capital rules, advanced approaches rule, market risk rule, and leverage rules in accordance with the transition provisions described below.

Consistent with the Proposed Rules, the Final Rules broadly revise the basic definitions and elements of regulatory capital; make substantial changes to the credit risk weightings for banking and trading book assets through the adoption of material elements of the Basel II standardized approach for credit risk weightings; and finalize changes made to the Basel capital framework in the aftermath of the financial crisis to large U.S. banking organizations subject to the advanced Basel II capital framework. As stated by the Agencies, the new regulatory capital rules will establish the benchmark capital rules and capital floors that are generally applicable to U.S. banks under Section 171 of the Dodd-Frank Act (the "Collins Amendment").

The Final Rules also make changes to the Advanced Approaches framework that was proposed for the largest U.S. banks last year, and are broadly consistent with the Proposed Rules. Further, the Agencies are proposing changes to the "Market Risk" capital rule, that applies to banks with large trading exposures, to align the Market Risk rule with changes made at the international level by the Basel Committee.

The Final Rules will become effective on January 1, 2014, but with a mandatory compliance date of January 1, 2015 for banks other than those subject to the Advanced Approaches. On that date, most banking organizations would be required to begin the transition to the full implementation of the new capital framework by 2018. The effective date and compliance period, and the beginning of the transitional adjustments, would be January 1, 2014 for Advanced Approaches banking organizations.

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[1] Office of the Comptroller of the Currency ("OCC"), Federal Reserve Board, Federal Deposit Insurance Corporation ("FDIC"), Regulatory Capital Rules: (i) Implementation of Basel III; Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Periods and Prompt Corrective Action ("Basel III Proposal"); (ii) Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements ("Standardized Approach Proposal"); and (iii) Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule ("Advanced Approaches Proposal"). *See,* 77 Fed. Reg. 52792, 52888, and 52978 (Aug. 30, 2012).

Highlights of the Final Rules

As is well known, the Proposed Rules were controversial and raised a number of fundamental questions as to the scope of their applicability, the granularity of their requirements, and their possible impact on bank activities, operations and services. With the adoption of the Final Rules, many, but not all, of these questions are answered, and in general probably not to the banking industry's liking. In substance, with few exceptions, the Final Rules do not differ in material respects from the Proposed Rules.[2] Accordingly, the Final Rules offer only modest accommodations to the concerns of community banks that the U.S. regulatory capital regime reflected in the Proposed Rules would be highly burdensome for smaller banks and that the broad application of the Basel regulatory framework to community banks was unnecessary.

Applicability; Scope and Exclusions. Like the Proposed Rules, the Final Rules generally apply to all U.S. banks that are subject to minimum capital requirements, including Federal and state savings banks, as well as to bank and savings and loan holding companies other than "small bank holding companies" (generally bank holding companies with consolidated assets of less than $500 million). In this regard, the Agencies were effectively unmoved by the petitions of the banking industry to scale back the scope of the Final Rules, particularly with respect to the elements, minimum requirements and calculations of regulatory capital. In this regard, the Agencies were influenced by recent studies and analyses showing that the banking industry generally would have little difficulty in complying with the new minimum capital requirements.

In response to insurance and nonfinancial industry concerns about the applicability of " bank-centric" regulatory capital rules to insurance and grandfathered nonfinancial enterprises, the Agencies have temporarily exempted savings and loan holding companies with more than 25 percent of their consolidated assets derived from insurance underwriting activities (other than credit insurance), as well as "grandfathered" unitary savings and loan holding companies with 50 percent or more of total consolidated assets or 50 percent or more of revenues on an enterprise-wide basis derived from nonfinancial activities. The purpose of this temporary exemption is to allow the Agencies to evaluate and study the appropriate consolidated capital requirements for these entities.

Components of Regulatory Capital. Under the Final Rules, as was the case with the Proposed Rules, and consistent with Basel III, Tier 1 capital will consist of common equity Tier 1 capital and additional Tier 1 capital. Total Tier 1 capital, plus Tier 2 capital, would constitute total risk-based capital.

