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Recent Proposals to Enhance Regulatory Capital Requirements: What You Need to Know

Guest Speakers:

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  Board of Governors of the Federal Reserve System

Federal Reserve System
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Our Host and Presenters Today

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Board of Governors
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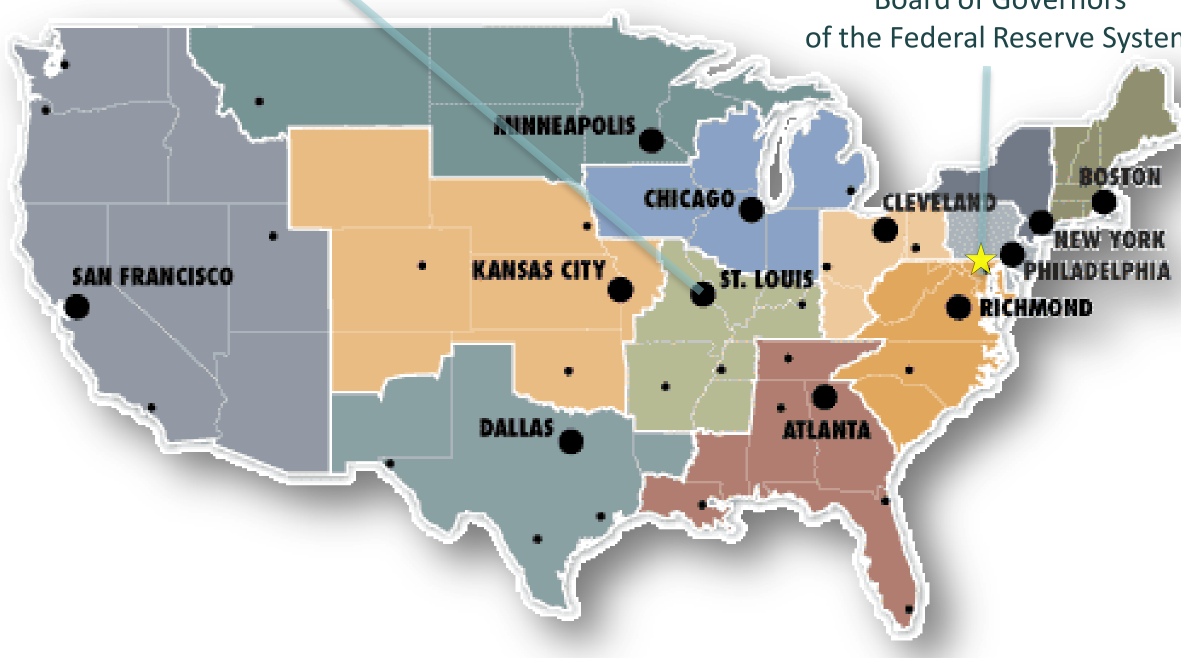
April Snyder



Presentation Goals

- Discuss the objectives and key provisions of the recently issued notices of proposed rulemaking (NPRs) on regulatory capital enhancements
- Provide an opportunity for affected banking organizations to ask questions and get clarification
- Encourage feedback through the public comment process

The NPRs

- Earlier in June 2012, the Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency 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)
- **1st NPR:** Definition of capital, minimum regulatory capital ratios, capital buffers, and prompt corrective action (PCA) framework
- **2nd NPR:** Standardized approach for risk-weighted assets
- **3rd NPR:** Advanced approaches and market risk

What the NPRs Would Do

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

Who Would Be Subject to the Proposed Rules?

- The 1st and 2nd NPRs would 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 <u>would not apply</u> to BHCs subject to the Board's Small BHC Policy Statement; however, the NPRs <u>would apply</u> to all banks, savings associations, and SLHCs, regardless of size.

- The 3rd NPR would apply to those banking organizations described above that meet the current advanced approaches or market risk quantitative thresholds.

