LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Basel III Is Not The End Of Regulatory Overhaul

Law360, New York (August 12, 2013, 10:06 AM ET) -- The U.S. bank regulatory agencies recently approved a final rule establishing a new comprehensive regulatory capital framework for essentially all U.S. banking organizations, including banks, savings associations, most top-tier U.S. bank holding companies (BHCs) and savings and loan holding companies (SLHCs) other than those with significant commercial or insurance underwriting activities.

The final rule brings the United States substantially into compliance with the Basel III capital framework, replaces the existing U.S. Basel I risk-based capital regime and implements several capital changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Aside from a few changes responding primarily to the concerns of smaller banking organizations, the major elements of the final rule are largely unchanged from the agencies' June 2012 proposals. The new capital framework imposes higher minimum capital requirements, additional capital buffers above minimum requirements, more restrictive definitions of capital, and higher risk weights for various assets, which together result in substantially more-demanding capital standards for U.S. banking organizations.

For large U.S. banking organizations subject to the "advanced approaches" method of computing risk-based regulatory capital, the final rule takes effect on Jan. 1, 2014. For the vast majority of U.S. banking organizations that will operate only under the "standardized approach," the effective date is Jan. 1, 2015.

Minimum Capital Requirements

The final rule adopts new minimum capital ratios consistent with the Basel III international package and unchanged from the proposed rules:

- a new 4.5-percent common equity tier-1 (CET1) capital requirement;
- a 6-percent tier-1 capital requirement (increased from 4 percent under the current rules); and
- an 8-percent total capital requirement (same as under the current rules).

All U.S. banking organizations will calculate the numerator of their minimum capital ratios using the more restrictive definitions of capital under the final rule. Standardized banks will apply only the standardized approach to compute the denominator of their risk-based capital ratios (i.e., risk-weighted assets). Advanced banks will calculate their risk-weighted assets using the advanced approaches but will use the standardized approach to establish the minimum “generally applicable” capital floor requirements for purposes of Section 171 of Dodd-Frank.

Capital Buffers. The final rule requires that all banking organizations maintain a CET1 “capital conservation buffer” above minimum requirements in an amount equal to 2.5 percent of risk-weighted assets in order to avoid restrictions on their ability to make capital distributions or discretionary bonus payments to executive officers. For advanced banks, the capital buffer may be increased during periods of “excessive credit growth” by an incremental “countercyclical capital buffer” of up to an additional 2.5 percent of risk-weighted assets.

Leverage Ratios. Consistent with the regulatory agencies' proposals, the final rule imposes a tier-1 minimum leverage ratio of 4 percent for all banking organizations and an additional supplementary tier-1 leverage ratio of 3 percent for advanced banks. The 3-percent supplementary leverage ratio incorporates in the denominator certain off-balance sheet exposures that are not included in the standard leverage ratio, including derivatives exposures based on potential future exposure (without collateral recognition) and 10 percent of unconditionally cancellable commitments.

Shortly after approving the final rule, the agencies approved a joint notice of proposed rulemaking (NPR) to implement an enhanced supplementary leverage ratio for the eight largest and most interconnected U.S. banking organizations identified as global systemically important banks (G-SIBs). BHCs covered by the leverage ratio NPR would be subject to a 2-percent tier-1 “supplementary leverage buffer” above the 3-percent supplementary leverage ratio requirement established in the final rule.

PCA Regime. The final rule makes conforming changes to the prompt corrective action (PCA) regime for insured depository institutions based on the new minimum capital requirements. Under the final rule, the “well-capitalized” standards consist of a minimum 5-percent leverage ratio requirement plus the 3-percent supplementary leverage ratio for advanced banks, a 6.5-percent CET1 risk-based capital requirement, an 8-percent tier-1 risk-based capital requirement and a 10-percent total risk-based capital requirement.

The leverage ratio NPR would increase the supplementary leverage ratio requirement for well-capitalized insured depository institution subsidiaries of U.S. G-SIBs to 6 percent.

Capital Definitions, Deductions and Adjustments

Consistent with the proposed rules and the Basel III international approach, the final rule includes more restrictive definitions for the components of capital as well as stricter deductions from and adjustments to capital, which have been adopted essentially as proposed with some technical clarifications.

