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Regulatory Practice Letter
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U.S. Basel III Implementation - Interagency Proposed Rule

Executive Summary

The Federal Reserve Board ("Fed"), Office of the Comptroller of the Currency ("OCC") and Federal Deposit Insurance Corporation ("FDIC") have jointly released three interagency proposed rules that would revise and replace the agencies' current capital rules to implement in the United States the Basel III capital framework agreed to by the Basel Committee on Banking Supervision ("*Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*," hereinafter "Basel III") as well as capital requirements mandated by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act"). The agencies indicate they have released three separate proposals to allow firms to focus on the aspects of the proposed revisions that are most relevant to them. They proposed rules address:

I. Regulatory capital implementation of Basel III, minimum regulatory capital ratios, capital adequacy and transition provisions ("Basel III Capital Proposal").
II. Risk-weight calculations under the standardized approach, as well as market discipline and disclosure requirements ("Standard Approach Proposal").
III. The advanced approaches risk-based capital rule and the market risk capital rule ("Advanced Approaches Proposal").

The Basel III Capital Proposal and the Standard Approach Proposal would apply to all banking organizations under the supervision of the agencies including all insured depository institutions, bank holding companies ("BHCs") with total consolidated assets of $500 million or more, and savings and loan holding companies ("SLHCs") of all sizes (collectively, "banking organizations"). The Advanced Approaches Proposal would generally apply to banking organizations, including savings associations and SLHCs, meeting specified thresholds:

- For the advanced approaches risk-based capital rule, 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 (collectively, "AA Banks").
- For the market risk capital rule, banking organizations with aggregate trading assets and trading liabilities equal to at least 10 percent of quarter-end total assets or $1 billion.

A BHC subsidiary of a foreign banking organization that is currently relying on the Fed's Supervision and Regulation Letter (SR) 01-1 would not be required to comply with the proposed capital requirements under any of these NPRs until July 21, 2015.

While the proposed rules, consistent with Basel Committee implementation schedules, were intended to become effective January 1, 2013, the timeline has been extended. Specifically, in early November, the agencies announced they were working "as expeditiously as possible to complete the rulemaking process," but would not meet the January 1, 2013 effective date. The agencies also stated they would "take operational and other considerations into account when determining appropriate implementation dates and associated transition periods". As proposed, many of the requirements would be phased in over several years and full implementation would not be required until January 1, 2019.

Overall, the proposed rules would implement:

- A new common equity tier 1 minimum capital requirement;
- A higher minimum tier 1 capital requirement;
- A capital conservation buffer consisting of common equity Tier 1 capital and a countercyclical capital buffer applicable to banking organizations subject to the advanced approaches that would increase the capital conservation buffer when needed;
- A supplementary leverage ratio for banking organizations subject to the advanced approaches capital rules that incorporates a broader set of exposures in the denominator measure. (The current leverage ratio requirement continues to apply to all banking organizations.)
- Limits on capital distributions and certain discretionary bonus payments if a banking organization does not hold a specified amount of common equity tier 1 capital in addition to the amount necessary to meet its minimum risk-based capital requirements.
- Stricter eligibility criteria for regulatory capital instruments;
- Alternatives to credit ratings as required by the Dodd-Frank Act, including a new "simplified supervisory formula approach" ("SSFA") to replace the ratings-based and internal assessment approaches;
- Enhanced disclosure requirements including disclosures related to regulatory capital instruments, that would apply to top-tier banking organizations domiciled in the United States with $50 billion or more in total assets,.

In addition to the three proposed rules, the agencies released a fourth rule, that makes final amendments to the market risk capital rule, which requires banking organizations with significant trading activities to adjust their capital requirements to account for the market risks of those activities (commonly referred to as the Basel 2.5 market risk capital framework). This final rule becomes effective January 1, 2013.

Background

The Group of Governors and Heads of Supervision (the "GGHS"), the oversight body of the Bank for International Settlements' ("BIS") Basel Committee on Banking Supervision reached agreement on Basel III in September 2010 (please refer to RPL 10-18). The three recently released proposed rules would implement Basel III in the United States with certain adjustments to timing and implementation that are intended to ensure compliance with the Dodd-Frank Act, including relying on alternatives to external credit ratings as required by Section 939A and the phase-out schedules provided for trust preferred securities included in tier 1 capital as required by Section 171.

