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Requirements for U.S. Banking Organizations Federal Banking Agencies Propose Basel III Capital

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On June 7, 2012, the Federal Reserve Board ("FRB") released three proposed rules relating to minimum capital requirements for U.S. banking organizations[1]. On June 12, the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC"), which jointly wrote the proposed regulations with the FRB, followed suit. The proposed requirements closely track the requirements put forth by the Basel Committee on Banking Supervision ("BCBS") in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" ("Basel III"). The proposed rules will require lenders to maintain higher capital reserves, primarily comprised of Common Equity capital meeting robust new standards. Additionally, the new rules would enact requirements found in sections 171 and 939A of the Dodd-Frank regulatory overhaul that banking organizations use alternative risk weighting, rather than "credit ratings," for the calculation of risk-weighted assets. The third proposal embraces Basel III's "Advanced Approaches" risk-based capital rule.

Comments regarding the proposals (which total 700 pages) must be submitted to the FRB, FDIC or OCC (collectively, "the Agencies") on or before September 7, 2012. This Client Alert highlights a number of the key issues in the three proposed rulemakings.

Basel III and New Requirements for U.S. Banking Organizations The Agencies' actions are intended to implement the capital and disclosure requirements of Basel III. The BCBS created the new requirements in response to the recent financial crisis. The lack of adequate capitalization in U.S. banking organizations has had clear ramifications: Since September 2007, the FDIC lists 439 banking organizations as having failed. The Basel III requirements superseded a set of recommendations known as Basel II, which banking regulators suggested did not require a capital cushion substantial enough to ensure banking organizations' resiliency in the event of a crisis. The oversight body of the Basel Committee approved the Basel III framework in 2010 and 2011, but each country adopting the framework must write its own rules. The proposed rules would begin implementation of some new requirements on January 1, 2013. The Agencies expect to fully phase in the requirements by January 1, 2019. According to Federal Reserve Chairman Ben Bernanke, the Agencies intend for the gradual timeline "to reduce compliance costs and minimize effects of higher capital on lending."

Higher Quantity and Quality for Capital Requirements and Capital Buffers

Capital Requirements The first of the Agencies' proposed rules, titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action,"[2] would force banking organizations to adopt higher capital requirements. This has attracted a great deal of attention

from the banking sector, due largely to its potential impact on banking organizations' profitability. The rule would both expand the amount of high-quality "Tier 1" capital banking organizations are required to hold and create a requirement that banking organizations hold a specified amount of Common Equity capital.

The minimum Tier 1 capital requirement would increase from the current level of 4.0% to 6.0% by 2015. This is consistent with the BCBS recommendation and responds to concerns regarding banking organizations' behavior during the financial crisis. The proposed rule notes that the crisis raised questions about banking organizations' "ability to conserve capital during a stressful period or to cancel or defer interest payments on Tier 1 capital instruments."

Likewise, the Common Equity capital requirement is designed to ensure that banking organizations have enough capital that can absorb large losses in the event of another crisis. The rule would require a ratio that 4.5% of risk-weighted assets are comprised of Common Equity capital, a more restrictive classification of capital than currently required for general Tier 1 capital. The new category of Common Equity capital seeks to avoid the inclusion of capital on a bank's books that "would cause a banking organization's condition to further weaken during periods of economic and market stress." Common Equity capital satisfies the requirements of Tier 1 capital.

Additionally, the rule proposes two new capital "buffers": (i) A Capital Conservation Buffer and (ii) a Countercyclical Capital Buffer. The Capital Conservation Buffer would serve to reinforce the strength of banking organizations throughout economic cycles and would apply to all banking organizations affected by the rule. It is separate from the minimum risk-based capital requirements. If the affected banking organization does not meet the requirement for the Capital Conservation Buffer, the organization would face limitations on capital distributions and discretionary bonus payments to executive officers based on a "maximum payout ratio." The ratio would apply limitations on payouts based on the size of a banking organization's Capital Conservation Buffer. For example, if a banking organization has a Capital Conservation Buffer of less than or equal to 0.625% during a previous quarter in 2018 (when the buffer requirement takes full effect), it would not be permitted to make any capital distributions or discretionary bonus payments during its current calendar quarter.