TruPS and Other Nonqualifying Capital. As required by Section 171 of Dodd-Frank, capital instruments such as trust preferred securities (TruPS) and cumulative preferred shares must be phased out of tier-1 capital by Jan. 1, 2016, for banking organizations with $15 billion or more in total consolidated assets.

However, unlike the proposed rules, the final rule permanently grandfathers as tier-1 capital such instruments issued prior to May 19, 2010, by banking organizations with less than $15 billion in assets. The final rule also permanently grandfathers as tier-2 capital TruPS issued before May 19, 2010, by standardized banks with assets of $15 billion or more.

Accumulated Other Comprehensive Income. Consistent with the Basel III international approach, the proposed rules would have required all banking organizations to include most components of accumulated other comprehensive income (AOCI) in CET1 capital, including unrealized gains and losses on "available-for-sale" debt securities.

Many commentators objected that reflecting AOCI in CET1 capital would introduce too much volatility. In response, the agencies provided standardized banks with a one-time "opt-out" right to continue excluding AOCI from CET1 capital. Advanced banks, however, will be required to recognize AOCI in CET1 capital as proposed.

Goodwill. The final rule requires that goodwill and most other intangible assets, net of associated deferred tax liabilities (DTLs), be deducted from CET1 capital. Unlike most of the CET1 deductions required in the final rule, the deduction for goodwill is not subject to any transition period.

DTAs, MSAs and Significant Investments in Unconsolidated Financial Institutions. Under the final rule, deferred tax assets (DTAs) that arise from net operating loss and tax credit carryforwards, net of associated DTLs, and valuation allowances are fully deducted from CET1 capital.

However, DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, along with mortgage servicing assets (MSAs) and "significant investments" in the common stock of unconsolidated financial institutions (i.e., more than 10 percent of common stock), are partially includible in CET1 capital, subject to deductions consistent with the proposed rules (i.e., deducted to the extent that any single item exceeds 10 percent of CET1 capital, or the items in the aggregate exceed 15 percent of CET1 capital). DTAs, MSAs and financial institution investments subject to these threshold deductions would be risk-weighted at 250 percent to the extent they are not deducted.

Other Investments in Financial Institutions. If a banking organization holds a significant investment in an unconsolidated financial institution, any holdings not in the form of common stock are fully deducted from capital using the "corresponding deduction approach." Nonsignificant investments in the capital of unconsolidated financial institutions are also deducted using the corresponding deduction approach, but only to the extent that they in the aggregate exceed 10 percent of the investing banking organization's CET1 capital.

Minority Interest. The final rule adopts without change the proposed treatment of capital issued by consolidated subsidiaries and not owned by the parent banking organization (i.e., "minority interest"). Thus, the final rule permits limited recognition — subject to restrictions — of minority interests as capital of the parent banking organization.

Risk-Weighted Assets

The final rule requires all banking organizations to calculate standardized risk-weighted asset amounts for on- and off-balance sheet exposures. Advanced banks must also calculate risk-weighted assets under the advanced approaches and apply whichever method yields the lower regulatory capital ratios for purposes of determining compliance with minimum requirements.

Residential Mortgages. The final rule abandons the controversial treatment of residential mortgages under the proposed rules. As proposed, residential mortgage exposures would have been subject to a risk-weighting of 35-200 percent based on loan characteristics. In response to criticism that the proposed framework failed to properly categorize risk and ultimately would inhibit lending, the final rule retains the treatment of residential mortgage loans that applies under the current rules (i.e., a 50-percent risk weight for most prudently underwritten first-lien mortgage loans and a 100-percent risk weight for all others).

Non-U.S. Sovereigns. The standardized approach under the final rule continues to risk-weight exposures to non-U.S. sovereign entities according to the Organization for Economic Cooperation and Development's country risk classifications (CRC), as proposed, but with changes necessary to account for the OECD decision to cease providing CRCs for certain high-income jurisdictions.

High-Volatility CRE Exposures. Consistent with the proposed rules, high-volatility commercial real estate (HVCRE) exposures will receive a risk-weighting of 150 percent under the standardized approach, as compared to 100 percent under the current rules. However, the agencies revised the definition of HVCRE exposures to exclude certain community development-related acquisition, development and construction loans, and certain agricultural loans.