1^{st} NPR

- Definition of capital
- Minimum regulatory capital ratios
- Capital conservation buffer
- PCA framework

1^{st} NPR

- This NPR implements changes to U.S. regulatory capital standards that would:
  - Increase the quantity and quality of regulatory capital by:
    1. Introducing a new common equity tier 1 (CET1) ratio
    2. Increasing the minimum tier 1 capital ratio
    3. 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 risk-weighted assets (RWAs) of 4.5 percent (a newly introduced requirement)
  - Tier 1 capital to total RWAs of 6 percent (increased from the current 4 percent requirement)
  - Total capital to total RWAs of 8 percent (unchanged)

- The phase-in period for the minimum risk-based capital ratios would start in 2013 and be completed by 2015.

Common Equity Tier 1 Capital

- Common equity is the highest-quality and most loss-absorbing form of capital.
- CET1 capital would primarily be composed of common stock and retained earnings.
  - Majority of regulatory capital deductions would come from CET1 capital
  - CET1 could include limited amounts of minority interest
  - Note that unrealized gains and losses on all available-for-sale securities would flow through to CET1 capital

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

“Threshold Deductions” from CET1 Capital

- Threshold deductions:
  - Amounts of MSAs, DTAs arising from temporary differences, and significant investments in the capital of unconsolidated financial institutions in the form of common stock that exceed certain thresholds would be deducted.
    - Amounts of each item that *individually* exceed 10 percent of CET1 capital would be deducted.
    - Amounts of the items that *collectively* exceed 15 percent of CET1 capital would be deducted.
- Deductions would be phased from 2014 to 2018.

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 United States, 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.

Leverage Ratio

- All banking organizations would be subject to a 4 percent minimum tier 1 leverage ratio using the revised definition of tier 1 capital.

- The NPR would eliminate the current minimum ratio of 3 percent for banks with a "1" supervisory composite rating under the Uniform Financial Institutions Rating System.

- Advanced approaches banking organizations would also be subject to a 3 percent supplementary leverage ratio.
  - The supplementary leverage ratio would be fully implemented by 2018.

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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 percent 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 (continued)

Capital conservation buffer (as a percentage of total risk-weighted assets)	Maximum payout ratio (as a percentage 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 1.25%, and greater than 0.625%	20%
Less than or equal to 0.625%	0%

NOTE: This table is for illustrative purposes and presumes there is no countercyclical capital buffer.

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%

Countercyclical Capital Buffer

- The NPR would implement a countercyclical capital buffer as a macro-prudential tool applicable to advanced approaches banking organizations only.
- The buffer amount in the United States would initially be set at zero.
- The buffer would act as an expansion of the capital conservation buffer by up to 2.5 percent of RWAs.

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

(amounts in percent)	**Total Risk-based Capital (RBC) Measure**	**Tier 1 RBC Measure**	**CET1 RBC Measure**	**Leverage Measure**	
				Leverage Ratio	**Supplementary Leverage Ratio** *(for advanced approaches banks only)*
Well Capitalized	≥ 10	≥ 8	≥ 6.5	≥ 5	N/A
Adequately Capitalized	≥ 8	≥ 6	≥ 4.5	≥ 4	≥ 3
Undercapitalized	< 8	< 6	< 4.5	< 4	< 3
Significantly undercapitalized	< 6	< 4	< 3	< 3	N/A
Critically undercapitalized	Tangible Equity (defined as tier 1 capital plus non-tier 1 perpetual preferred stock) to Total Assets ≤ 2				N/A

Interaction Between PCA Levels and Capital Conservation Buffer

Example for illustrative purposes

CET1 Ratio

Above 7.0%: well capitalized (WC) for PCA; no payout ratio limitation for capital conservation buffer (CCB) purposes.

At 6.5%: WC for PCA; 60% maximum payout ratio for CCB purposes.

