# Regulatory Capital Requirements: Proposed Rules

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# The NPRs

- In June 2012, the Board, FDIC, and OCC approved three joint NPRs for public comment that were designed to:
  - Improve the resiliency of the U.S. banking system
  - Increase the quantity and quality of regulatory capital
  - Enhance risk sensitivity
  - Address weaknesses identified over the past several years
  - Address certain requirements of the Dodd-Frank Act (DFA)
- Today's discussion will focus on the two NPRs that apply predominantly to community banking organizations.
  - **1st NPR**: Definition of capital, minimum regulatory capital ratios, capital buffers, and prompt corrective action (PCA)
  - **2nd NPR**: Standardized approach for risk-weighted assets (RWA)

# What would the NPRs do?

- Replace the federal agencies' general risk-based capital rules
- Establish consolidated capital requirements for savings and loan holding companies (SLHCs)
- Restructure the capital rules into an integrated, harmonized, regulatory capital framework

# Who is subject to the new rules?

- The two NPRs apply to all banks, savings associations, SLHCs, and bank holding companies (BHCs) that are subject to minimum capital requirements.
  - As is the case today, the NPRs would <u>not</u> apply to BHCs subject to the Board's Small BHC Policy Statement.
  - However, the NPRs <u>would</u> apply to all banks, savings associations, and SLHCs, regardless of size.

# 1st NPR

- This NPR implements changes to U.S. regulatory capital standards that would:
  - Increase the quantity and quality of regulatory capital by:
    - Introducing a new common equity tier 1 (CET1) ratio
    - Increasing the minimum tier 1 capital ratio
    - Requiring a stricter set of minimum eligibility criteria for regulatory capital instruments that improves the loss absorbency of such instruments
  - Establish a capital conservation buffer for all banking organizations
  - Update the PCA framework to reflect the new requirements

# Minimum Risk-based Capital Ratios

- Regulatory capital components include **CET1 capital**, **additional tier 1 capital**, and **tier 2 capital**, based on proposed eligibility criteria.
- The minimum risk-based capital ratios would be:
  - CET1 capital to total RWAs of 4.5% (new requirement)
  - Tier 1 capital to total RWAs of 6% (increased from the current 4% requirement)
  - Total capital to total RWAs of 8% (unchanged)
- Changes will be phased in starting in 2013 and completed by 2015

# Common Equity Tier 1 Capital (CET 1)

- Common equity is the highest-quality and most loss-absorbing form of capital.
- CET1 would primarily be composed of common stock (and associated surplus) and retained earnings.
  - Majority of regulatory capital deductions would come from CET1 capital
  - CET1 could include limited amounts of minority interests
  - Unrealized gains and losses on all available-for-sale securities would flow through to CET1 capital
    - Phased in from 2013 to 2018

# Deductions from CET1 Capital

- Deductions from CET1 capital would include:
  - Goodwill and other intangibles, except mortgage servicing assets (MSAs)
  - Deferred tax assets (DTAs) that arise from operating losses and tax credit carry-forwards
  - Certain defined benefit pension fund assets
  - Investments in own shares

# Additional Tier 1 Capital

- The revised eligibility criteria for additional tier 1 capital instruments would effectively remove cumulative preferred and trust preferred-like instruments from tier 1 capital.
- In the U.S., additional tier 1 capital would be primarily composed of non-cumulative perpetual preferred securities.
- Non-qualifying capital instruments (such as trust preferred securities) would be phased out by 2016 for depository institution holding companies with at least $15 billion in assets, and by 2022 for other banking organizations.
  - TARP and SBLF capital is grandfathered as additional tier 1 capital for the life of the instruments.

# Tier 2 Capital

- The ALLL remains eligible as tier 2 capital up to 1.25% of RWAs.
- Trust preferred securities would generally be eligible as tier 2 capital if they meet the proposed criteria.
- The proposal would eliminate the limit on the amount of tier 2 capital includable in total capital.

# Leverage Ratio

- All banking organizations would be subject to a 4% minimum tier 1 leverage ratio using the revised definition of tier 1 capital.
- The NPR would eliminate the current minimum ratio of 3% for banks with a ‘1’ composite rating under the Uniform Financial Institutions Rating System.

# Capital Conservation Buffer

- The NPR would implement a capital conservation buffer to help banking organizations remain above regulatory capital minimums during a systemic stress event.
- Banking organizations would need to hold a buffer of more than 2.5% CET1 in addition to their minimum risk-based capital requirements to avoid restrictions on capital distributions and discretionary bonus payments to executive officers.
- The transition period for the capital conservation buffer would start in 2016 and be completed by 2019.

