Revised Regulatory Capital Framework: The Final Rule

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On July 2, 2013, the Federal Reserve Board approved a final rule to help ensure banks maintain strong capital positions that will enable them to continue lending to creditworthy households and businesses even after unforeseen losses and during severe economic downturns. This Ask the Fed® session discussed revisions to the regulatory capital framework, including increasing the minimum requirements for both the quality and quantity of capital held by banking organizations and improvements in the methodology for calculating risk-weighted assets to enhance risk sensitivity.

Final Rule – Background

On July 2, 2013, the Federal Reserve Board (FRB) approved a final regulatory capital rule, which: improves the overall resiliency of the U.S. banking system, increases the quantity and quality of regulatory capital, and addresses certain requirements of the Dodd-Frank Act (DFA). The final rule establishes an integrated regulatory capital framework.

Who is subject to the final rule?

The final rule applies to all banks, savings associations, bank holding companies (BHCs) currently subject to minimum capital requirements, and savings and loan holding companies (SLHCs) that do not have significant commercial or insurance underwriting activities as defined under the rule.

Certain aspects of the rule apply only to the largest, internationally active banking organizations (advanced approaches rule) or to those with significant trading activity (market risk rule).

- *Advanced approaches rule*: generally applies to banking organizations that have consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion. The following requirements only apply to these banking organizations: the supplementary leverage ratio; the countercyclical capital buffer; higher counterparty credit risk capital requirements on over-the-counter derivatives; and higher capital requirements for exposures to unregulated financial institutions and large regulated financial institutions.
- *Market risk rule*: generally applies to banking organizations with aggregate trading assets and trading liabilities equal to at least 10 percent of quarter-end total assets or $1 billion.

Implementation and timing

January 1, 2014	**January 1, 2015**	**January 1, 2016**
Advanced approaches banking organizations: ▪ Phase-in of minimum capital requirements and definition of capital begins ▪ Begin compliance with updated advanced approaches RWAs	All other banking organizations (including covered SLHCs): ▪ Meet minimums and begin phase-in of definition of capital ▪ Implement the standardized approach RWAs	All banking organizations ▪ Begin the transition period for the capital conservation buffer (and countercyclical capital buffer for advanced approaches)

Revisions to the minimum risk-based capital ratios

The rule requires the following minimum capital ratios:

- Common Equity Tier 1 (CET1) capital to total risk-weighted assets (RWAs) ratio of 4.5 percent
- Tier 1 capital to total RWAs ratio of 6 percent
- Total capital to total RWAs ratio of 8 percent

CET1 capital (highest quality and most loss absorbing form of capital):

- Primarily composed of common stock and retained earnings, minus applicable regulatory capital deductions
- Includes limited amounts of CET1 minority interest
- For advanced approaches banking organizations, most accumulated other comprehensive income (AOCI) items are included in CET1 capital
    - Other banking organizations are given a one-time option to retain the current AOCI filter

Certain items are **fully** deducted from CET1 capital in order to reflect uncertainty regarding a bank's ability to realize value from certain assets; particularly in times of stress. These items include:

- Goodwill and other intangibles (except mortgage servicing assets, which are subject to **threshold** deductions)
- Deferred tax assets (DTAs) that arise from operating losses and tax credit carry-forwards
- Gain on sale in connection with a securitization exposure
- Certain defined benefit pension fund assets
- Investments in own shares

<u>Leverage Ratio</u>

- All banking organizations are subject to a minimum 4 percent leverage ratio (tier 1 capital/average total consolidated assets) that uses the revised definition of tier 1 capital.
- Advanced approaches banking organizations are additionally subject to a minimum 3 percent supplementary leverage ratio consistent with the international leverage ratio set forth by the Basel Committee on Banking Supervision under Basel III.
    - The supplementary leverage ratio uses a broader exposure base that includes off-balance sheet exposures in the denominator
    - Advanced approaches banking organizations are required to calculate and report the supplementary leverage ratio starting on January 1, 2015, and to meet the 3 percent minimum requirement beginning January 1, 2018.

<u>Capital Conservation Buffer</u>

- Need to hold a buffer of CET1 capital greater than 2.5 percent above minimum risk-based capital requirements to avoid restrictions on capital distributions and discretionary bonus payments
- Applies to all banking organizations; transition period is between 2016 and 2019

Transition Schedule for New Ratios and Capital Definitions

Year (as of January 1)	2015	2016	2017	2018	2019
Minimum common equity tier 1 capital ratio	4.5%	4.5%	4.5%	4.5%	4.5%
Common equity tier 1 capital conservation buffer	N/A	0.625%	1.25%	1.875%	2.5%
Minimum common equity tier 1 capital ratio plus capital conservation buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of most deductions from common equity tier 1 (including threshold deduction items that are over the limits)	40%	60%	80%	100%	100%
Minimum tier 1 capital ratio	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum tier 1 capital ratio plus capital conservation buffer	N/A	6.625%	7.25%	7.875%	8.5%
Minimum total capital ratio	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital ratio plus capital conservation buffer	N/A	8.625%	9.25%	9.875%	10.5%

Note: Table does not address 2014 transition items that affect advanced approaches banking organizations.

Revised PCA Levels for Insured Depository Institutions to Reflect the New Requirements

(amounts in percent)	**Total Risk-based Capital (RBC) Measure**	**Tier 1 RBC Measure**	**CET1 RBC Measure**	**Leverage Measure: Leverage Ratio**	**Leverage Measure: 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

Standardized Approach Risk-Weighted Assets (RWA)

- Replaces the calculation of risk weights under the general risk based capital rules
- Removes reference to credit ratings and provides alternative standards of creditworthiness, in accordance with section 939(A) of the DFA
- Applies to all banking organizations subject to the final rule starting on January 1, 2015[1]

Key changes to the calculation of RWAs include: exposures more than 90 days past due or on nonaccrual status (150 percent risk weight); certain commercial real estate exposures related to higher risk acquisition, development, and construction financing that have not yet converted to permanent financing (150 percent risk weight); short-term off-balance sheet commitments not unconditionally cancellable (credit conversion factor revised from zero to 20 percent); and certain foreign sovereign, bank, and public sector exposures. Risk weights for exposures to securities firms and equity exposures also changed.

[1] Until that date, banking organizations not subject to the advanced approaches rule will continue to use the current general risk-based capital rules to calculate their risk-weighted assets.