The Proposed Rules, however, would have required that all unrealized gains and losses in accumulated other comprehensive income ("AOCI") (with the exception of unrealized gains and losses on cash flow hedges relating to items that are not fair valued on the balance sheet) be included in the common equity tier 1 capital of all banking organizations. The Agencies, however, have decided to allow banking organizations (other than Advanced Approaches banking organizations) to make a one-time election to "opt-out" of the requirement to include most AOCI components in the calculation of common equity tier 1 capital and, in effect, retain the AOCI treatment under the current capital rules. Qualifying banking organizations may make this one-time, permanent election to effectively continue using the AOCI treatment under the general risk-based capital rules for their regulatory calculations when filing the first Call Report or FR Y-9 series report after the date upon which they become subject to the Final Rules.

In addition, the Final Rules would effectively "grandfather" certain trust preferred securities issued by smaller banking organizations by not requiring a phase out of non-qualifying Tier 1 capital instruments issued prior to May 19, 2010, by banking organizations with less than $15 billion in assets as of December 31, 2009, or that were organized in mutual form as of May 19, 2010.

[2] Please refer to our June 2012 analysis of the Proposed Rules, *available at* *http://www.mofo.com/files/Uploads/Images/120613-Banking-Agencies-New-Regulatory-Capital-Proposals.pdf*.

Revised Definitions and Calculations of Capital. Under the Final Rules, with slight modifications from the Proposed Rules:

- Qualifying common equity Tier 1 capital, which would be the sum of qualifying common equity instruments, related surplus, and qualifying Tier 1 minority interests, minus applicable regulatory adjustments and deductions, would have to satisfy multiple criteria, including the requirement (unlike the Basel III accord itself) that these instruments qualify as equity under generally accepted accounting principles.

- Additional Tier 1 Capital would be the sum of non-common equity capital instruments that satisfy separate criteria, related surplus, and Tier 1 minority interests that are not included in a banking organization's common equity Tier 1 capital, minus applicable regulatory adjustments and deductions. Non-cumulative perpetual preferred stock, which now qualifies as simple Tier 1 capital, would not qualify as common equity Tier 1 capital, but would qualify as additional Tier 1 capital.

- Cumulative preferred stock would no longer qualify as Tier 1 capital of any kind, and certain hybrid capital instruments, including trust preferred securities (subject to the grandfathering noted above), no longer will qualify as Tier 1 capital of any kind.

- Tier 2 Capital of a banking organization must satisfy other separate criteria.

Treatment of Minority Interests. The Final Rules adopt the restrictive treatment of minority interests set forth in the Proposed Rules.

- Minority interests would be classified as a common equity Tier 1, 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 would be limited to a depository institution or foreign bank that is a consolidated subsidiary of a banking organization.

- Limits on the amount of minority interest that may be included in the consolidated capital of a banking organization would be determined under a formula that is generally based on the amount and distribution of capital of the consolidated subsidiary.

Exclusions and Deductions from Capital. As was the case with the Proposed Rules, the Final Rules will require a number of required capital adjustments, exclusions and deductions (primarily from Tier 1 capital), including items such as deductions of goodwill and other intangibles, most deferred tax assets, capital investments in financial firms, and reciprocal cross-holdings, but the Agencies have provided for a more extended transition period to conform to these requirements. The Agencies, however, do not appear to have made substantive changes to these required exclusions and deductions (other than the treatment of AOCI and small banking organization trust-preferred instruments noted above).

Minimum Capital Requirements. The Final Rules adopt without change the minimum capital requirements in the Proposed Rules. The required minimum capital ratios would be:

- a common equity Tier 1 capital ratio of 4.5 percent;

- a Tier 1 capital ratio of 6 percent;

- a total capital ratio of 8 percent;

- a Tier 1 leverage ratio to average consolidated assets of 4 percent; and

- for Advanced Approaches banking organizations only, an additional leverage ratio of Tier 1 capital to total leverage exposure of 3 percent.

Capital Conservation Buffer. The Final Rules adopt as proposed a new phased-in capital conservation buffer for all covered banking organizations equal to 2.5% of total risk-weighted assets ("TRWA"). The Agencies declined industry requests to scale back or eliminate this requirement for smaller banking organizations.