# Capital Conservation Buffer (cont'd)

- A banking organization's capital conservation buffer would be the **lowest** of the following measures:
  - The banking organization's CET1 capital ratio minus the minimum CET1 capital ratio (4.5%);
  - The banking organization's tier 1 capital ratio minus the minimum tier 1 capital ratio (6%); and
  - The banking organization's total capital ratio minus the minimum total capital ratio (8%).

# Capital Conservation Buffer (cont'd)

## Example

| | Sample Bank | Regulatory Minimum | Difference |
|---|---|---|---|
| CET1 RBC Ratio | 7.5% | 4.5% | 3.0% |
| Tier 1 RBC Ratio | 9.0% | 6.0% | 3.0% |
| Total RBC | 10.0% | 8.0% | **2.0%** |

In this example, the bank's capital conservation buffer would be 2%.

# Capital Conservation Buffer (cont'd)

| Capital conservation buffer (as a % of total RWAs) | Maximum payout ratio (as a % of eligible retained income) |
|---|---|
| Greater than 2.5% | No payout ratio 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 2.5% and greater than 0.625% | 20% |
| Less than or equal to 0.625% | 0% |

# Risk-based Capital Ratios Plus Capital Conservation Buffer

| | CET1 Capital/ RWAs | Tier 1 Capital/ RWAs | Total Capital/ RWAs |
|---|---|---|---|
| Minimum | 4.5% | 6.0% | 8.0% |
| Conservation Buffer | 2.5% | 2.5% | 2.5% |
| Minimum + Buffer | 7.0% | 8.5% | 10.5% |

# Proposed Revisions to the PCA Framework

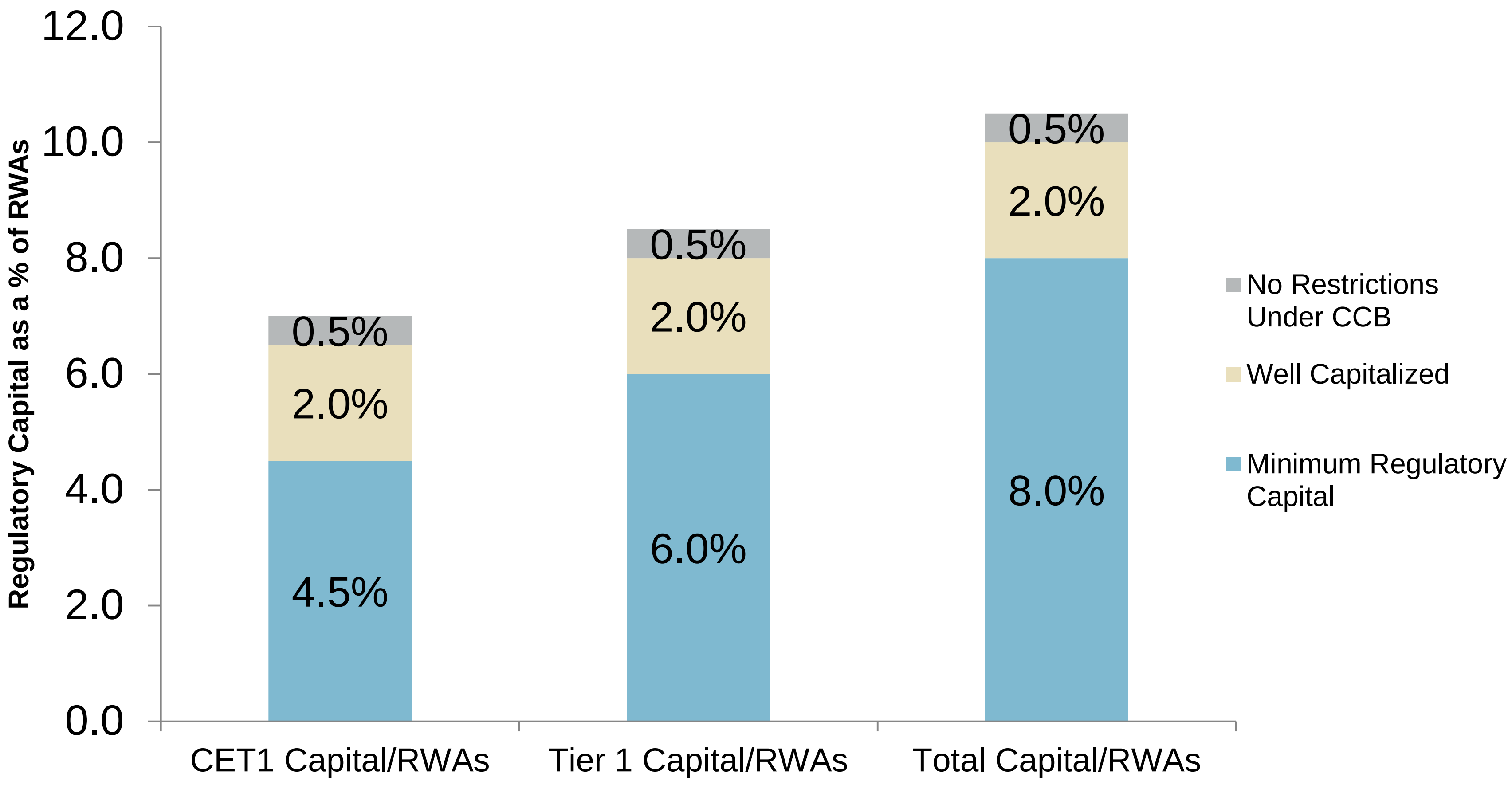
- The NPR would:
  - Revise the current PCA thresholds to incorporate the proposed regulatory capital minimums, including the newly proposed CET1 capital ratio
  - Update the definition of tangible common equity