Tier 1 Capital Ratio

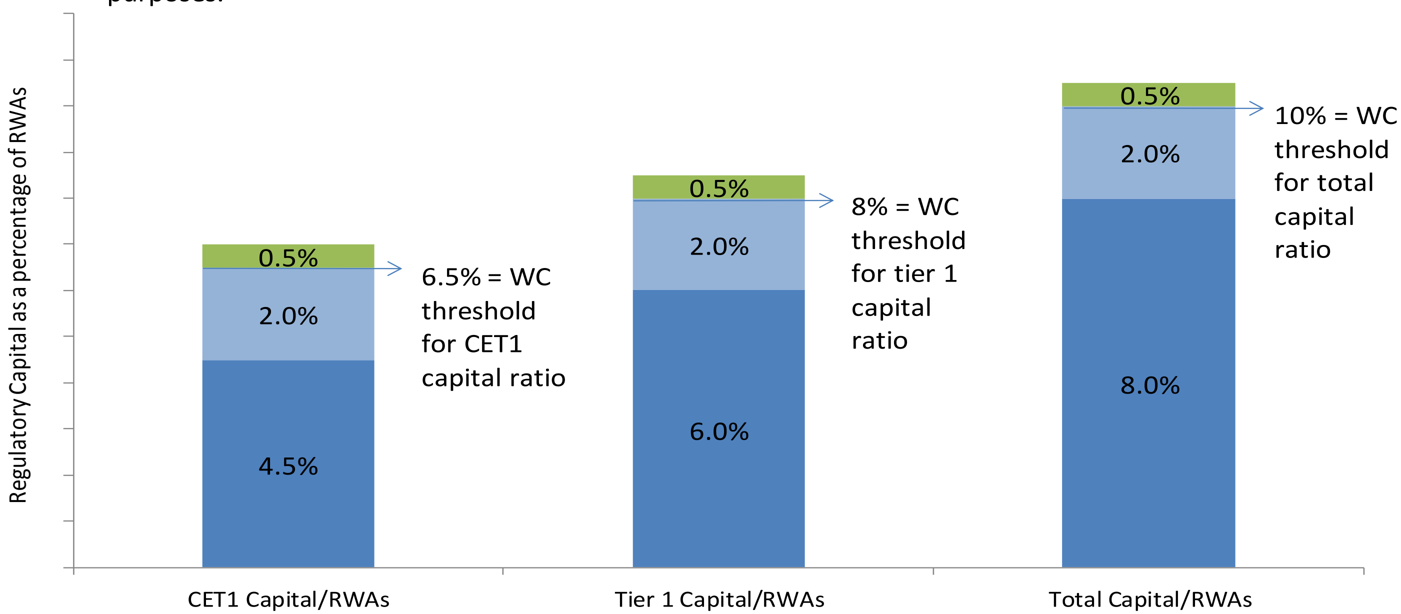
Above 8.5%: WC for PCA; no payout ratio limitation for CCB purposes.

At 8.0%: WC for PCA; 60% maximum payout ratio for CCB purposes.

Total Capital Ratio

Above 10.5%: WC for PCA; no payout ratio limitation CCB purposes.

At 10.0%: WC for PCA; 60% maximum payout ratio for CCB purposes.



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2nd NPR

- **Standardized Approach for RWAs**

2^{nd} 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.

2nd NPR (continued)

- Consistent with requirements under section 939A of DFA, this NPR would remove references to credit ratings.

- Additionally, consistent with requirements under Section 171 of DFA, regulatory capital ratios calculated in accordance with the requirements of these two NPRs would serve as a floor to those calculated under the advanced approaches rule.

RWA Calculations

- NPR retains current risk-weighting for many significant exposures of 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 (continued)

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

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

RWA Calculations (continued)

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

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

RWA Calculations (continued)

- 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 (SSFA) (developed as an alternative to credit ratings) 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 percent risk weight to such exposures.

