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Frequently Asked Questions on the Regulatory Capital Rule

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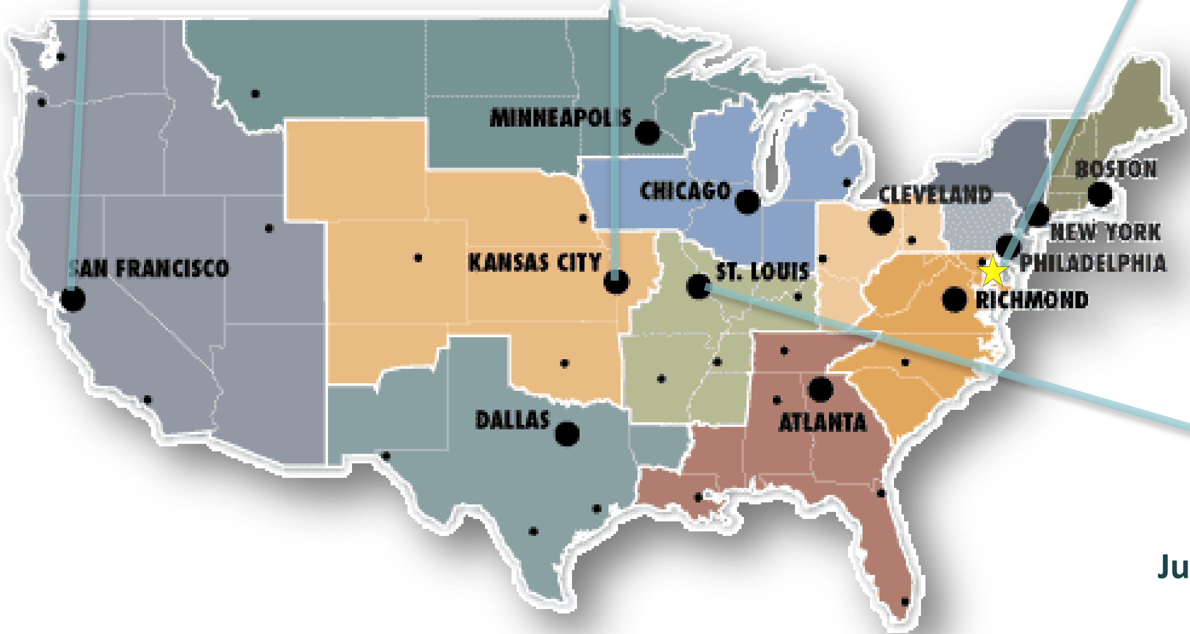

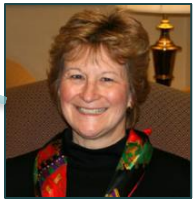

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Presentation Overview

- Overview of regulatory capital
  - Ratios
  - Prompt Corrective Action (PCA) levels
  - Components of capital
  - Capital buffers
  - Regulatory capital deductions
- High-volatility commercial real estate (HVCRE)
- Small Bank Holding Company Policy Statement (Policy Statement)
- Regulatory reporting changes
- Nontraditional capital structures

Minimum Regulatory Capital Ratios

- The regulatory capital components under the revised framework are common equity tier 1 (CET1) capital, additional tier 1 (AT1) capital, and tier 2 (T2) capital, as well as the tier 1 leverage ratio.
- The rule requires all banking organizations to meet the following minimum capital ratios:
  - CET1 capital: 4.5 percent of risk-weighted assets (RWAs)
  - Tier 1 capital: 6 percent of RWAs
  - Total capital: 8 percent of RWAs
  - Tier 1 leverage ratio: 4 percent of average total assets
  - There are no transition periods for any of these ratios.

Revised PCA Levels for Insured Depository Institutions

	Total Capital Ratio	Tier 1 Capital Ratio	CET1 Capital Ratio	Domestic Leverage Ratio
	(amounts in percent)			
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%			

Components of Capital

- **CET1 capital**
  - Includes any common stock instruments (net of treasury stock), surplus, and retained earnings, limited amount of minority interest
  - Non-advanced approaches banking organizations are given a one-time option to retain the previous capital rule's accumulated other comprehensive income filter
- **AT1 capital**
  - Includes noncumulative perpetual preferred stock and limited amount of tier 1 minority interest
- **T2 capital**
  - Includes subordinated debt, perpetual preferred stock not included in tier 1 capital, limited amounts of total capital minority interest, and limited amounts of allowance for loan and lease losses

