



The Federal Banking Agencies' Regulatory Capital Proposals – A Summary

On June 12, 2012, the Federal banking agencies (the OCC, Federal Reserve Board and FDIC) (the “Agencies”) formally proposed for comment, in three separate but related proposals, significant changes to the U.S. regulatory capital framework: the Basel III Proposal, which applies the Basel III capital framework to almost all U.S. banking organizations; the Standardized Approach Proposal, which applies certain elements of the Basel II standardized approach for credit risk weightings to almost all U.S. banking organizations, and the Advanced Approaches Proposal, which applies changes made to Basel II and Basel III in the past few years to large U.S. banking organizations subject to the advanced Basel II capital framework.

Comments on the three proposals are due by September 7, 2012.

Clients and other interested persons are invited to read our more detailed discussion of these proposals in our memorandum on the subject [here](#). We expect to report separately in further detail on specific elements of the regulatory capital proposals, including their effects on financial products, derivatives activities, and securitizations.

Basel III Proposal

Applicability. This proposal is applicable to all U.S. banks that are subject to minimum capital requirements, including Federal and state savings banks, as well as to bank and savings and loan holding companies other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than \$500 million).

Proposed Effective Dates/Transitional Periods. There will be separate phase-in/phase-out periods for minimum capital ratios; regulatory capital adjustments and deductions; non-qualifying capital instruments; capital conservation and countercyclical capital buffers; supplemental leverage ratio for advanced approaches banks; and changes to the Agencies Prompt Corrective Actions (“PCA”) rules. Almost all these changes would be effective by January 1, 2019.

Revised Definitions and Calculations of Capital. Tier 1 Capital would consist of common equity Tier 1 capital and additional Tier 1 capital. Total Tier 1 capital, plus Tier 2 capital, would constitute total risk-based capital. The proposed criteria for common equity and additional tier 1 capital instruments, and Tier 2 capital instruments, are broadly consistent with the Basel III criteria.

Common Equity Tier 1 Capital would be the sum of outstanding common equity tier 1 capital instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income, and common

equity Tier 1 minority interest, minus certain adjustments and deductions. Unrealized gains and losses on all available-for-sale securities held by the banking organization would flow through to common equity Tier 1 capital. Qualifying common equity Tier 1 capital would have to satisfy 13 criteria that are generally designed to assure that the capital is perpetual and is unconditionally available to absorb first losses on a going-concern basis, especially in times of financial stress.

Additional Tier 1 Capital would be the sum of non-common equity capital instruments that satisfy 13 separate criteria (14 for advanced approaches banking organizations), related surplus, and Tier 1 minority interests that are not included in a banking organization's common equity Tier 1 capital, minus applicable regulatory adjustments and deductions. The 14 criteria in question generally are designed to assure that the capital instrument is available to absorb going-concern losses and does not possess credit sensitive or other terms that would impair its availability in times of financial stress. Non-cumulative perpetual preferred stock, which now qualifies as simple Tier 1 capital, would not qualify as common equity Tier 1 capital, but would qualify as additional Tier 1 capital. Cumulative preferred stock would no longer qualify as Tier 1 capital of any kind. Certain hybrid capital instruments, including trust preferred securities, no longer will qualify as Tier 1 capital of any kind.

Tier 2 Capital of a banking organization must satisfy 10 separate criteria (11 for advanced approaches banking organizations), all of which are designed to assure adequate subordination and stability of availability. An advanced approaches banking organization may include the excess of eligible credit reserves over its total expected credit losses ("ECL") to the extent that such amount does not exceed 0.6 percent of its total credit risk weighted-assets.

Compliance with Basel III Non-Viability Standards. The Agencies believe that the Basel III Proposal and U.S. law are consistent with the Basel III non-viability standard.

Leverage Requirement. A separate Tier 1 leverage capital requirement, measured as a ratio of Tier 1 capital (minus required deductions) to average on-balance sheet assets, is proposed for U.S. banking organizations. The practical impact of this requirement should be relatively modest, inasmuch as U.S. banking organizations already are subject to leverage capital requirements, although the minimum leverage ratio requirement for all banks will now be 4 percent. Advanced approaches banking organizations would be subject to a new and separate supplementary leverage ratio, where they would maintain capital not only against their on-balance sheet assets (less amounts deducted from Tier 1 capital), but also certain off-balance sheet assets and exposures. Covered off-balance sheet exposures would include future exposure amounts arising under certain derivatives contracts, 10 percent of the notional amount of unconditionally cancellable commitments, and the notional amount of most other off-balance sheet exposures (excluding securities lending and borrowing, reverse repurchase agreement transactions, and unconditionally cancellable commitments).

Exclusions and Deductions from Capital. A number of required capital adjustments, exclusions and deductions (primarily from Tier 1 capital) would be required, including items such as deductions of goodwill and other intangibles, most deferred tax assets, capital investments in financial firms, and reciprocal cross-holdings. These adjustments and deductions are broadly consistent with Basel III.

Treatment of Minority Interests. The Basel III Proposal limits the type and amount of qualifying minority interests that can be included in Tier 1 capital. 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. Qualifying common equity Tier 1 minority interests would be limited to a depository institution or foreign bank that is a consolidated subsidiary of a banking organization. Limits on the amount of minority interest that may be included in the consolidated capital of a banking organization would be based on a formula generally based on the amount and distribution of capital of the consolidated subsidiary.