RWA Calculations (continued)

- More risk-sensitive treatment for exposures to *foreign* sovereigns, banks, and PSEs
  - Would tie to the Organization for Economic Cooperation and Development's country risk classification (CRC) rating of the sovereign
  - 100 percent risk weight if no CRC rating
  - 150 percent risk weight in cases of sovereign default, including instances of voluntary or involuntary restructuring

- More risk-sensitive treatment for equity exposures (generally risk weighted at either 300 or 400 percent)

RWA Calculations (continued)

- Enhanced recognition of the risk-mitigating effects of collateral and guarantees in determining RWAs

- Preferential capital requirements for cleared derivative and repo-style transactions with central counterparties (vs. non-cleared transactions)

- Requirement that a clearing member of a central counterparty calculate a capital requirement for its default fund contributions to that central counterparty

RWA Calculations (continued)

- Special provisions for certain exposures relating to insurance activities, whether conducted by BHCs or SLHCs:
  - Non-guaranteed separate accounts: zero percent risk weight
  - Policy loans: 20 percent risk weight

- BHCs and SLHCs would be required to consolidate and deduct the minimum regulatory capital requirement of insurance underwriting subsidiaries that is required by the state insurance regulator from total capital.

Enhanced Disclosures

- Under the 2nd NPR, a banking organization with at least $50 billion in total consolidated assets would be required to make certain public disclosures to allow market participants to better evaluate its financial condition and risk exposures
  - Qualitative disclosures related to regulatory capital and various types of assets, including information on how the banking organization assesses capital adequacy and manages risk
  - Quantitative disclosures including the amount of each category of regulatory capital that the banking organization holds and its aggregate risk-weighted asset amount for various categories of assets

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3rd NPR

- **Advanced Approaches and Market Risk**

3rd NPR

- Applies to banking organizations that meet the applicable thresholds (including SLHCs)

- Proposed advanced approaches changes would:
  - Implement Basel III enhancements to counterparty credit risk
  - Increase capital requirements for exposures to non-regulated financial institutions and to regulated financial institutions with consolidated assets ≥ $100 billion
  - Remove references to credit ratings consistent with DFA requirements

Counterparty Credit Risk

- Proposed advanced approaches changes would:
  - Implement a higher counterparty credit risk capital requirement by requiring banking organizations to account for credit valuation adjustments on over-the-counter derivatives
  - Require banking organizations to consider stressed inputs when using the internal models methodology to calculate their counterparty credit risk exposure
  - Introduce capital requirements for cleared transactions with central counterparties and for default fund contributions to central counterparties

Exposures to Financial Institutions

- The proposed advanced approaches changes would also include a higher correlation factor to recognize the correlation of financial institutions' creditworthiness.
- The higher correlation factor would apply to wholesale exposures to:
  - Regulated financial institutions with consolidated assets of ≥ $100 billion
  - Unregulated financial institutions that generate a majority of their revenue from financial activities, including highly leveraged entities such as financial guarantors

Securitization Exposures

- In the proposed advanced approaches changes, the hierarchy for securitization exposures generally would function as follows:

  1. If a banking organization qualifies for the supervisory formula approach (SFA) and has sufficient information on the underlying exposures in a securitization to calculate the SFA, it would assign a risk weight to the exposure using the SFA.
  2. If a banking organization cannot apply the SFA because not all relevant qualification criteria are met, it would apply the SSFA.
  3. If the banking organization does not apply the SSFA, it would be required to assign a 1,250 percent risk weight to the exposure.

Advanced Approaches and Market Risk

- Enhanced disclosures (advanced approaches)
  - The proposal would expand the advanced approaches disclosure requirements to reflect enhanced disclosure requirements in Basel 2.5 and Basel III. The new disclosure requirements would focus on the definition of capital and securitization activities.
- Market risk
  - The proposal would integrate the recently finalized market risk capital rule into the comprehensive capital framework.
  - It would also extend the applicability of the market risk capital rule to SLHCs and savings associations meeting defined thresholds.

Next Steps

- The comment period on the proposals concludes on September 7, 2012 and your written feedback is welcomed and encouraged.

- Upcoming Federal Reserve outreach sessions include:
  - **For organizations with under $50 billion in assets**
    - July 18th Ask the Fed® ("live" from Kansas City Fed)
  - To register: www.askthefed.org

- Related regulatory reports and related instructions will be updated and proposed for comment.

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