The Countercyclical Capital Buffer similarly would act to offset vulnerabilities that banks experience as a result of periods of expansionary growth and borrowing, but would impact only "Advanced Approaches" banking organizations. The Advanced Approaches guidelines, discussed in further detail in the Agencies' third proposed rule, would generally apply to banking organizations that have $250 billion or more in total assets or total on-balance sheet foreign exposure equal to $10 billion or more. The Countercyclical Capital Buffer would begin at zero, and the Agencies would mandate its use only if financial markets are "experiencing a period of excessive aggregate credit growth that is associated with an increase in system-wide risk." If invoked, it could reach a maximum of 2.5% by 2019. The Agencies would jointly decide whether to increase the countercyclical capital buffer based on a range of factors, and the agencies expect that the buffer would be the same at the depository institution and holding company levels. Both the capital conservation and Countercyclical Capital Buffers would have to be composed of Common Equity Tier 1 capital.

Federal and State Savings Associations Thrift institutions, known sometimes as savings and loans and referred to in the proposed rules as “Federal and state savings associations,” would see a new set of requirements designed to better integrate them with national banks. Under current law, if a savings association makes “investments in and extensions of credit” to a subsidiary engaged in activity that is impermissible for a national bank[3], such an investment must be deducted from the savings association’s assets and regulatory capital. Under the proposed rule, savings associations in most cases would have to deduct these investments from Common Equity Tier 1 capital.

Finally, the proposed rule subjects Federal and state savings associations to a tangible capital requirement of 1.5%. This requirement is separate from the Tier 1 capital requirement and could encompass a broader range of capital. It includes not only the amount of Tier 1 capital not included in previously tabulated Tier 1 capital totals, but also outstanding perpetual preferred stock.

Table 1 – Minimum Capital Requirements over the 2013-2019 Phase-in Period.

Year (as of Jan. 1)	Current	2013	2014	2015	2016	2017	2018	2019
Minimum Common Equity Tier 1 ratio	N/A	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer	N/A	N/A	N/A	N/A	0.625%	1.25%	1.875%	2.5%
Countercyclical Capital Buffer (potential maximum)	N/A	N/A	N/A	N/A	0.625%	1.25%	1.875%	2.5%
Common Equity Tier 1 plus CCB	N/A	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum Tier 1 Capital (Common Equity plus Additional Tier 1 Capital)	4.0%	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital (Tier 1 plus Tier 2)	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus Conservation Buffer	8.0%	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%

As shown in Table 1, Tier 1 capital includes both Common Equity capital and additional Tier 1 capital that does not qualify as Common Equity capital. While the requirements for additional Tier 1 capital are not as stringent, they still exclude many types of securities. Non-cumulative perpetual preferred stock can remain within the Tier 1 category, but that categorization likely would not include Trust Preferred Securities. The proposed rules state that additional Tier 1 capital may include equity capital instruments as well as some minority interests.

Total capital held by banking organization, as a portion of total assets, would remain at a level of at least 8.0%. As much as a quarter of that designated total capital could include Tier 2 capital, which encompasses a broader range of securities than Common Equity capital or additional Tier 1 capital. Tier 2 capital likely does include Trust Preferred Securities. Tier 2 capital has similar restrictions as Tier 1 capital on the exercise of call options, but significantly, Tier 2 capital may have a maturity date if at least five years have passed since the instrument’s issuance.

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Table 2 – Comparison of Requirements for Common Equity Tier 1 Capital, Additional Tier 1 Capital and Tier 2 Capital.