Past Due Exposures. Also consistent with the proposed rules, exposures that are more than 90 days past due will receive a risk weight of 150 percent under the standardized approach, up from 100 percent under the current rules.

Off-Balance Sheet Items. The final rule retains, without change, the proposed credit conversion factors (CCFs) for off-balance sheet exposures, including a controversial 20-percent CCF for commitments with an original maturity of one year or less that are not unconditionally cancelable (compared to 0 percent under the current rules).

Early Payment Default Repurchase Obligations. A banking organization is generally subject to a capital charge when it provides credit-enhancing representations and warranties on assets sold to third parties. The agencies had proposed to eliminate the current "safe harbor" from this capital charge for residential mortgage loans sold subject to early default clauses that permit the return of a loan within 120 days. The final rule, however, retains the 120-day safe harbor, avoiding substantially higher capital requirements for banks that sell large volumes of mortgage loans.

OTC Derivatives and Cleared Transactions. Consistent with the proposed rules, the final rule generally retains the treatment of over-the-counter derivatives under the current rules for both standardized and advanced banks.

Accordingly, OTC derivatives exposures will be calculated using the "current exposure method," consisting generally of current mark-to-market exposure plus potential future exposure, with only limited recognition of netting. An advanced bank would have the option to use internal models if approved by its regulator. Despite industry opposition, the final rule removes the 50-percent risk-weight cap for OTC derivatives exposures under the current rules.

The final rule incorporates more favorable capital treatment for cleared derivatives and securities financing transactions, generally as proposed.

In addition to maintaining capital against their OTC derivatives exposures, advanced banks also must maintain capital to cover "credit valuation adjustment" (CVA) risk (i.e., the risk of mark-to-market losses to a derivatives contract resulting from deterioration in the counterparty's credit risk), applying either a "simple" or "advanced" CVA approach.

Equity Exposures. The final rule substantially revises the existing capital requirements for equity exposures, adopting a range of risk weights from 0 percent (for entities whose debt securities are eligible for a 0-percent risk weight) to 600 percent (for exposures to certain leveraged investment firms that otherwise meet the definition of "traditional securitization"). Publicly traded equities generally attract a risk weight of 300 percent, compared to 400 percent for nonpublicly traded.

Banking organizations have three options for risk-weighting equity exposures to investment funds:

(1) a “full look-through approach” where the aggregate risk-weighted asset amounts for all investments held by the fund are multiplied by the banking organization’s proportional interest in the fund;

(2) a “simple modified look-through approach,” where a banking organization multiplies its exposure to the fund by the highest risk weight of the assets in the fund; and

(3) an “alternative modified look-through approach,” where a banking organization assigns risk weights on a pro rata basis according to the investment limits in the fund's offering documents.

Each method is subject to a risk-weight floor of 20 percent.

Securitization Framework

The final rule adopts the more restrictive securitization framework generally as proposed. Accordingly, the existing ratings-based approach under the current rules is replaced by the simplified supervisory formula approach (SSFA) for both standardized and advanced banks.

The SSFA calculates capital for securitization exposures based on the risk weights and performance of the underlying exposures, and the relative position of the exposure in the structure. Standardized banks must use either the SSFA or “gross-up” approach (calculate risk weight of underlying assets allocable to the securitization exposure plus all senior positions). Advanced banks must, if possible, use the supervisory formula approach (SFA), or otherwise the SSFA.

The SFA requires substantially more data on the underlying exposures in order to compute loan-level parameters. Significantly, the final rule retains the controversial 20-percent risk-weight floor under both the SFA and the SSFA, as well as the new due diligence requirements and accompanying 1250-percent risk-weight penalty for inadequate due diligence.

The final rule retains in the definition of “traditional securitization exposure” the proposed distinction between operating companies and investment firms, as well as the agencies’ discretion to “scope out” certain investment firms based on factors intended to distinguish structured finance transactions from hedge funds and private equity funds.

The final rule continues to treat as a resecuritization any securitization exposure in which even a minimal amount of the underlying assets are securitization exposures, but it excludes retranched single underlying exposures (e.g., resecuritized real estate mortgage investment conduits, or re-REMICs) from treatment as a resecuritization. The final rule also clarifies when an exposure to an asset-backed commercial paper (ABCP) program must be treated as a resecuritization.

