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# Basel III Proposals: Issues for Community Banks

August 8, 2012

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# Introduction

The OCC, FRB, and FDIC jointly issued 3 Notices of Proposed Rulemaking (NPRs) that would revise and replace the agencies' current capital rules

- Basel III NPR (Capital)
- Standardized Approach NPR (Risk-weighted assets)
- Advanced Approaches NPR

Applicability: Basel III and Standardized Approach NPRs most relevant to community banks; apply to all banks, savings associations, SLHCs, and U.S. BHCs with greater than $500 million in total assets

Comment Period Ends September 7, 2012

# Basel III NPR - Summary

1. Revises definitions of regulatory capital components and changes eligibility criteria of certain capital instruments
2. Changes minimum capital requirements and adds a new Common Equity Tier 1 Risk-based Capital Ratio (fully phased-in: 4.5%)
3. Revises the Prompt Corrective Action (PCA) rules to incorporate changes
4. New Capital Conservation Buffer that may restrict capital distributions and executive bonuses
5. Establishes transition periods

# Standardized Approach NPR - Summary

1. Proposed modification to the calculation of risk-weighted assets (i.e., the calculation of the denominator of a bank's risk-based capital ratios)
2. Modification of risk weights for 11 asset classes, including residential mortgage exposures, high volatility commercial loans, past due assets, and other assets
3. Proposed effective date of January 1, 2015

# Prompt Corrective Action (PCA) Categories

| Measure | Well Capitalized | Adequately Capitalized | Undercapitalized | Significantly Undercapitalized | Critically Undercapitalized |
|---|---|---|---|---|---|
| Total Risk Based Capital (RBC) | ≥10% | ≥8% | <8% | <6% | Tangible Equity[1] to Total Assets ≤ 2% |
| Tier 1 RBC (Current \| Proposed) | ≥6% \| ≥8% | ≥4% \| ≥6% | <4% \| <6% | <3% \| <4% | Tangible Equity[1] to Total Assets ≤ 2% |
| Common Equity Tier 1 RBC (Proposed) | ≥6.5% | ≥4.5% | <4.5% | <3% | Tangible Equity[1] to Total Assets ≤ 2% |
| Leverage Measure | ≥5% | ≥4%[2] | <4% | <3% | Tangible Equity[1] to Total Assets ≤ 2% |
| PCA Requirement | None | May limit activities and limits brokered deposits | Limits on asset growth, dividends; requires a capital plan | Limits sub-debt payments | Generally receivership or conservatorship w/in 90 days |

[1] Tangible equity is defined as tier 1 capital + non-tier 1 perpetual preferred stock.

[2] The minimum leverage ratio for 1-rated institutions that are not experiencing significant growth is currently 3%.

# Capital Conservation Buffer

| Capital conservation buffer (as a % of total risk-weighted assets) | Maximum payout ratio (as a % of eligible retained income) |
|---|---|
| Greater than 2.5% | No payout limitation applies |
| Less than or equal to 2.5%, and greater than 1.875% | 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 0.625% | 0% |

1. Phases in from 1/1/2016 – 1/1/2019.

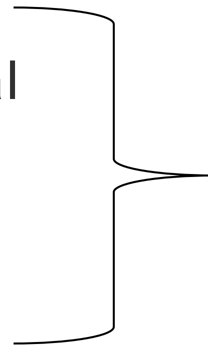
2. The maximum payout ratio limits capital distributions and discretionary bonus payments to executive officers as the conservation buffer falls to 0%. The conservation buffer would be equal to the smallest cushion that a bank has in one of three capital ratios: its common equity tier 1 capital ratio, its tier 1 capital ratio, or its total capital ratio. If the Bank maintains its ratios at or near minimum levels, its maximum payout would be zero.

# Basel III NPR – Capital Components

Total Capital =

Common Equity Tier 1 Capital

+ Additional Tier 1 Capital



Tier 1 Capital

+ Tier 2 Capital

# Common Equity Tier 1 Capital

Common Equity Tier 1 Capital is the sum of the following:

1. Common equity tier 1 capital instruments and related surplus (net of treasury stock), plus
2. Retained earnings, plus
3. Accumulated other comprehensive income (AOCI), plus
4. Minority interests in common equity tier 1 instruments in unconsolidated financial institutions

Minus

- Regulatory adjustments and deductions

# Common Equity Tier 1 Capital Instruments

Common Equity Capital Instruments must have the following characteristics, among others:

1. Be paid in, issued directly by the bank, and represent the most subordinated claim in a receivership, insolvency, or liquidation.
2. Must have no maturity date and be redeemable only with regulatory approval through discretionary repurchases.
3. Cash dividends are discretionary, paid out of net income and retained earnings, and are not subject to a limit imposed by the instrument's contractual terms.
4. Holders bear losses as they occur equally with the holders of all other common stock instruments before any losses are borne by holders with senior claims.
5. The paid-in amount is classified as equity under GAAP.
6. The instrument is not secured or covered by a guarantee of the bank or a bank affiliate, and is not subject to any other arrangement that legally or economically enhances its seniority.
7. The instrument is reported on the bank's regulatory financial statements separately from other capital instruments.