	Common Equity	**Additional Tier 1 Capital**	**Tier 2 Capital**
Issuance	"The instrument is . . . issued directly by the banking organization." .	"The instrument is issued and paid in."	"The instrument is issued and paid in."
Subordination	The instrument "represents the most subordinated claim in a receivership, insolvency, liquidation, or similar proceeding of the banking organization."	"The instrument is subordinated to depositors, general creditors, and subordinated debt holders of the banking organization in a receivership, insolvency, liquidation, or similar proceeding."	"The instrument is subordinated to depositors and general creditors of the banking organization."
Maturity Date	"The instrument has no maturity date . . ."	"The instrument has no maturity date . . ."	"The instrument has a minimum original maturity of at least five years. At the beginning of each of the last five years of the life of the instrument, the amount that is eligible to be included in Tier 2 capital is reduced by 20% of the original amount of the instrument (net of redemptions) and is excluded from regulatory capital when remaining maturity is less than one year. . ."
Redemption	The instrument "can only be redeemed via discretionary repurchases with the prior approval of the agency, and does not contain any term or feature that creates an incentive to redeem."	This instrument "does not contain a dividend step-up or any other term or feature that creates an incentive to redeem . . . If callable by its terms, the instrument may be called by the banking organization only after a minimum of five years following issuance, except that the terms of the instrument may allow	"The instrument, by its terms, may be called by the banking organization only after a minimum of five years following issuance, except that the terms of the instrument may allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in tier 2 capital, or a tax event. In addition: The

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		it to be called earlier than five years upon the occurrence of a regulatory event (as defined in the agreement governing the instrument) that precludes the instrument from being included in additional tier 1 capital or a tax event."	banking organization must receive the prior approval of the agency to exercise a call option on the instrument . . . [and cannot] create at issuance, through action or communication, an expectation the call option will be exercised.
Guarantee	"The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument." "The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument."	"The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument."	"The instrument is not secured, not covered by a guarantee of the banking organization or of an affiliate of the banking organization, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims."
Dividends	"The banking organization has full discretion at all times to refrain from paying any dividends and making any other capital distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of any other restrictions on the banking organization."	"The banking organization has full discretion at all times to cancel dividends or other capital distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the banking organization except in relation to any capital distributions to holders of common	"The instrument has no credit-sensitive feature, such as a dividend or interest rate that is reset periodically based in whole or in part on the banking organization's credit standing, but may have a dividend rate that is adjusted periodically independent of the banking organization's credit standing, in relation to general market interest rates or similar

		stock.”	adjustments.”
Losses	“The holders of the instrument bear losses as they occur equally, proportionately, and simultaneously with the holders of all other common stock instruments before any losses are borne by holders of claims on the banking organization with greater priority in a receivership, insolvency, liquidation, or	[No similar provision.]	[No similar provision.]
GAAP	The paid-in amount is classified as equity under GAAP.	The paid-in amount is classified as equity under GAAP.	[No similar provision.]
Regulatory Requirement	“The instrument has been issued in accordance with applicable laws and regulations . . . . The instrument is reported on the banking organization’s regulatory financial statements separately from other capital instruments.”	[No similar provision.]	[No similar provision.]
Funding	“The banking organization, or an entity that the banking organization controls, did not purchase or directly or indirectly fund the purchase of the instrument.”	“The banking organization, or an entity that the banking organization controls, did not purchase or directly or indirectly fund the purchase of the instrument.”	“The banking organization, or an entity that the banking organization controls, has not purchased and has not directly or indirectly funded the purchase of the instrument.”

Deductions Notably, banking organizations must make a series of deductions from their Common Equity Tier 1 capital elements in order to calculate their capital levels. These deductions fall into several categories:

- *Goodwill.* Purchase price is allocated to acquired assets and liabilities based on estimated fair values. Any excess of cost over the fair value of the net assets acquired is recorded as goodwill. Goodwill would be assigned to an operating unit of the acquiring company. Banking organizations would have to deduct the full amount of goodwill from Common Equity Tier 1 capital beginning in 2013.

- *Deferred Tax Assets (DTAs) Arising From Operating Loss and Credit Carryforwards.* This represents the increase or decrease in taxes payable or refundable in future years that arise from operating loss and carryforwards. Banking organizations would have to deduct the full amount of DTAs from operating loss and credit carryforwards from Common Equity Tier 1 Capital beginning in 2013 and gradually apply the deductions to all Tier 1 capital by 2018.