Minimum Capital Requirements. Required minimum capital ratios would be: (i) a common equity Tier 1 capital ratio of 4.5 percent; (ii) a Tier 1 capital ratio of 6 percent; (iii) a total capital ratio of 8 percent; and (iv) a Tier 1

leverage ratio to average consolidated assets of 4 percent and, for advanced approaches banking organizations only, an additional leverage ratio of Tier 1 capital to total leverage exposure of 3 percent. The common equity Tier 1 capital ratio would be a new minimum requirement.

Capital Conservation Buffer. A new phased-in capital conservation buffer for all covered banking organizations equal to 2.5% of total risk-weighted assets (“TRWA”) is being proposed.

Countercyclical Capital Buffer. A macro-economic countercyclical capital buffer of up to 2.5% of TRWA applicable *only* to advanced approaches banking organizations is proposed. The countercyclical capital buffer, applied upon a joint determination by the Agencies, would augment the capital conservation buffer.

Changes to Prompt Corrective Action Rules. The Agencies propose to amend the Agencies’ PCA regulations to assure consistency with the new regulatory capital requirements.

Standardized Approach Proposal

Applicability. This proposal would be generally applicable to the same banks that would be subject to the Basel III Proposal.

Proposed Effective Date. January 1, 2015. Banks have the option to adopt the rules earlier.

General Elements. The proposal revises a large number, although not quite all, of the risk weights (or their methodologies) for bank assets. For nearly every class, the proposal requires a more complex, detailed and calibrated assessment of credit risk and calculation of risk weightings.

General Coverage/Highlights

- Two categories of residential mortgage lending would be created: traditional lending would be category 1, where the risk weights range from 35 to 100 percent. Nontraditional loans would fall within category 2, where the risk weights would range from 50 to 150 percent.
- Most commercial loans would continue to be risk-weighted at 100 percent; “high volatility” commercial real estate loans would be risk-weighted at 150 percent.
- Over-the-counter derivative contracts (“OTC derivatives”) would no longer be subject to the existing 50 percent risk weight cap.
- Transactions cleared through central counterparties (“CCPs”) would receive more favorable treatment than transactions conducted and cleared over the counter, although the extent of the advantage would depend on the nature of the CCP.
- Guarantees and collateral would be subject to mixed treatment. A greater variety of these credit enhancements are permitted, but the conditions for their qualification would be tightened.
- Securitization exposures would be weighted according to either the current gross-up method or a new formula to replace the existing method that is based on credit ratings. The proposal also imposes new qualitative/due diligence requirements.

- Equity exposures to unconsolidated counterparties would be risk weighted under one of two broad methods, depending on whether the exposure is to an entity other than an investment fund, or an investment fund. Risk-weighting formulas for these exposures would be significantly more granular.
- Risk-weightings of sovereign debt and exposures to foreign banks would vary primarily according to OECD “country risk” classifications.
- Regulatory capital disclosure requirements would apply to banks with total consolidated assets of \$50 billion or more and that are not subject to the disclosure requirements under the advanced approaches rule.

Advanced Approaches Proposal

Applicability. This proposal applies to banking organizations that are subject to the “advanced approaches” rule under Basel II, including qualifying Federal and state savings associations and their holding companies. It addresses counterparty credit risk, removal of credit rating references, securitization exposures, and conforming technical changes. It also proposes the expansion of those banking organizations that are subject to the market risk capital rule.

Proposed Effective Date: None specified.

Counterparty Credit Risk. Changes proposed include:

- Revisions to the recognition of eligible financial collateral.
- Lengthening the assumed holding periods and the calculation of certain collateralized OTC exposures under the collateral haircut and simple Value-at-Risk (VaR) approaches.
- Increasing capital requirements associated with the internal models methodology; better identification and management of wrong-way risk associated with certain counterparty exposures.
- Additional capital requirement for credit value adjustments relating to OTC derivatives exposures.
- Changing the capital requirements for qualifying and other central counterparty (CCP) exposures, including capital calculations for CCP default fund contributions.
- Requiring application of a continuous 12-month stress period in calculating market price and foreign volatility exposures under the collateral haircut method, based on internal estimates.

Removal of Credit Rating References. Consistent with section 939A of the Dodd-Frank Act, the Advanced Approaches Proposal would remove references to credit ratings that currently exist in the advanced approaches capital rules and replace these references with alternative standards of creditworthiness. In this regard, the Agencies would remove the ratings-based and internal assessment approaches for securitization exposures and require banking organizations to use the supervisory formula approach (SFA) or its simplified version in calculating their capital requirements for these exposures.

Securitization Exposures. The Agencies also propose to create a new definition of resecuritization exposures and broaden the definition of securitization exposures, while excluding certain traditional investment firms from that definition. These changes also are consistent with changes proposed in the Standardized Approach Proposal. The resecuritization definition would capture exposures to securitizations that are comprised of asset-backed

securities (e.g., CDOs and some ABCP conduits) and which are now subject to higher risk-weightings under the 2009 changes to Basel II.

Market Risk Capital Rule Applicability. Federal and state savings banks and their holding companies that meet the market risk capital rule threshold criteria would become subject to the rule.

Authors

Charles Horn
(202) 887-1555
charleshorn@mofocom

Dwight Smith
(202) 887-1562
dsmith@mofocom

Contacts

Oliver Ireland
(202) 778-1614
oireland@mofocom

David H. Kaufman
(212) 468-8237
dkaufman@mofocom

Jeremy Jennings-Mares
44 20 7920 4072
jjenningsmares@mofocom

Anna T. Pinedo
(212) 468-8179
apinedo@mofocom

Barbara Mendelson
(212) 468-8118
bmendelson@mofocom

James Tanenbaum
(212) 468-8163
jtanenbaum@mofocom

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer's* A-List for eight straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofocom. © 2012 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.