Consistent with the proposed rule, the final rule preserves various special provisions for treatment of ABCP exposures. Among other things, the final rule permits an eligible ABCP liquidity facility to be risk-weighted based on the highest risk weight applicable to any of the underlying exposures, and permits a securitization exposure that is in a second-loss position or better to an ABCP program to be risk-weighted at the higher of 100 percent or the highest risk weight applicable to any of the underlying exposures, provided certain conditions are met.

Credit Risk Mitigation

The final rule recognizes a broader range of credit risk mitigation (CRM) than the current rules, essentially extending the CRM principles that are available to advanced banks to standardized banks.

Guarantees and Credit Derivatives. Like the current rules, the final rule permits a banking organization to apply a "substitution approach" to recognize the CRM effect of an eligible guarantee or credit derivative from an eligible guarantor. The final rule permits a broader range of eligible guarantors than the current rules, including sovereigns, certain international development organizations, the Federal Home Loan Banks, depository institutions, BHCs and SLHCs, foreign banks, and entities other than special-purpose entities and monoline insurers that have issued outstanding investment-grade unsecured debt securities.

Collateral. The final rule also expands the definition of "financial collateral" that may be recognized for CRM purposes, including: (1) cash on deposit with the banking organization; (2) gold bullion; (3) investment-grade debt securities other than resecuritization exposures; (4) publicly traded equity securities; (5) publicly traded convertible bonds; and (6) shares of money market funds and mutual funds that are publicly quoted on a daily basis.

Despite industry objections, the final rule retains the proposed exclusion of resecuritizations, conforming residential mortgages, and noninvestment-grade debt securities as eligible financial collateral.

The final rule permits recognition of financial collateral using either a "simple approach" (which can be applied for any type of exposure, subject in most cases to a 20-percent floor) or a "collateral haircut approach" (which can be applied only with respect to repos, collateralized derivative transactions, eligible margin loans, or single-product netting sets of such transactions).

Revisions to the Advanced Approaches for Risk-Weighted Assets

The proposed rules included several revisions to the existing advanced approaches to incorporate Basel 2.5 and Basel III requirements to hold more appropriate levels of capital for counterparty credit risk, CVA adjustments and "wrong-way" risk, as well as to strengthen the risk-based capital requirements for certain securitization exposures and exposures to large financial institutions. The final rule adopts these revisions to the advanced approaches framework largely as proposed.

Disclosure Requirements

Under the final rule, each advanced bank and each top-tier U.S. BHC or SLHC with $50 billion or more in total consolidated assets that is a standardized bank is subject to quantitative and qualitative disclosure requirements with respect to its regulatory capital. These disclosures will be required on a quarterly basis, beginning in 2015.

Implementation Schedule and Transition Provisions

As proposed, advanced banks will begin transitioning to the new minimum capital requirements imposed by the final rule on Jan. 1, 2014. Standardized banks received a one-year delay under the final rule and will not be required to begin implementing the standardized approach under the final rule until Jan. 1, 2015.

Both advanced and standardized banks would begin to phase in the capital conservation buffer in January 2016. The specific transition rules are complex and highly detailed. Of course, market expectations and other considerations often force early compliance with new or emerging capital requirements despite available transition rules.

Conclusion

Despite the significant step of adopting final rules to implement the Basel III capital regime, the post-financial crisis evolution of U.S. regulatory capital requirements remains far from complete. Separate proposals to implement enhanced capital requirements for various categories of the largest U.S. banks, particularly the U.S. G-SIBs, are already well under way.

At the international level, the Basel Committee has recently issued new proposals that would affect many areas covered by the final rule. More broadly, policy debates continue over the proper purpose, calibration, consistency and economic impact of regulatory capital and related requirements.

As a result, at the same time U.S. banking organizations begin the difficult work of navigating a completely overhauled regulatory capital landscape, they must do so with the understanding that yet more changes are likely and that regulatory capital requirements are themselves only part of a series of fundamental changes taking place in the overall regulatory environment.

--By Scott A. Anenberg and Donald S. Waack, Mayer Brown LLP

Scott Anenberg is a partner and Donald Waack is an associate in Mayer Brown's Washington, D.C., office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2013, Portfolio Media, Inc.