- *Gain-on-Sale Associated With a Securitization Exposure.* Banking organizations would deduct any after-tax gains associated with a securitization exposure. Banking organizations would have to deduct these gains from Common Equity Tier 1 Capital beginning in 2013 and gradually apply the deductions to all Tier 1 capital by 2018.

- *Defined Benefit Pension Fund Assets.* This would apply to any defined benefit pension fund net asset, net of any associated deferred tax liability. But the proposed rule states that it would not apply to insured depository institutions that have their own defined benefit pension plan. Banking organizations would have to deduct the full amount of defined benefit pension fund asset from Common Equity Tier 1 Capital beginning in 2013 and gradually apply the deductions to all Tier 1 capital by 2018.

- *Expected Credit Loss That Exceeds Eligible Credit Reserves For Certain Banking Organizations.* This concerns the deduction of negative amounts arising from expected losses. The proposed rule would apply to only Advanced Approaches banking organization. Banking organizations would have to deduct expected credit losses exceeding eligible credit reserves from Common Equity Tier 1 Capital beginning in 2013 and gradually apply the deductions to all Tier 1 capital by 2018.

Table 3 – Phase-in of Deductions for Tier 1 Capital.

Calendar Year	**Deduction for Goodwill**	**Deductions for DTA From Operating Loss and Credit Carryforwards, Gain-on-Sale From Securitization, Defined Benefit Pension Fund Assets, Expected Credit Loss Exceeding Credit Reserves**	
	Percentage From Common Equity Tier 1 Capital	Percentage from All Tier 1 Capital	Capital Percentage from All Tier 1 Capital
2013	100.0%	0%	100.0%
2014	100.0%	20.0%	80.0%
2015	100.0%	40.0%	60.0%
2016	100.0%	60.0%	40.0%
2017	100.0%	80.0%	20.0%
2018	100.0%	100.0%	0.0%

Leverage Ratio Basel III introduces the concept of a “leverage ratio” to the Basel capital requirements, although U.S. banking regulators had previously required a similar ratio. This ratio places a limit on how much a banking organization can leverage its equity capital base. Banking

organizations would have to calculate the ratio by (1) finding a numerator that totals Tier 1 capital; and (2) dividing by a denominator that includes average total on-balance sheet assets (as reflected on the FR Y-9C for bank holding companies and on depositories' Call Reports) minus required deductions from Tier 1 capital. Previously, U.S. regulators allowed banking organization to assume a lower ratio if the banking organization had a composite "1" rating under the CAMELS system, which measures the overall condition of a bank. The new rule would subject all banking organizations, regardless of their CAMELS rating, to the leverage ratio requirement.

Additionally, banking organizations subject to the Advanced Approaches rule would have to maintain a supplementary leverage ratio of 3.0%. The supplementary leverage ratio uses an identical numerator to the first leverage ratio, but assumes a larger base of assets for the denominator to include "off-balance sheet exposures." The proposed rules state that the supplementary leverage ratio is needed to account for the complexity of larger banking organizations' leverage ratio calculations. While the supplementary leverage ratio rule would not go into effect until 2018, Advanced Approaches banking organization would have to begin reporting their supplementary leverage ratios in 2015.

Table 4 – Comparison of Current Leverage Ratio Requirements with Proposed Leverage Requirements.

	Current Requirements	**Proposed Requirements for 2018**
Leverage Ratio for Banking Organizations without a 1 Supervisory Rating	4.0%	4.0%
Leverage Ratio For Banking Organizations with a 1 Supervisory Rating	3.0%	4.0%
Supplemental Leverage Ratio for Advanced Approaches Banking Organizations	0%	3.0%