Regulatory Capital Deductions

- The capital rule requires certain deductions from regulatory capital in order to reflect uncertainty regarding a bank's ability to realize value from certain assets, particularly during times of stress.
- Under the capital rule, the majority of deductions are from CET1 capital and not from tier 1 capital as was the case under the prior framework.
- Items fully deducted include, but are not limited to:
  - Goodwill and other intangibles (other than mortgage servicing assets (MSAs))
  - Deferred tax assets (DTAs) arising from operating losses and tax credit carry-forwards (e.g., tax losses of a company that can be carried forward to reduce taxable income in future years)
- Certain defined benefit pension fund assets
- Investments in own shares

Regulatory Capital Deductions (Continued)

- Items subject to individual and collective threshold deductions:
  - MSAs
  - DTAs arising from temporary differences
  - Significant investments in the capital of unconsolidated financial institutions in the form of common stock
- Amounts exceeding an individual limit of 10 percent of CET1 capital elements and a collective limit of 15 percent of CET1 capital elements are deducted from CET1 capital.
- Amounts of these items that are not deducted are assigned to the 100 percent risk weight (RW) until December 2017 and to the 250 percent RW starting on January 1, 2018).

Capital Conservation Buffer

- Designed to incent institutions to conserve capital during benign economic periods in order to better withstand severe stress events and still remain above their minimum requirements.
- When fully phased-in, firms must hold a buffer of 2.5 percent of CET1 capital in addition to their minimum risk-based capital requirements in order to avoid restrictions on capital distributions and discretionary bonus payments to executive officers.
- The following table sets forth the regulatory capital levels that banks must satisfy to avoid limitations on capital distributions and discretionary bonus payments during the applicable transition period from January 1, 2016, until January 1, 2019.

	Jan. 1, 2015	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Capital conservation buffer	N/A	0.625%	1.25%	1.875%	2.5%
Minimum CET1 capital ratio + capital conservation buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum tier 1 capital ratio + capital conservation buffer	6.0%	6.625%	7.25%	7.875%	8.5%
Minimum total capital ratio + capital conservation buffer	8.0%	8.625%	9.25%	9.875%	10.5%

RWAs Under the Standardized Approach

- **The capital rule retains the prior risk-weighting for many significant bank exposures, including:**
  - U.S. government, its agencies and U.S. public sector entities, such as states and municipalities
  - U.S. government-sponsored entities
  - U.S. depository institutions and credit unions
  - Residential mortgages, most commercial mortgages, and other retail exposures
- **The RWs have been revised for:**
  - Foreign sovereign, bank, and public sector exposures
  - Equity exposures
  - Securitization exposures
  - HVCRE loans (150% percent RW)
  - Collateralized and guaranteed exposures
  - Repo-style transactions
  - Exposures more than 90 days past due or on nonaccrual status (150% RW)
  - Short-term commitments (increased credit conversion factor from zero to 20%)

HVCRE

- HVCRE exposures are a subset of acquisition, development, or construction (ADC) loans (which are a subset of commercial real estate exposures), and such loans are short-term financings used typically by developers to purchase and develop commercial properties.
- The risk and performance of an ADC loan is dependent on the initial estimate of the property's valuation upon completion and on the amount of capital contributed by the borrower.
- HVCRE exposures are assigned a 150% RW.
  - Higher RW than under the previous framework (100%).

HVCRE (Continued)

- The capital rule defines an HVCRE exposure as a credit facility that, prior to conversion to permanent financing, finances or has financed the ADC of real property, *unless the facility finances:*
  - 1-4 family residential properties
  - A community development project or a "qualified investment" as defined by the revised rule (see Section 2 of the capital rule for full exemption and citations)
  - The purchase or development of agricultural land, provided the valuation of the land is based solely on its value for agricultural purposes
  - Commercial real estate loans
    - That meet applicable regulatory loan-to-value (LTV) requirements (12 Code of Federal Regulations part 208, Appendix C)
    - Where the borrower has contributed capital (in form of cash or unencumbered readily marketable assets) to the project of at least 15 percent of the real estate's "appraised as completed" value
    - Where the borrower-contributed capital is contractually required to remain in the project until the credit facility is converted to permanent financing, sold, or paid in full

HVCRE Frequently Asked Questions (FAQs)

- To meet the exemption criteria for HVCRE exposures, a borrower must contribute 15 percent or more in capital *prior* to the bank distributing funds. After that, only conversion to permanent financing would remove HVCRE designation.
- The following *qualify* as “contributed capital:”
  - Cash used to buy land that is used in an ADC project
  - “Soft costs” that contribute to the completion and value of the project and that count as development expenses, such as:
    - Reasonable developer fees, leasing expenses, brokerage commissions, and management fees payable to related parties
    - Site preparation, such as engineering and permits

