



## CLIENT ALERT

Banking & Financial Institutions Practice Group Update

July 3, 2013

### FEDERAL BANKING AGENCIES FINAL RULE ON CAPITAL (BASEL III)

On July 2, 2013, the Federal Reserve and the Office of the Comptroller of the Currency adopted a final rule that will revise the current risk-based and leverage capital requirements for banking organizations. The FDIC did not join in the notice, but has indicated that it will consider the notice as an interim final rule effective July 9, 2013. The final rule is a continuation of the joint notices of proposed rulemaking published in the Federal Register last August, which launched a wave of industry comment letters, particularly with regard to the capital treatment for outstanding trust preferred securities, the available-for-sale securities portfolio, and risk-weighting rules.

The final rule implements a revised definition of regulatory capital, a new common equity tier 1 minimum capital requirement, and a higher overall minimum tier 1 capital requirement, incorporating these new requirements into the existing prompt corrective action (PCA) framework. It also establishes limits on a banking organization's capital distributions and certain discretionary bonus payments if the organization does not hold a specified amount of common equity tier 1 capital in addition to the amount necessary to meet its minimum risk-based capital requirements (referred to as the "capital conservation buffer"). The "countercyclical capital buffer" provisions from the proposed rule have also been adopted, however, they apply only to large financial institutions (banks and bank holding companies with total consolidated assets of \$250 billion or more) implementing the "advanced approaches" framework.

The final rule permanently grandfathers the tier 1 capital treatment for certain non-qualifying capital instruments, including trust preferred securities, outstanding as of May 19, 2010.

Under the proposed rules released last August, banks would have been required to recognize in regulatory capital all components of accumulated other comprehensive income (excluding accumulated net gains and losses on cash-flow hedges that relate to the hedging of items that are not recognized at fair value on the balance sheet). The final rule carries this requirement forward, with one very important exception for smaller banking organizations not subject to the "advanced approaches" rule. Such organizations may make a one-time election not to include most elements of accumulated other comprehensive income (including unrealized gains and losses on securities designated as available-for-sale) in regulatory capital under the final rule. Banking organizations making this election will be permitted to use the currently existing treatment under the general risk-based capital rules that exclude most accumulated other comprehensive income elements from regulatory capital. The election must be made with the first call report or FR Y-9 report filed after the banking organization becomes subject to the final rule (January 2015 for most banks and bank holding companies).

The new rule amends the existing methodologies for determining risk-weighted assets for all banking organizations. Of particular note is the fact that the banking agencies have decided not to adopt the risk weight treatment for residential mortgages as originally proposed. Specifically, the final rule assigns a 50% or

100% risk weight to mortgage loans secured by one-to-four family residential properties. Generally, residential mortgage loans secured by a first lien on a one- to-four family residential property that are prudently underwritten and that are performing according to their original terms receive a 50% risk weight. All other one-to-four family residential mortgage loans, including loans secured by a junior lien on residential property, are assigned a 100% risk weight.

The mandatory compliance date for banks and bank holding companies with less than \$250 billion in total consolidated assets will be January 1, 2015, with a transition period for the capital conservation buffer beginning on January 1, 2016, and additional transition periods for certain other measures.

The text of the final rule (all 972 pages of it) is available at the following address:

<http://www.federalreserve.gov/bcreg20130702a.pdf>

In addition, the Federal Reserve has distributed a Community Bank Guide to accompany the new rule, which is attached to this Alert for your convenience.

Please do not hesitate to contact us should you have questions about the final rule, its applicability to your institution, or capital planning in general.

If you have any questions about this Alert, please feel free to call (919.781.4000) or e-mail your Wyrick Robbins contact or one of the following members of our Banking & Financial Institutions practice group: **Anthony Gaeta, Jr.** (tgaeta@wyrick.com); **Todd H. Eveson** (teveson@wyrick.com); **Alexander M. Donaldson** (adonaldson@wyrick.com); **Jonathan A. Greene** (jgreene@wyrick.com); or **Stuart M. Rigot** (srigot@wyrick.com).

## Final Rule on Enhanced Regulatory Capital Standards—Implications for Community Banking Organizations

On July 2, 2013, the Federal Reserve Board approved a final rule that implements changes to the regulatory capital framework for all banking organizations.<sup>1</sup> This table highlights the provisions that are most relevant to smaller, non-complex banking organizations and compares the new capital requirements to the current standards.

	Current Treatment	Treatment in Final Rule	Section(s) in Rule Text
<b>Minimum Regulatory Capital Ratios and Capital Buffer</b>			
Common equity tier 1 capital (CET1) ratio	N/A	4.5%	Subpart B, § 10
Tier 1 capital ratio	4%	6%	
Total capital ratio	8%	8% (no change)	
Leverage ratio	4% (or 3%) <sup>2</sup>	4%	
Capital conservation buffer	N/A	Capital conservation buffer (composed of CET1 capital) equivalent to 2.5% of risk-weighted assets in addition to the minimum CET1, tier 1, and total capital ratios	Subpart B, § 11
<b>Definition of Capital</b>			
CET1	No specific definition	Common stock (plus related surplus) and retained earnings less the majority of the regulatory deductions	Subpart C, § 20(b) and § 22
Tier 1 capital	Common stock (plus related surplus) and retained earnings plus preferred stock and trust-preferred securities (for bank holding companies), less regulatory deductions	CET1 plus non-cumulative perpetual preferred stock and grandfathered trust-preferred and other securities, less certain regulatory deductions	Subpart C, § 20(c) and § 22
Mortgage servicing assets (MSAs), certain deferred tax assets (DTAs) arising from temporary differences, and certain significant investments in the stock of unconsolidated financial institutions	MSAs and DTAs that are not deducted are subject to a 100% risk weight	These items are subject to more stringent limits and a 250% risk weight; amounts above the limits are deducted from CET1 capital	Subpart C, § 22(d)
<b>Standardized Approach for Risk-Weighted Assets</b>			
Commercial real estate (CRE) loans	100%	100% for most CRE loans and 150% for high volatility commercial real estate (HVCRE), <sup>3</sup> which is a subset of CRE	Subpart D, § 32(j)
Past due exposures	Risk weight generally does not change when loan is past due (except for residential mortgage exposures)	Generally, 150% risk weight (except for sovereign and residential mortgage exposures)	Subpart D, § 32(k)
Conversion factors for commitments with an original maturity of one year or less	0%	0% if unconditionally cancellable at any time; otherwise 20%	Subpart D, § 33

<sup>1</sup> The final rule includes transition periods to help ease potential burden; community banking organizations must begin complying with the rule on January 1, 2015.

<sup>2</sup> Currently, banking organizations with the highest supervisory composite rating are subject to a 3% minimum leverage ratio; generally, other community banking organizations are subject to a 4% minimum leverage ratio.

<sup>3</sup> HVCRE is a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction of real property, unless the facility finances: (1) one- to four-family residential properties; (2) certain community development projects; (3) the purchase or development of agricultural land; or (4) commercial real estate projects that meet the criteria in the rule, including criteria regarding the loan-to-value ratio and capital contributions to the project.