Prompt Corrective Action Requirements The Agencies have previously established a set of categories to help determine the viability of banking organizations and the possible need to take action to limit their operations or even close them. These categories, known as Prompt Corrective Action ("PCA") categories, include (1) "well capitalized," (2) "adequately capitalized," (3) "undercapitalized," (4) "significantly under- capitalized," and (5) "critically undercapitalized." At each level except "well capitalized," the Agencies may impose restrictions on banks, with the least significant restrictions on "adequately capitalized" banks and the most significant restrictions – which include closing – on "critically undercapitalized" banks. The proposed rule would add a Common Equity Tier 1 requirement for all of the categories except "critically undercapitalized." Additionally, the proposed rule would revise the three current capital measures – total risk-based capital ("RBC"), Tier 1 risk-based capital ("Tier 1 RBC"), and leverage ratio – in line with other parts of the proposed rule dealing with capital levels and deductions. As discussed previously, the proposed rule would rescind the 3.0% leverage ratio for banking organizations with a 1 rating under the CAMELS system and subject all banking organizations to the minimum 4.0% leverage ratio.

The table below shows the proposed new PCA guidelines by showing capital as a percentage of

total assets as well as corresponding PCA requirements for each category. The current capital percentages are shown in parentheses, with the exception of Common Equity Tier 1 capital ratio because there is no current requirement for it.

Table 5 – Prompt Corrective Action Measures. Ratio measures in parentheses are current standards.

Category	Total RBC Measure	Tier 1 RBC Measure	Common Equity Tier 1 RBC Measure	Leverage Measure	PCA requirements
Well Capitalized	≥ 10.0% (10.0%)	≥ 8.0% (6.0%)	≥6.50%	≥ 5.0% (5.0%)	None
Adequately Capitalized	≥ 8.0% (8.0%)	≥ 6.0% (4.0%)	≥4.50%	(4.0%, or 3.0% for CAMELS 1s)	May limit nonbank activities at depository institution's financial holding company and includes limits on brokered deposits
Undercapitalize	< 8.0% (8.0%)	≥ 6.0% (4.0%)	< 4.50%	(4.0%, or 3.0% for CAMELS 1s)	Includes adequately capitalized restrictions, and also includes restrictions on asset growth; dividends; requires a capital plan
Significantly Undercapitalized	< 6.0% (6.0%)	< 4.0% (3.0%)	< 3.0%	< 3.0% (3.0%)	Includes undercapitalized restrictions, and also includes restrictions on sub-debt payments
Critically Undercapitalized	Tangible Equity to Total Assets ≤ 2.0%				Generally, receivership/conservatorship within 90 days

New Capital Definitions and Risk Weighting for Standardized Approach The Agencies' second proposed rule, titled "Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements,"[4] puts forth a Standardized Approach for banking organizations to calculate their total risk-weighted assets. This is a determination that heavily impacts capital requirements, since capital is measured as a percentage of total assets. The proposed rule would apply to Standardized Approach banking organizations, which means that they are applicable to insured depository institutions "without regard to asset size or foreign financial exposure." The proposed rule closely resembles similar guidelines created under Basel II but never enacted. The version of the Standardized Approach in the rules adheres to restrictions enacted in Section 939A of the Dodd-Frank Act, which orders Agencies to end their reliance on use of credit ratings. The proposed rule's formulas for risk weighting are scheduled to take effect on January 1, 2015, if not adopted earlier.

The proposed rule expands the number of risk-weighting categories and would assign risk weightings based on the type of exposure held by a bank. The most prominent examples include: (i) U.S. government, public-sector entities and depository institutions; (ii) foreign sovereigns, public sector entities and depository institutions; (iii) corporate exposures; (iv)

residential mortgage exposures; and (v) commercial real estate exposures. In addition, this proposal would expand disclosure requirements for the top-tier banking organizations with $50 billion or more in risk-weighted assets.

U.S. Government, Public-Sector Entities and Depository Institutions Risk-weighting for exposure to the U.S. government, its Agencies and its central bank remain unchanged at zero percent under the proposed rule. The risk-based capital rules assign weights for sovereigns based in large part on classifications generated by the Organization for Economic Co-operation and Development ("OECD"). The proposed rule states that these classifications are permissible under Section 939A of the Dodd-Frank Act. Pursuant to current agency rules, exposures to U.S. states and municipalities and any affiliated public-owned entity or authority would receive one of two risk weights. General obligations from these entities that are backed by their full faith and credit and financed through general tax funds would receive a 20.0% risk weight, while revenue obligations backed with funds only from a specific project would receive a 50.0% risk weight. U.S. depository institutions and credit unions would receive a 20.0% risk weight.