Countercyclical Capital Buffer. The proposed macro-economic countercyclical capital buffer of up to 2.5% of TRWA applicable *only* to advanced approaches banking organizations has been adopted in the Final Rules. In a change from the Proposed Rules, under the Final Rules those Advanced Approaches banking organizations that have completed their Advanced Approaches "parallel run" processes would be required to calculate the capital conservation buffer using the lower of their standardized approach and advanced approaches risk-based capital ratios.

Leverage Requirement. The Agencies have adopted, without change from the Proposed Rules, the separate Tier 1 leverage capital requirement, measured as a ratio of Tier 1 capital (minus required deductions) to average on-balance sheet assets. Consistent with the Proposed Rules, Advanced Approaches banking organizations will be subject to a new and separate supplementary leverage ratio, where they would maintain capital not only against their on-balance sheet assets (less amounts deducted from Tier 1 capital), but also certain off-balance sheet assets and exposures, including derivatives exposures, 10 percent of the notional amount of unconditionally cancellable commitments, and the notional amount of most other off-balance sheet exposures (excluding securities lending and borrowing, reverse repurchase agreement transactions, and unconditionally cancellable commitments). In this regard, the Basel Committee is continuing its work on the international leverage ratio,[3] and the Agencies would expect to adjust the U.S. requirements in a manner consistent with the Basel Committee's future actions.

Changes to Prompt Corrective Action ("PCA") Rules. The Final Rules adopt the elements of the Proposed Rules' changes to the PCA regulations to assure consistency with the new regulatory capital requirements, including the required element of common equity Tier 1 capital, and an increase in certain of the trigger thresholds for prompt corrective action. Compliance with these new provisions would be required beginning on January 1, 2015.

Standardized Approach for Risk-Weightings of Bank Assets. The Final Rules generally preserve the Standardized Approach risk-weighting architecture of the Proposed Rules, but do make certain material changes to accommodate the concerns of the banking industry, particularly with respect to the risk-weighting of residential real estate mortgages. Compliance with these risk-weighting provisions would be required beginning on January 1, 2015.

- The Proposed Rules would have required two broad categories of residential mortgage lending: traditional and nontraditional loans. In an important accommodation of banking industry concerns, the Final Rules do not include the Proposed Rules' risk weights and instead adopt the risk weights for residential mortgages under the existing general risk-based capital rules, which assign a risk weight of either 50 percent (for most first-lien exposures) or 100 percent for other residential mortgage exposures.

- Most commercial loans would continue to be risk-weighted at 100 percent; "high volatility" commercial real estate loans would be risk-weighted at 150 percent, as was previously proposed. Certain changes to

[3] *See,* our July 1, 2013 discussion of the Basel's Committee's new consultative paper on the Basel leverage ratio, *available at* *http://www.mofo.com/files/Uploads/Images/130701-Basel-Capital-Framework.pdf*.

the definition of high-volatility commercial real estate, however, have been made, including the exclusion of agricultural and community development loans from the definition.

- The Proposed Rules' general treatment of over-the-counter derivative contracts, transactions cleared through central counterparties (with some changes to reflect interim Basel Committee guidance on cleared transactions), guarantees and collateral, other credit risk mitigants, and equity exposures (with some clarifications) have been adopted in the Final Rules.

- As proposed, under the Final Rules securitization exposures would be weighted according to either the current gross-up method or a new formula to replace the existing method that is based on credit ratings. The Final Rules, however, will modify the "simplified supervisory formula approach" to recognize common deferral features associated with student and consumer loans unrelated to credit risk, in response to industry comments. Other minor refinements also have been incorporated into the Final Rules.

- As set forth in the Proposed Rules, risk-weightings of sovereign debt and exposures to foreign banks would vary primarily according to OECD "country risk" classifications. The Final Rules adopt this approach with a few minor modifications.

- The Final Rules, like the Proposed Rules, will apply regulatory capital disclosure requirements to banks with total consolidated assets of $50 billion or more and that are not subject to the disclosure requirements under the Advanced Approaches rule.