# Accumulated Other Comprehensive Income (AOCI)

1. Under the proposal, net unrealized gains and losses on available-for-sale (AFS) debt and equity securities would be included in Common Equity Tier 1.
2. Under the current rules, AFS equity securities losses are included in Tier 1 and a portion of AFS equity securities gains are included in Tier 2.
3. The new requirement that bank's adjust their capital ratios based upon movements in the value of AFS capital instruments, including as a result of changes in interest rates, is expected to add significant volatility and an additional regulatory burden.

# Regulatory Adjustments and Deductions

1. General Deductions
    a. Goodwill
    b. Deferred Tax Assets (NOLs & carryforwards)
    c. Other intangibles (excluding mortgage servicing assets (MSAs))
    d. Gain on sale of securitization exposure
    e. Deductions for non-significant investments subject to 10% threshold
2. Threshold Deductions (>10% individually and >15% in the aggregate)
    a. MSAs
    b. DTAs (relating to temporary timing differences)
    c. Significant investments in another financial institution's common stock

# Additional Tier 1 Capital

1. Non-cumulative perpetual preferred, SBLF and TARP
2. Does not include TruPS or cumulative preferred instruments, subject to a phase-out
3. 14 criteria, including:
   a. Must be subordinated to depositors, general creditors and the bank's subordinated debt holders;
   b. Must not be secured or guaranteed by the bank or any bank affiliate;
   c. Must be perpetual, without maturity date or incentive to redeem;
   d. Be callable only with regulatory approval after at least five years;
   e. The bank may cancel distributions at any time;
   f. If classified as liabilities, have principal loss absorption through conversion to common shares.

# Tier 2 Capital

Tier 2 Capital is the sum of the following:

1. Tier 2 capital instruments and related surplus, plus
2. total capital minority interests not included in a bank's tier 1 capital, plus
3. Limited amounts of ALLL

Minus

- Regulatory adjustments and deductions

# Transition Rules

| Item | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|
| Phase-in of certain deductions from Common Equity Tier 1 | | 20% | 40% | 60% | 80% | 100% | |
| Minimum Common Equity Tier 1 | 3.5% | 4.0% | 4.5% | | | | |
| Minimum Tier 1 | 4.5% | 5.5% | 6.0% | | | | |
| Minimum Total | 8.0% | | | | | | |
| Capital Conservation Buffer | | | | 0.625% | 1.25% | 1.875% | 2.50% |

The phase –out of capital instruments that no longer qualify as additional tier 1 and tier 2 will be accomplished over a 10-year period beginning in 2013.

# Standardized Approach NPR

Modifications to Risk-weighting for certain assets, consistent with Dodd-Frank Section 939A, including:

1. Residential mortgage exposures
2. High volatility commercial real estate
3. Past due assets
4. Securitization exposures
5. Other Assets

Proposed Effective Date is January 1, 2015

# Residential Mortgage Loans – Category 1

Category 1

1. Term: ≤ 30 years
2. Regular periodic payments
3. No increases in principal, deferments, or balloons
4. Underwriting and repayment ability based on: (i) Principal, interest, taxes, insurance, and assessments; (ii) Maximum interest rate that may apply in first 5 years; (iii) Maximum exposure over the life of the mortgage loan; (iv) Documented and verified income; (v) No loans over 90 days past due
5. Annual interest rate may increase no more than 2% per 12-month period and 6% over the life of the loan
6. 1st lien HELOCS: maximum contractual exposure under terms of HELOC
7. If a bank holds a 1st mortgage lien and junior mortgage lien on the same residential property:
   a. no other party may hold an intervening position
   b. each residential mortgage exposure must have the characteristics of a category 1 mortgage loan

# Residential Mortgage Loans – Category 2

Category 2

1. Any residential mortgage exposure that does not fall into category 1
2. Junior liens
3. If a bank holds two or more mortgage loans on the same residential property and one of the loans is category 2, then the bank would treat all the loans on the property as category 2
4. Nontraditional mortgage products generally

# Residential Mortgage Loans – Risk Weighting

| LTV Ratio | Risk Weight for Category 1 Loans | Risk Weight for Category 2 Loans |
|---|---|---|
| ≤ 60% | 35% | 100% |
| 60% - 80% | 50% | 100% |
| >80% - 90% | 75% | 150% |
| >90% | 100% | 200% |

- LTV Ratio = loan amount/value of the property.
- "Loan amount" for a 1st lien transaction would be the maximum contractual principal amount of the loan. For a junior lien loan, the loan amount would be the maximum contractual principal amount of the loan plus the maximum contractual principal amount of all more senior loans secured by the same residential property.
- "Value of the property" is the lesser of the acquisition cost (for a purchase transaction) or the estimate of the property's value at the origination of the loan or restructuring.
- PMI is ignored for purposes of calculating the LTV ratio
- For commitments, the unfunded portion of the loan amount would be subject to a credit conversion factor of 20% or 50% depending on original maturity.