HVCRE FAQs (Continued)

- The following do *not* count as "contributed capital:"
  - An upward change in the market value of land being developed
  - Unrelated real estate owned "free and clear" by the borrower
  - Purchasers' deposits on units in a condominium project
  - Cash received as a grant from a nonprofit, municipality, state, or federal agency
  - Deferred developer's profit, incurred overhead expenses, or interest or other holding fees paid or accrued on contributed land
  - Proceeds from another loan provided by the same bank that is financing the ADC project, or a second mortgage provided by another bank

HVCRE FAQs (Continued)

- "As completed" value reflects the property's market value as of the time that development is expected to be completed.
  - Different than "as stabilized" value. See Interagency Appraisal and Evaluation Guidelines.
- Lower LTV due to favorable subsequent appraisal does *not* remove HVCRE designation. Bank can only consider initial LTV at origination.
- "Permanent financing" is achieved only when HVCRE is converted to permanent financing in accordance with the bank's normal lending terms or is paid in full.
  - Typically, a new credit facility in the form of a term loan replaces the ADC facility.
  - Issuance of certificate of occupancy does *not* qualify as "permanent financing."
- The rule does *not* grandfather existing ADC loans. Such ADC loans are treated as HVCRE exposures if they do not meet the exemption criteria.

Small Bank Holding Company (BHC) Policy Statement

- Holding companies subject to the Policy Statement are not subject to the capital rule.
  - Currently, the Policy Statement applies to BHCs with less than $500 million in total consolidated assets that do not engage in “complex activities.”
- The intent of the Policy Statement is to facilitate the transfer of ownership of small community banks by allowing their holding companies to operate with higher levels of debt than would otherwise be permitted.

Proposed Expansion of Policy Statement

- Late last year, Congress passed an Act directing the Federal Reserve Board of Governors to make certain changes to the Policy Statement.
- As a result, the Board recently issued an interim final rule that excludes savings and loan holding companies (SLHCs) that have total consolidated assets of less than $500 million and that meet the Policy Statement’s qualitative requirements from the Board’s capital rules, effectively placing these companies on equal footing with similarly sized BHCs.

Proposed Expansion of Small BHC Policy Statement

- The Board simultaneously issued a proposal that would increase the Policy Statement's threshold from $500 million to $1 billion in total consolidated assets and would expand its scope to include SLHCs.
- The Board also took action to reduce the regulatory reporting burden for these small noncomplex holding companies, permitting them to reduce the amount and frequency of their regulatory reporting.
- The comment period for the notice of proposed rulemaking (NPR) closes on March 4, 2015.

Regulatory Reporting Changes

- The Federal Reserve recently revised Schedule HC-R, Part II, Risk-Weighted Assets and Schedule HC-L, Derivatives and Off-Balance Sheet Items of the FR Y-9C.
  - The revisions become effective for the March 31, 2015, report date.
  - The Federal Reserve, in concert with the other Federal Financial Institutions Examination Council agencies, finalized parallel revisions in Schedule RC-R of the Call Report.
- As a result of the potential changes to the Policy Statement, the Board did not finalize the proposed changes to Schedule SC-R of the FR Y-9SP.

Regulatory Reporting Changes (Continued)

- **Y9-C Schedule HC-R, Part II, divided into the following sections:**
  - (A) balance sheet asset categories
  - (B) on- and off-balance sheet securitization exposures
  - (C) total balance sheet assets
  - (D) derivatives, off-balance sheet, and other items subject to risk weighting
  - (E) totals
  - (F) memoranda
- **Y9-C Schedule HC-L**
  - A new line item is added exclusively for securities borrowed (item 6(b))
    - Current line item 6 will change to 6(a)
  - Institutions should report all types of securities borrowing, regardless of collateral type or purpose

Nontraditional Capital Structures

- Certain capital instruments issued by non-stock entities, such as limited liability companies (LLC) and limited partners (LP), may not qualify as CET1 capital under the capital rule.
- In December 2014, the Board issued a proposal providing examples of capital instruments issued by LLCs and LPs, discussing features that would disqualify certain instruments from qualifying as CET1 capital, and offering potential solutions for holding companies to resolve these qualification issues.
- Holding companies that have nontraditional capital structures must file the appropriate regulatory reports pursuant to the capital rule beginning January 1, 2015. Under the proposal, instruments issued by these entities that would not qualify as CET1 capital in light of the capital rule may be recognized as CET1 capital for 2015.
- The comment period on the NPR closes on February 28, 2015.

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