Section 165 of the Dodd-Frank Act requires the Fed to adopt enhanced risk-based and leverage capital requirements for BHCs with total consolidated assets of $50 billion or more. The Fed notes that the three proposed capital rules will serve a key part of meeting this requirement. Further it intends to propose a supplemental risk-based capital charge for global systemically important banks ("G-SIBs"). The OCC indicates it is also considering whether to propose to a similar surcharge for globally significant national banks.

Description

The agencies' Basel III Capital Proposal would introduce Basel III standards for the components of, adjustments to, and deductions from regulatory capital.

Proposed Rules – Regulatory Capital

Regulatory Capital

The agencies are proposing to require that banking organizations comply, on a consolidated basis, with the following minimum capital ratios by January 1, 2015:

- A new common equity tier 1 capital ratio of 4.5 percent;
- A tier 1 (common equity plus additional tier 1 capital) capital ratio of 6 percent;
- A total capital ratio of 8 percent; and
- A tier I capital to average consolidated assets (leverage ratio) of 4 percent.
  - AA Banks would be required to meet a supplemental leverage ratio (the "Basel III supplemental leverage ratio"), calculated as the ratio of tier 1 capital to total leverage exposure (on- and certain off-balance sheet exposures), of 3 percent. The ratio would be required to be calculated monthly and quarterly (as a simple arithmetic mean of the quarterly ratios). AA Banks would be expected to calculate and report the Basel III supplemental leverage ratio beginning 2015 and meet the requirement beginning 2018.
  - The current exception for banking organizations with a supervisory composite rating of 1 would be removed and the exception for BHCs also subject to the market risk rule would be removed.

In addition, a banking organization would be subject to:

- A capital conservation buffer, which would be calculated as the lowest of the banking organization's:
  - Common equity tier 1 capital ratio minus its minimum common equity tier I capital ratio;
  - Tier 1 capital ratio minus its minimum tier 1 capital ratio; and
  - Total capital ratio minus its minimum total capital ratio.
    Note: AA Banks would calculate using risk-weighted assets ("RWA") calculated under the AA.

  Once fully phased-in (January 1, 2019), the capital conservation buffer of 2.5 percent of total RWA would be required and failure to meet this amount would result in limitations on capital distributions (repurchase, early redemption, dividends or other similar payouts) and discretionary bonus payments to executive officers. The capital conservation buffer would be calculated on a quarterly basis and any relevant restrictions would be applied in the next quarter.
- A countercyclical capital buffer which would supplement the capital conservation buffer and apply only to AA Banks. The amount of the required buffer would be set by the agencies based on macroeconomic and financial factors that indicate a

potential increase in systemic risk. It would be set initially at 0 (zero) percent though increases would be announced as much as 12 months prior to implementation. A cap of 2.5 percent of RWA would be applied.

Consistent with current rules, the proposed rule contains a reservation authority that permits the agencies to require a banking organization to hold a different amount of capital than would otherwise be required under the proposal if the capital is not determined to be commensurate with the banking organization's credit, market, operational or other risks. Similarly, though a banking organization may not be subject to limitations on its capital distributions and discretionary bonus payments under the capital rules, it could be limited by the regulators for other reasons.

Prompt Corrective Action

The agencies are proposing changes to the Prompt Corrective Action ("PCA") categories. Currently, the five PCA categories are: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." Specifically, the agencies are proposing to:

- Augment the PCA capital categories by introducing a common equity Tier 1 capital measure for all but the critically undercapitalized PCA category.
- Amend the current PCA leverage measure for AA Banks to include an additional leverage ratio based on the Basel III supplemental leverage ratio applicable to those institutions. The added leverage measure would be considered for the "adequately capitalized" and "undercapitalized" capital categories only and an AA Bank would have to maintain a Basel III supplemental leverage ratio of 3 percent or more to be considered "adequately capitalized".
- Modify the definitions of capital to meet new definitions.

The proposed changes to the current minimum PCA thresholds and the introduction of a new common equity tier 1 capital measure would take effect January 1, 2015. The proposed amendments to the current PCA leverage measure for AA Banks would take effect on January 1, 2018.

Savings Associations

The OCC and the FDIC are proposing to include a tangible capital requirement of not less than 1.5 percent of adjusted total assets for Federal and state savings associations, respectively. "Tangible capital" would be defined as the amount of tier 1 capital plus the amount of outstanding perpetual preferred stock (including related surplus) not included in tier 1 capital.