- The proposed PCA requirements would be fully effective starting in 2015.

# Proposed PCA Levels for Insured Depository Institutions

| | Total Risk-based Capital (RBC)/ RWAs | Tier 1 RBC/ RWAs | CET1 RBC/ RWAs | Leverage Ratio |
|---|---|---|---|---|
| Well Capitalized | ≥ 10% | ≥ 8% | ≥ 6.5% | ≥ 5% |
| Adequately Capitalized | ≥ 8% | ≥ 6% | ≥ 4.5% | ≥ 4% |
| Undercapitalized | < 8 | < 6 | < 4.5 | < 4 |
| Significantly Undercapitalized | < 6 | < 4 | < 3 | < 3 |
| Critically Undercapitalized | Tangible equity (defined as tier 1 capital plus non-tier 1 perpetual preferred stock) to total assets ≤ 2 | | | |

# Interaction Between PCA and Capital Conservation Buffer

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# 2nd NPR

- This NPR would retain the current treatment for many exposures, but provide a more risk-sensitive treatment for others to address weaknesses identified over recent years.

- The proposed changes would take effect by 2015, with an option for early adoption.

# RWA Calculations

- NPR retains current risk-weighting for many significant exposures of community banking organizations, including:
  - U.S. government and its agencies
  - U.S. government-sponsored entities
  - U.S. depository institutions and credit unions
  - U.S. public sector entities (PSEs), such as states and municipalities
  - Corporate exposures (not included in another category)
  - Most commercial mortgages
  - Retail exposures

# RWA Calculations (cont'd)

- Residential mortgage exposures would be assigned a range of risk weight categories (between 35% and 200%) based on a mortgage's loan-to-value ratio, performance, and certain mortgage product features.

- High-volatility commercial real estate exposures related to acquisition, development, and construction financing would generally be assigned a 150% risk weighting.

# RWA Calculations (cont'd)

- Exposures more than 90 days past due or in nonaccrual status would receive a 150% risk weighting.

- The credit conversion factor for most short-term off-balance sheet commitments would be raised from zero to 20%.

# RWA Calculations (cont'd)

- With the exception of those subject to the market risk rule, banking organizations may use one of two approaches for securitization exposures:
  - The existing gross-up approach that is based on the subordination of a securitization exposure; or
  - A simplified supervisory formula approach (SFFA) that would result in higher capital requirements for the more risky junior tranches of a securitization and lower capital requirements for the most senior positions.
- The NPR would require banking organizations to demonstrate a certain level of due diligence and understanding of the material risks associated with their securitization exposures, or assign a 1,250% risk weight to such exposures.

# Comment Period

- Extended to October 22, 2012
- Submit comments by e-mail
  - OCC: regs.comment@occ.treas.gov
  - FRB: regs.comment@federalreserve.gov
  - FDIC: comments@fdic.gov

  - You must reference the docket number. See the NPRs for specific instructions.

# Resources

- Ask the Fed
  - Recent Proposals to Enhance Regulatory Capital Requirements: What You Need to Know (July 2012)
  - www.askthefed.org

- Community Banking Connections
  - The Regulatory Capital Proposals: FAQ (August 2012)
  - www.communitybankingconnections.org

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