BANKING

BASEL III LITE: REGULATORS ADJUST CAPITAL RULES FOR COMMUNITY BANKS
by John K. Lawrence

The three Federal bank regulatory agencies (the "Agencies") have adopted new capital regulations implementing the first portion of the international principles, known as "Basel III," agreed in the Basel Committee on Banking Supervision ("BCBS"). The new rules will become effective for community banking organizations on January 1, 2015, a year after their application to larger banks.[1]

The actions by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation came almost a year after they proposed rules embodying those principles. Following vigorous opposition to portions of the proposals by community bankers and members of Congress, and extensive inter-agency negotiations, the new regulations reflect significant adjustments to meet the concerns of community banks.

Backgound

In the wake of the 2008 crisis in the financial services sector, the BCBS, a committee of bank supervisors established by the central bank governors of the G-10 countries, undertook to fashion principles to improve the quality and quantity of banking organizations' capital and to strengthen international standards for calculating regulatory capital. The resulting principles, adopted in 2010 and subsequently modified, comprise Basel III. In addition, certain provisions of the Dodd-Frank Act, enacted in July, 2010, modified U.S. law regarding capital standards applicable to banking organizations in the U.S. Both Basel III and those Dodd-Frank Act provisions were reflected in the Agencies' 2012 proposals and are implemented in the Agencies' new regulations.

The Agencies' proposals would have made several changes to their existing risk-based capital regulations that might have had significant effects on many community banks. The proposals (i) included changes to the risk-weighting of residential mortgage loans, (ii) would have required banks to include most components of accumulated other comprehensive income ("AOCI")[2] in calculating their Tier 1 capital, and (iii) would have required the phase-out of certain types of capital instruments, including trust preferred securities, from Tier 1 capital of bank holding companies.

These aspects of the proposals generated considerable adverse comment, political interest, and controversy. The Agencies responded to those comments by adjusting the final regulations on each of these issues.

Modifications to Proposals in New Regulations

The new regulations make no change in the existing risk-weighting of residential mortgage loans. This means that prudently underwritten, first lien, one- to four-family residential mortgage loans that are not past due, non-accrual or restructured will continue to attract a 50% risk weight, while all other such residential mortgage loans will be weighted at 100%.

Although the new regulations generally require banking organizations to recognize in regulatory capital most components of AOCI, an exception is provided for community banking organizations and others not subject to the advanced approaches rule. Those banking organizations may make a permanent, one-time election not to include most components of AOCI in regulatory capital, and instead calculate regulatory capital by using the treatment for AOCI in the Agencies' existing capital rules, which excludes most elements of AOCI.

An AOCI opt-out election must be made on the first quarterly regulatory report by the institution after it becomes subject to the new regulations. As noted above, for community banks, that will be the first quarterly filing after January 1, 2015.

Unlike the proposals, but consistent with the Dodd-Frank Act, the new regulations allow a bank holding company, which had total assets of less than $15 billion on December 31, 2009, to continue to include capital instruments, such as trust preferred securities and cumulative perpetual preferred stock, issued before May 19, 2010, in its Tier 1 capital. This change will be important to many bank holding companies in meeting the increased capital requirements contained in the new regulations.

Other Significant Features of the New Regulations

The new regulations create a common equity Tier 1 ("CET 1") capital requirement that becomes effective for community banks on January 1, 2015. From that date, each such banking organization must maintain a minimum ratio of common equity Tier 1 capital to risk-weighted assets ("RWA") of 4.5%.

A new capital conservation buffer, in addition to the CET 1 capital requirement, is specified in the new regulations. In order to avoid limitations on its ability to make capital distributions, including dividends and certain discretionary bonus payments, a banking organization will be required to hold additional amounts of common equity Tier 1 capital. The capital conservation buffer will be phased-in commencing January 1, 2016, beginning at 0.625% of RWA, and rising to 2.5% on January 1, 2019.

Beyond introducing those metrics, the new regulations make further definitional and computational changes to existing rules intended to improve the quality of required capital. This is reflected in stricter criteria for qualifying capital instruments, and in required regulatory adjustments and deductions in calculating capital. Mortgage-servicing assets, deferred tax assets, minority interests, and certain investments in the capital of unconsolidated financial institutions are among the elements more strictly limited than under the Agencies' current capital rules. These changes are subject to phase-in over specified transition periods.

The new regulations also refine the recognition of risk inherent in certain assets. Although residential mortgage loan risk-weightings are unchanged, other categories will attract higher risk-weightings. For example, past-due loans (to the extent not secured or guaranteed), and certain types of loans for the acquisition, development, and construction of commercial real estate, will have a risk-weighting of 150%.

Similarly, higher credit conversion factors will be applicable to some off-balance sheet exposures. Among the new requirements, a 20% conversion factor will apply to the unused portion of loan commitments with an original maturity less than one year, unless the commitment is unconditionally cancellable by the banking organization.

The new regulations increase the minimum ratio of Tier 1 capital to RWA for all banking organizations. The increased minimum for Tier 1 capital is 6.0% (compared to the current 4.0%). The minimum ratio of total risk-based capital remains at 8.0%. The minimum leverage ratio (that is, Tier 1 capital to total consolidated assets) is set at 4.0% for all organizations. These requirements become effective for all banking organizations on January 1, 2015.

The Agencies' prompt corrective action ("PCA") rules, which currently use the Tier 1 risk-based capital ratio, the total risk-based capital ratio, and the leverage ratio as yardsticks in assigning banking organizations to one of five capital adequacy categories, will be modified to include the CET 1 ratio created by the new regulations. In addition, the numerical levels for each of the top four capital adequacy categories will be adjusted to reflect the higher minimum capital levels specified in the new regulations, other than the capital conservation buffer. These changes will take effect over the applicable transition periods specified for the definitional and computational changes already noted for the individual capital components.

Conclusions

By providing adjustments for community banking organizations to the generally applicable Basel III principles, the new regulations reflect an increased awareness on the part of the Agencies of the need to avoid a "one-size fits all" approach to regulation of banking organizations. Nevertheless, even with those adjustments to the timing and standards to be applied, the new regulations may pose significant challenges for some community banking organizations.

This Client Alert summarizes only a portion of the extensive content of the new regulations. Although January 1, 2015 is some ways off, it is not too early for compliance planning to begin.

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[1] The new regulations, which will replace the Agencies' existing risk-based capital, advanced approaches, market risk, and leverage rules, generally apply to all U.S. banks, including Federal and State savings banks, and bank and savings and loan holding companies, other than "small bank holding companies" (generally, those with consolidated assets of less than $500 million). Certain savings and loan holding companies substantially engaged in insurance underwriting or commercial activities are temporarily exempted from the new regulations.

[2] AOCI generally includes accumulated unrealized gains and losses on certain assets and liabilities that are not included in net income, although they are included in equity under U.S. generally accepted accounting principles. One such component, not reflected in regulatory capital under the Agencies' current capital rules, is unrealized gains and losses on available-for-sale ("AFS") securities.

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