Definitions of Capital

- Common equity tier 1 capital - would be the sum of outstanding common equity tier 1 capital instruments, subject to certain eligibility requirements and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income ("AOCI"), and common equity tier I minority interests.
  - As proposed, unrealized gains and losses on all AFS securities would flow through to common equity tier I capital.
- Additional tier 1 capital - would be the sum of: additional tier 1 capital instruments that satisfy certain criteria, related surplus, and tier 1 minority interest that is not included in common equity tier 1 capital (subject to certain proposed limitations on minority interests)

- Non-cumulative perpetual preferred stock is generally expected to continue to qualify as Tier 1 capital though cumulative perpetual preferred stock and trust preferred instruments would no longer qualify as Tier 1 capital.

- Tier 2 capital - would be the sum of: tier 2 capital instruments that satisfy certain criteria, related surplus, total capital minority interests not included in tier I capital (subject to proposed limitations and requirements on minority interests), and limited amounts of the allowance for loan and lease losses ("ALLL"); less any applicable regulatory adjustments and deductions.
  - The proposal would eliminate the existing limit on tier 2 capital as well as separate limits on term subordinated debt, limited-life preferred stock, and trust preferred securities.
- 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. Common equity tier 1 minority interest would have to be issued by a depository institution or foreign bank that is a consolidated subsidiary of a banking organization. The limits on the amount of minority interest that may be included in consolidated capital would be based on the amount of capital held by the consolidated subsidiary, relative to the amount of capital the subsidiary would have to hold in order to avoid any restrictions on capital distributions and discretionary bonus payments under the capital conservation buffer framework.
- Regulatory adjustments and deductions - the proposed rule would make significant and detailed amendments to the existing regulatory adjustments and deductions including, among others:
  - Goodwill and other intangible assets other than mortgage servicing assets ("MSAs") ,net of deferred tax liabilities ("DTLs"), would be fully deducted from common equity tier 1 capital.
  - Deferred tax assets ("DTAs") that arise from operating loss and tax credit carryforwards, net of any related valuation allowances and certain DTLs, would be deducted from common equity tier 1 capital.
  - After-tax gains on sale associated with securitization exposures would be deducted from common equity tier 1 capital.
  - Defined benefit pension fund assets would be deducted from common equity tier 1 capital unless, subject to supervisory approval, the banking organization has unrestricted and unfettered access to the assets. Defined benefit pension fund liabilities would be fully recognized.
  - Unrealized gains and losses resulting from the banking organization's creditworthiness, as well as unrealized gains and losses on certain cash flow hedges would be required to be adjusted in common equity tier 1 capital.
  - Investments in a banking organization's own capital would be deducted from common equity tier 1 capital.
  - Direct and indirect investments in the capital of unconsolidated financial institutions, subject to certain thresholds, would generally be deducted.
  - Items subject to a 10 percent individual and 15 percent aggregate threshold deduction. This would apply to certain DTAs, MSAs net of DTLs, and significant investments in financial institutions in the form of capital stock.

Transitions (As Proposed and subject to change based on the November 2012 extension)

- The transition period for the minimum common equity tier 1 and tier 1 capital ratios will begin January 1, 2013 and end on January 1, 2015.

- The Basel III supplemental leverage ratio would be required to be calculated and reported (by AA BO) beginning January 1, 2015 and would be applied as a ratio requirement beginning January 1, 2018.
- The capital conservation buffer and the potential countercyclical capital buffer would be phased in between January 1, 2016 and January 1, 2019.
- The transition period for adjustments and deductions from capital would begin January 1, 2013 and end January 1, 2018 and vary in accordance with the proposed provisions for each type of asset and liability.
- Nonqualifying capital instruments, including cumulative perpetual preferred stock and trust preferred securities, would be phased out of tier 1 capital as follows:
  - Depository institution holding companies with total consolidated assets of $15 billion or more (as of December 31, 2009) would be required to deduct nonqualifying capital instruments (issued prior to May 19, 2010) from tier 1 capital pursuant to a three-year phase-out schedule beginning January 1, 2013 and ending January 1, 2016.
  - Depository institutions and depository institution holding companies with total consolidated assets of less than $15 billion would be required to deduct nonqualifying capital instruments that were outstanding as of January 1, 2013, from tier 1 capital pursuant to a ten-year phase-out schedule beginning January 1, 2013 and ending January 1, 2022.
  - Nonqualifying capital instruments that meet the proposed eligibility requirements for tier 2 capital would be permitted to be included in tier 2 capital without limitation.