Advanced Approaches Rules. Under the Final Rules, Advanced Approaches banking organizations, including qualifying Federal and state savings associations and their holding companies, will be subject to the changes, with some modifications, set forth in the Proposed Rules. These changes include the treatment of counterparty credit risk, removal of credit rating references, securitization exposures, and conforming technical changes. Further, consistent with Section 939A of the Dodd-Frank Act, the Final Rules remove references to credit ratings that currently exist in the Advanced Approaches capital rules and replace these references with alternative standards of creditworthiness.

Proposed Effective Dates/Transitional Periods. There will be somewhat elaborate, phase-in/phase-out periods for minimum capital ratios; regulatory capital adjustments and deductions; non-qualifying capital instruments; capital conservation and countercyclical capital buffers; supplemental leverage ratio for advanced approaches banks; and changes to the PCA rules. Almost all these changes would be effective by January 1, 2019. The Agencies, however, have made some rather significant changes in the effective dates and transition periods from those that were previously proposed. These changes were made to take into account the length of time needed to publish the Final Rules and the need to allow affected banks sufficient time to come into compliance with the Final Rules.

Proposed Changes to Market Risk Capital Rules. The Agencies are proposing, in a separate release with a 60-day comment period, changes to the market risk capital rules. In general, these changes would align the treatment of these items with the treatment in the Final Rules rule during the transition to the new regulatory capital framework. These changes would revise 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. Further, these changes would clarify the timing of disclosures required under the current market risk rule.

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A Few Preliminary Observations

We can look forward to much discussion of the Final Rules, but in the interests of brevity and accuracy we will limit our initial observations pending further study of the Final Rules.

What is eminently apparent from the Final Rules is that the Agencies are firmly committed to stringent capital requirements for banks across the board. Thus, to the extent that the banking industry was hoping for substantial relief from the revised regulatory capital framework for smaller and community banks, the Final Rules may fall short of those hopes. With few material exceptions, the Agencies have not limited or scaled back the applicability of the new regulatory capital framework to the broad banking community, either with respect to the elements and calculations of regulatory capital, the required minimum levels of capital, or the risk-weightings of assets under the modified Standardized Approach. Citing various studies and analyses, the Agencies also rejected the arguments of the banking industry that the new regulatory capital framework would increase the costs of equity and borrowing for banking organizations in general.

There have been some accommodations to industry concerns in discrete areas (*e.g.*, the AOCI "opt-out," the limited grandfathering of small company trust-preferred instruments, and the retention of the existing risk-weightings for residential mortgages). The major relief that the Agencies have provided, however, appears to be primarily to give banking organizations more time to transition to the new capital and risk-weighting requirements. Having said this, the Agencies have appeared to have made a number of minor changes to, and refinements or clarifications of, the requirements of the Proposed Rules in a variety of areas that we expect to point out in upcoming, and more detailed, discussions of the Final Rules.

The Agencies are mindful of regulatory capital developments at the international level, and have indicated the need for further changes in response to Basel Committee and other global activities. For example, the Agencies expect to issue proposed rules shortly to adopt the Basel Committee's capital surcharge requirements for systemically important financial institutions. In addition, the Agencies have been explicit in saying that regulatory capital requirements are an integral element of overall systemic prudential regulation in the post-Dodd-Frank world, and adjustments to these requirements in the future certainly are not beyond the realm of possibility. That being said, U.S. banking organizations probably should not expect current or future regulatory capital or other regulatory developments to allow for any meaningful leniency in future regulatory capital requirements; if anything, the current trend appears to be in quite the opposite direction.

In sum, the wait for the new regulatory capital rules is over, and now the task of compliance and implementation begins in earnest. We will be publishing more detailed discussions of the Final Rules in the near future, and also expect to report separately at various times on specific elements of the regulatory capital rules, including their effects on specific types of financial products and banking/trading book exposures such as derivatives, securitizations and real estate lending activities.

Authors

Charles M. Horn
Washington, D.C.
(202) 887-1555
chorn@mofo.com

Oliver I. Ireland
Washington, D.C.
(202) 778-1614
oireland@mofo.com

Contacts

Jeremy C. Jennings-Mares
London
44 20 7920 4072
jjenningsmares@mofo.com

Barbara R. Mendelson
New York
(212) 468-8118
bmendelson@mofo.com

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