Foreign Sovereigns, Public Sector Entities and Depository Institutions The OECD methodology classifies countries into one of eight possible risk categories from zero to 7, with zero being the lowest risk assessment and 7 having the highest risk assessment. These classifications are known as country rate classifications, or CRCs. Sovereign exposures would receive a risk weighting corresponding with their CRC, and exposures to banking organizations within those countries would also correspond with their respective countries' CRCs. However, sovereign exposures are weighted one level below foreign bank exposures.

Table 6 – Risk Weights for Various Institutional Exposures.

Types of Exposure	Risk Weight
-Non-U.S. Sovereigns with CRCs 0-1	0%
-Non-U.S. Sovereigns with CRC 2 -Foreign Banking organization with CRCs 0-1 -Non-U.S. PSE General Obligations with CRCs 0-1	20.0%
-Non-U.S. Sovereigns with CRC 3 -Foreign Banking organization with CRC 2 -Non-U.S. PSE General Obligations with CRC 2 -Non-U.S. PSE Revenue Obligations with CRCs 0-1	50.0%
-Non-U.S. Sovereigns with CRCs 4-6 -Foreign Banking organization with CRC 3 -Non-U.S. PSE General Obligations with CRC 3 -Non-U.S. PSE Revenue Obligations with CRCs 2-3	100.0%
-Non-U.S. Sovereigns with CRC 7 -Foreign Banking organization with CRCs 4-7 -Non-U.S. PSE General Obligations with CRCs 4-7 -Non-U.S. PSE Revenue Obligations with CRCs 4-7	150.0%
-Non-U.S. Sovereigns with No CRC -Foreign Banking organization with No CRC	100.0%

-Non-U.S. PSE General Obligations with No CRC Non-U.S. PSE Revenue Obligations with No CRC	
-Non-U.S. Sovereigns with a Default in Previous Five Years -Foreign Banking organization in Country With Default in Previous Five Years -Non-U.S. PSE General Obligations in Country with Default in Previous Five Years -Non-U.S. PSE Revenue Obligations in Country with Default in Previous Five Years	150.0%

Corporate Exposures While the proposed rule states that the Agencies sought an alternative to credit ratings that would provide a more "granular" approach to risk weighting for corporate exposures, the proposed rule would adopt a uniform, 100.0% risk weighting for all corporate exposures. The proposed rule would change risk weighting for securities firm exposures from 20.0% to 100.0%.

Residential Mortgages Due to the crisis in the U.S. housing market in recent years, the proposed rule adopts risk weighting for residential mortgage exposures that are more sensitive than the current rule or the rules proposed under Basel III. Currently, mortgage loans secured by first liens on 1-4 family residential structures that meet federal standards – such as adherence to prudent underwriting standards, performance in accordance with original terms and on-time payment – receive a 50.0% risk weighting. All other mortgages currently receive a 100.0% risk weighting. Under the proposed rules, the Agencies would weigh residential mortgages in accordance with loan-to-value ratio. Mortgages would fall into two categories. Category 1 mortgages would include mortgages meeting an array of standards, such as not exceeding 30 years in length, not resulting in ballooning or increases in principal balance over time, and use of sound underwriting methods. All other mortgages would fall into Category 2. Risk weighting could reach as high as 200.0% under the new approach.

The table below shows the proposed new risk weighting for residential mortgages with their loan-to-value exposures.

Table 7 – Proposed New Risk Weightings for Residential Mortgages.

Loan-to-Value Ratio	Category 1 Exposure	Category 2 Exposure
Less Than Or Equal to 60%	35%	100%
Greater Than 60% and Less Than or Equal to 80%	50%	100%
Greater Than 80% and Less Than or Equal to 90%	75%	150%
Greater than 90%	100%	200%

Commercial Real Estate The proposed rule would require banking organizations to assign a 150.0% risk weight to any High Volatility Commercial Real Estate exposure ("HVCRE"). Commercial real estate without the HVCRE designation would receive a weighting of 100.0%. The HVRCE designation would apply to a credit facility that finances the "acquisition, development, or construction" of real property unless the property finances 1-4 family residential structures or commercial real estate meeting borrowing standards relating to loan-to-value ratio and other factors. The Agencies currently assign these high-risk exposures a 100.0% risk weight.