Proposed Rules – Standardized Approach

The second of the proposed rules, the Standardized Approach Proposal, would modify the agencies' general risk-based capital requirements for determining RWA. The changes are intended to enhance risk sensitivity and address identified weaknesses, including by incorporating certain international capital standards of the Basel Committee's Basel II framework and other proposals addressed in recent Basel Committee consultative papers. The changes are proposed to take effect beginning January 1, 2015 though there would also be an option to adopt the approach early.

As proposed, a banking organization would determine its standardized total RWA by calculating the sum of:

- RWA for general credit risk, cleared transactions, default fund contributions, unsettled transactions, securitization exposures, and equity exposures, each as defined in the rule, plus
- Market risk-weighted assets, if applicable, less
- The banking organization's ALLL that is not included in tier 2 capital.

The proposed rule contains alternatives to credit ratings for calculating RWA for certain assets, consistent with Section 939A of the Dodd-Frank Act, including methodologies for determining RWA for residential mortgages, securitization exposures, and counterparty credit risk.

Disclosures

Banking organizations with more than $50 billion in total consolidated assets would be required to make certain disclosures quarterly. The agencies indicate the public disclosure requirements, which include both qualitative and quantitative information, are “designed to provide important information to market participants on the scope of application, capital, risk exposures, risk assessment processes, and, thus, the capital adequacy of the institution.” Ten separate tables of information are proposed covering: scope of application, capital structure, capital adequacy, capital conservation buffer, credit risk, counterparty risk, credit risk mitigation, securitization, certain equity securities, and interest rate risk for non-trading activities.

The banking organization would be required to have a formal disclosure policy approved by its board of directors that addresses the approach for determining what disclosures to make, internal controls and disclosure controls. One or more senior officers would be required to attest that the disclosures meet the requirements of the Standard Approach Proposal.

The proposal suggests a banking organization would decide the relevant disclosures to make based on materiality. Information would be considered material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making investment decisions. The agencies indicate they expect all of the disclosures could be made without revealing proprietary or confidential information. However if a banking organization believes it would be compromised by revealing certain information it would be permitted to disclose more general information with explanatory notes regarding why it has not disclosed more specific information.

Proposed Rules – Advanced Approaches

The Advanced Approaches Proposal would revise the agencies’ advanced approaches risk-based capital rule to be consistent with Basel III and other changes to the Basel Committee’s capital standards. The primary revisions would address the treatment of counterparty credit risk, the securitization framework, and disclosures for securitizations.

Credit Ratings

The Advanced Approaches Proposal would also address requirements of Sections 939A of the Dodd-Frank Act. In general, the ratings-based standards would be replaced with a new “investment grade” standard, which would be defined as a determination by the bank that an entity to which the bank has exposure through a loan or security, or the reference entity with respect to a credit derivative, has adequate financial capacity to satisfy all commitments under the exposure for the projected life of the investment. Such an entity would have an adequate capacity to meet financial commitments if its risk of default is low, and full and timely repayment of principal is expected. In addition, the agencies are proposing to revise the collateral haircut approach by removing references to credit ratings from the matrix used to determine the standard supervisory market price volatility haircuts applicable to certain forms of collateral. Under the proposed rule, the market price volatility haircut would be based, in part, on the risk weight applicable to collateral under the Standardized Approaches Proposal.

Application

The Advanced Approaches Proposal would generally apply to banking organizations that meet specified thresholds. The advanced approaches risk-based capital rule would apply 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 would generally apply to those banking organizations with aggregate trading assets and trading liabilities equal to at least 10 percent of quarter-end total assets or $1 billion.

Certain proposed provisions would expand the scope of the rules to entities formerly supervised by the Office of Thrift Supervision by applying the market risk capital rules to Federal and state savings associations under the supervision of the OCC and FDIC, as well as by applying the Fed's advanced approaches and market risk capital rules to top-tier U.S. SLHCs.

Final Rules – Market Risk

The agencies separately released a final rule that modifies the market risk capital rule, which requires banking organizations with significant trading activities to adjust their capital requirements to account for the market risks of those activities. The final rule implements certain revisions made by the Basel Committee to its market risk framework between 2005 and 2010, and among other things, it is expected to reduce pro-cyclicality in the market risk capital requirements, enhance sensitivity to risks, and increase transparency through enhanced disclosures. The final rule will become effective January 1, 2013.