# Residential Mortgage Loans – Additional Notes

| 1-4 family loans | Current Risk Weight | Proposal |
|---|---|---|
| | 50% if 1st lien, prudentially underwritten, owner-occupied or rented, current or <90 days past due<br><br>100% otherwise | Category 1: 35%, 50%, 75%, 100% depending on LTV<br><br>Category 2: 100%, 150%, or 200% depending on LTV |

- FHA and VA loans would continue to receive zero percent risk weight due to their unconditional government guarantee. Residential mortgage exposures that are conditionally guaranteed by the U.S. government or a U.S. agency would continue to receive a 20 percent risk weight.
- Restructured and modified mortgages would be assigned risk weights based on their LTVs and classification as category 1 or category 2 residential mortgage exposures based on the modified contractual terms.
- Some confusion whether loans modified or restructured under the Treasury's HAMP program would be considered modified or restructured for the purposes of the proposal.

# High Volatility Commercial Real Estate Loans

New category: High Volatility Commercial Real Estate Loans (HVCRE)

An HVCRE exposure is a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

- One- to four-family residential properties; or
- Commercial real estate projects in which:
  - The LTV ratio is ≤ the applicable maximum supervisory LTV ratio;
  - Borrower has contributed at least 15 % of the real estate's appraised "as completed" value; and
  - Borrower contributed such amount before the bank advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project (i.e., only when the credit facility is converted to permanent financing or is sold or paid in full.)
- HVCRE exposures carry a 150% risk weight

# Residential Construction Loans

| Loan Type | Current Risk Weight | Proposal |
|---|---|---|
| Presold residential construction loans | 50% if the loan meets all criteria in the regulation; 100% if cancelled; 100% otherwise. | 50% if the loan meets all criteria in the regulation; [1] 100% if cancelled; 100% otherwise. |
| Multifamily loans | 50% if the loan meets all criteria in the regulation; 100% otherwise. | 50% if the loan meets all criteria in the regulation; [2] 100% otherwise. |

[1] Generally, (i) the loan is prudently underwritten; (ii) the purchaser: (a) is an individual(s) that intends to occupy the residence; (b) has entered into a legally binding written sales contract; (c) has a firm written commitment for permanent financing; and (d) has made an earnest money deposit≥3%; (iii) the builder must incur at least the first 10% of the direct costs of construction; (iv) the loan≤80% of the sales price; and (v) the loan is not more than 90 days past due, or on nonaccrual.

[2] Generally, (i) the loan is prudently underwritten; (ii) the LTV does not exceed 80% (or 75% if the interest rate is variable); (iii) all p+i payments on the loan must have been made on time for at least 1 year prior to applying the 50% risk weight; (iv) amortization of p+i on the loan≤ 30 years and the minimum original maturity for repayment of principal >7 years; (v) annual NOI (before debt service) generated by the property during its most recent fiscal year≥120% of the loan's current annual debt service (or 115% if interest rate is variable); and (vi) the loan is not >90 days past due, or on nonaccrual.

# Past Due Exposures

| | Current Risk Weight | Proposal |
|---|---|---|
| Revenue Bonds,<br>Multifamily Loans,<br>Consumer Loans,<br>Commercial and Industrial,<br>Non-Farm Residential,<br>Agricultural | Generally the risk weight does not change when the loan is past due<br><br>Except, 1-4 family loans that are past due 90 days or more are given a 100% risk weight | 150% for the portion that is not guaranteed or secured<br><br>Does not apply to 1-4 family residential mortgage exposures or HVCRE |

# Structured Securities

| Category | Current Risk Weight | Proposal |
| --- | --- | --- |
| MBS, ABS, and Structured Securities (including TruPS) | 20%:AAA&AA;<br>50%:A-rated<br>100%:BBB<br>200%:BB-rated<br><br>Gross-up Approach | Deduction for the after-tax gain-on-sale of a securitization;<br><br>1,250% risk weight for a CEIO and 100% for interest-only MBS that are not credit-enhancing.<br><br>For other securitization exposures, a choice among:<br><br>(i) Existing gross-up approach;<br>(ii) SSFA; or<br>(iii) 1,250% |

There would be no change to the existing treatment for securitization exposures guaranteed by the U.S. Government or GSEs; i.e. Ginnie Mae securities receive a 0% risk-weight to the extent they are unconditionally guaranteed; Fannie Mae and Freddie Mac guaranteed securities receive a 20% risk weight; and Fannie Mae and Freddie Mac non-credit enhancing IO securities receive a 100% risk weight.

# Other Assets

Exposures not otherwise assigned to a specific risk weight category, which are generally consistent with the risk weights in the general risk-based capital rules:

- 0% - cash owned and held in a bank's offices or in transit; gold bullion; exposures from the settlement of certain cash transactions with a central counterparty;
- 20% - cash items in the process of collection;
- 100% - deferred tax assets (DTAs) arising from temporary differences that the bank could realize through net operating loss carrybacks;
- 250% - mortgage servicing assets and DTAs arising from temporary differences that the bank could not realize through net operating loss carrybacks that are not deducted from common equity tier 1 capital; and
- 100% - all assets not specifically assigned a different risk weight (e.g., consumer loans and credit cards).

# Conclusions and Questions