Advanced Approaches Proposal The third proposed rule, titled "Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule,"[5] seeks to write rules more sensitive to risk stemming from the banking organizations' dealings with counterparties. Banking organizations can mitigate counterparty risk by adjusting their exposure-at-default ("EAD"), which is simply the amount exposed to a counterparty in the event of a default. Counterparty credit risk, largely reflected in the EAD metric, would see significantly revised treatment under the rule. As stated before, the Advanced Approaches rules apply to banking organizations that have $250 billion or more in total assets or total on-balance sheet foreign exposure equal to $10 billion or more. Like the Standardized Approach rule, the Advanced Approaches rule eliminates references to credit ratings in accordance with Section 939A of Dodd-Frank. The Agencies substituted for the references an "investment-grade" standard for weighting exposures that ensures that the entity to which the bank is exposed "has adequate capacity to meet financial commitments for the projected life of the asset or exposure."

Eligible Financial Collateral Under the proposed rule, resecuritizations would no longer qualify as eligible financial collateral for banking organizations, and therefore could not be used to adjust the EAD. A securitization in which the underlying exposure is a securitization is a resecuritization.

Likewise, conforming residential mortgages and debt securities that are not investment grade are excluded from the definition of financial collateral.

Revised Supervisory Haircuts Because securitization exposures have "increased levels of volatility relative to other collateral types," the proposed rules would establish standard "haircuts" for securitization exposures while removing reference to credit ratings in accordance with Section 939A of Dodd-Frank. The haircuts effectively discount the value of the exposures mostly in line with the risk weights assigned in the second proposed rule dealing with the Standardized Approach.

Changes to Internal Models Methodology The Agencies found that banking organizations had higher counterparty exposures than expected during the recent financial crisis due to flaws in their internal models. The proposed rule for Advanced Approaches banking organizations would require the capital requirement for exposures to counterparty credit risk to be "equal to the larger of the capital requirement for those exposures calculated using data from the most recent three-year period" and from a three-year period that "contains a period of stress reflected in the credit default spreads of the bank's counterparties."

Credit Valuation Adjustments In over-the-counter derivative contracts, credit valuation adjustments ("CVA") are used to compute counterparty credit risk. While Basel II included metrics to account for credit migration (the risk of counterparty credit deteriorating short of default), the Agencies found that the method was "not suitable for addressing" credit valuation agreement risk. Under the proposed rule, an additional capital requirement reflects credit valuation adjustments, which effectively measure a counterparty's default risk at market value. Banking organizations would have to multiply their CVA capital requirement by 12.5 to "convert" the CVA requirement to a risk-weighted requirement.

Implications The approval of the proposed rules by the Agencies could pose major challenges for U.S. banking organization by potentially diminishing their market performance:

- Large banking organizations face the potential for major declines in their return on equity. Because of banking organizations' upcoming need to raise new capital in order to meet the higher Basel III requirements, retention of earnings appears to be a likely prospect in many instances. Fitch Ratings recently found that the 28 global systemically important financial institutions would have to raise $566 billion in additional Common Equity in order to meet the new minimum requirements.[6] Fitch estimates that banking organizations would have a drop in return on equity to 8.5%, from an average of 10.8 % from 2005 to 2001. In turn, lower return on equity could make it difficult for banking organizations to raise the necessary funds to meet capital requirements on a continual basis. While higher capital requirements may attract some risk-averse investors, the potential for underperformance of banking organizations in the market could require recalibration of the Basel II regulations by the Agencies.

- Banking organizations may have to charge more for loans in order to meet the higher and stricter capital requirements. A study released by the Institute of International Finance finds that 40% of surveyed banking organizations able to estimate the impact of Basel III expected that loan interest rate would increase between a half and a full percentage point, and 26% expected an even larger increase.[7] Curtailed access to financing for U.S. businesses, which would exacerbate the economic sluggishness, could emerge as an unwelcome counterbalance to the advantages yielded by U.S. banking organizations' sounder capital reserves under the Basel III regime.