Highlights of the final market risk rule include, among others:

- Specific criteria to define covered positions;
- Requirements for regulatory approval to use a value at risk ("VaR") model to calculate general market risk or to use the model for other purposes. The same model must be used to calculate a stressed VaR;
- Requirements for regulatory approval to use an internal model to measure specific risk;
- Use of the simplified supervisory formula approach ("SSFA") for calculating standardized capital charges for securitization purposes; and
- Introduction of an incremental risk charge (default and credit migration risk not captured in the VaR) and requirements for regulatory approval of any incremental risk model.

Consistent with Section 939A of the Dodd-Frank Act, the final rule does not include provisions of the Basel Committee's market risk framework that rely on credit ratings, but rather includes alternative standards of creditworthiness for determining specific risk capital requirements for certain debt and securitization positions including:

- Government, agency, and government-sponsored entity positions;
- Depository institution and credit union positions;
- Public sector entities positions;
- Corporate positions; and
- Securitization exposures.

The final rule does not modify the scope of application for the current market risk capital rule. However, as noted above, the agencies have proposed to apply the market risk capital rule to savings and loan associations and SLHCs that meet the applicable thresholds (aggregate trading assets and trading liabilities equal to at least 10 percent of quarter-end total assets or $1 billion).

Commentary

November 2012 The breadth and complexity of the proposed rule changes have prompted thousands of industry participants to submit comment letters to the agencies. In recent testimony before Congress, Michael Gibson, Director of the Fed's Division of Supervision and Banking, noted that the most common specific areas of concern identified by financial institutions, regardless of institution size, were related to the proposed treatments of AOCI (accumulated other comprehensive income), which would require unrealized gains and losses on available-for-sale securities to flow through to regulatory capital, and residential mortgage exposures, which would introduce more differentiated categories and risk-weightings. He stated that community banks, in particular, have asserted that they have fewer strategies available to address increased capital volatility resulting from the proposed treatment of AOCI, and that the risk-weighting proposed for certain mortgage products would penalize the kinds of mortgage loan products in which community banks specialize. Mr. Gibson also indicated that agencies would "seek to further tailor the requirements as appropriate for community banking organizations" in finalizing the rule.

As proposed, the rules were intended to become effective January 1, 2013 with implementation to be phased-in over several years, reaching full implementation by January 1, 2019. Although the agencies have announced they would not meet the January 1, 2013 effective date they have not addressed the phase-in schedule except to say they would "take operational and other considerations into account when determining appropriate implementation dates and associated transition periods." It is quite possible that the implementation schedules, which have been set for a long time (they were approved by the Basel Committee in 2010 (see Regulatory Practice Letter 10-18) and proposed by the U.S. agencies in mid-2012), will not change. Mr. Gibson noted in his testimony that "the vast majority of banking organizations [those that currently meet minimum regulatory capital requirements] would not be required to raise additional capital because they already meet, on a fully phased-in basis, the proposed higher minimum requirements…and approximately 90 percent of community banking organizations already have sufficient capital to meet or exceed the proposed buffer, thus avoiding restrictions on capital distributions and certain executive bonus payments."

All banking organizations, which include all insured depository institutions, BHCs with total consolidated assets of $500 million or more, and SLHCs, will be impacted by the proposals to implement Basel III in the U.S. and despite the extended implementation timeframes and the relative strength in their current capital positions overall, they should be in the process of preparing for the new requirements. At its heart, the Basel III provisions are intended to:

- Increase capital holdings (increased minimums);
- Increase the quality of capital holdings (more stringent definitions);
- Reduce leverage;
- Increase short-term liquidity;
- Increase stable long term balance sheet funding; and
- Strengthen risk capture.

Banking organizations should give consideration to, among other things:

- Assessing the impact of the proposed rules, either through the use of internal models or the Regulatory Capital Estimation Tool released by the agencies. Focus should include capital planning, earnings projections, risk-weights, and profitability analyses.
- Evaluating and testing the adequacy of internal capital and liquidity models and assessing the need for modifications (e.g., data quality, data inputs).
- Evaluating and modifying as needed capital and liquidity management strategies to meet the new requirements, including defining relevant capital objectives, capital transactions, business structure, strategies and product offerings, as well as analyzing capital raising strategies.
- Assessing and implementing modifications to policies and procedures, systems, data and management reporting, and management incentives.
- Assessing the impact of the proposed liquidity requirements.
- Early implementation of the standardized approach as permitted by the rule.

While the timeline has been delayed, institutions will need to continue internal efforts to prepare for the expected changes. In particular, SLHCs, which will be subject for the first time to consolidated capital requirements, and large, internationally active organizations, will face additional challenges and requirements warranting continued preparatory efforts.

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