- Issuance of the Basel III regulations may mean that banking organizations seek to redeem trust-preferred securities.[8] In most cases, the securities may be redeemed if there is a qualifying regulatory event. In this case, the regulatory event would be the exclusion of trust-preferred securities from banking organizations' regulatory capital, as would be required under the proposed rules. The upside of this scenario is that banking organizations would save money by not paying dividends from trust preferred securities called back from investors.

- Regulators plan to accompany a push for more robust capital requirements with requirements for better disclosures by banking organizations of the composition of their capital. The BCBS issued a statement on June 26 that said improvements to the disclosure of banking organizations' capital is "under consideration as part of the Committee's review of Basel III implementation."[9] The BCBS noted that insufficient disclosures by banking organizations during the financial crisis "masked" the lack of loss-absorbent capital.

- For competitive reasons, expect that the banking organizations will want to meet and exceed the minimum requirements well before the phase-in periods. Whether they will be able to either attract the necessary capital or reduce their assets early enough will be a race to the wire.

- Because the proposed rules would subject thrifts to the higher capital requirements and new risk weights for residential mortgages, the price of generated mortgage loans will become much higher for those institutions and place them under severe stress[10]. Thrifts' traditional business model – leveraging capital through a high volume of residential loans – will become more difficult and less profitable. Thrifts have increasingly refocused their business into non-residential lending areas, which is a trend that may continue with the adoption of Basel III in the U.S. According to a recent study by the investment banking firm Keefe, Bruyette & Woods, the median ratio of residential mortgages to total loans at the 20 biggest thrifts fell from 78% in 2006 to 61% in March 31 of this year.

- The increased risk-weights based on loan-to-value ratios for residential mortgages beyond the current standard 50% risk weight for home mortgages, which definitely contributed to the overabundance of mortgages and was a major factor for the recent crisis, will put in question how robust the housing market will be in the long run and will likely reduce the size of the home construction industry. At the same time, it will help recalibrate home ownership in the country to a more rational level.

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1. The proposed rules refer to "banking organizations," a term that includes national banks, state member banks, state nonmember banks, state and federal savings associations, most top-tier bank holding companies domiciled in the United States and top-tier savings and loan holding companies domiciled in the United States.
2. Notice of Proposed Rulemaking, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120607a1.pdf.
3. The OCC maintains a list of activities that are permissible for national banks, *available* at http://www.occ.gov/publications/publications-by-type/other-publications-reports/bankact.pdf.
4. Notice of Proposed Rulemaking, *Regulatory Capital Rules: Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120607a2.pdf.*
5. Notice of Proposed Rulemaking, *Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule, available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120607a3.pdf.
6. *Basel III: Return and Deleveraging Pressures* (Fitch Ratings), May 17, 2012, at 1, *available at* http://www.scribd.com/doc/93881226/Basel-III-Report.
7. Paul Hannon, Banking organization tie higher corporate loan costs to Basel III, DOW JONES NEWSWIRES, June 21, 2002, *available at* http://www.marketwatch.com/story/banking organization-tie-higher-corporate-loan-costs to-basel-iii-2012-06-21.
8. Danielle Robinson, *New Fed rules seen triggering $30bn of TruPs redemptions*, REUTERS, June 9, 2012, *available at* http://in.reuters.com/article/2012/06/08/markets-credit-idINL1E8H8E4120120608.
9. Press Release, Basel Committee on Banking Supervision, Final rules on banking organization' disclosure of the composition of their capital issued by the Basel Committee (June

26, 2012), *available at* http://www.bis.org/press/p120626.htm.
10. *See* Andy Peters, *Thrifts Face Crossroads with New Capital Rule*, THE AMERICAN BANKER, June 15, 2012, *available at* http://www.americanbanker.com/issues/177_116/Basel-Fed-thrifts-1050173-1.html?zkPrintable=1&nopagination=1.

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