Capital Rulemakings

- Pertain to the capital requirements of banks:
  - Not mere guidelines
  - Enforceable by law since 1983 (under ILSA)

- Capital rules are impacted/influence by following:
  - Federal legislation
  - Basel international capital standards
  - U.S. GAAP
  - Industry comments/feedback
Recent Developments:

- EGRPRA Initiatives
  The Economic Growth and Regulatory Paperwork Reduction Act

- High Volatility Commercial Real Estate (HVCRE):
  Simplifications NPR

- MSAs, Timing Difference DTAs, Investments in Financial Institutions, Minority Interest:
  Transitions Final Rule, Simplifications NPR

- NCUA Capital Updates:
  NCUA capital regulations

- Basel Developments:
  International capital standards

EGRPRA

The Economic Growth and Regulatory Paperwork Reduction Act

- Every 10 years the FFIEC and the federal banking agencies must review, with input from the public, outdated, unnecessary, or unduly burdensome regulations.

- The federal banking agencies must consider how to reduce regulatory burden for banks, while, at the same time, ensuring their safety and soundness and the safety and soundness of the financial system.

- A report must be submitted to Congress.
EGRPRA

• Agencies submitted an EGRPRA Joint Report to Congress in March 2017
  – In relation to capital rules, the agencies highlighted intent to reduce regulatory burden, especially on *community banks*
  – Agencies indicated they would develop a proposal that would consider amendments to certain areas of the capital rules that drew lots of questions and comments

EGRPRA

• Agencies identified the following areas for consideration in the Joint Report to Congress:
  – Definition and treatment of HVCRE exposures;
  – treatment for MSAs, timing difference DTAs, and investments in financial institutions (FIs); and
  – Simplify the limitations on minority interest
Simplifications NPR

• Fed, FDIC, and OCC published Simplifications to the Capital Rule Pursuant to EGRPRA NPR

• Issued on October 27, 2017

• Comment period closed on December 26, 2017
  — Received around 100 comment letters from banks and trade associations

• Addressed those areas highlighted in the EGRPRA Joint Report to Congress for community banks:
  — Definition and treatment of HVCRE exposures,
  — Treatment of MSAs, timing difference DTAs, and investments in FIs; and
  — The limitations on minority interest

Simplifications NPR

Definition and treatment of HVCRE/HVADC Exposures
Simplifications NPR: HVADC/HVCRE

Under the **standardized approach**: 

- Definition of high volatility acquisition, development, and construction (HVADC) would replace HVCRE definition
- HVADC definition would be less complex than HVCRE
- HVADC would capture more ADC loans than under HVCRE
- Risk weights on HVADC loans would be reduced to 130% from 150% under HVCRE
- Net result would be an expected increase in capital requirements on ADC loans for some banks, while others may see a decrease

### HVCRE under the current rule

1. **HVCRE 150% Risk Weight**

2. **Total ADC Loans**

   - Less

   - **1-4 Family Residential Properties**
   - **Purchase or Development of Agricultural Land**
   - **ADC Loans Meeting Certain Criteria**
   - **Certain Community Development Loans**

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1. ADC loans mean all real estate acquisition, development, or construction loans.

2. ADC loans meeting certain criteria are not HVCRE:  
   - LTV is at or below maximum supervisory LTV; and  
   - Borrower has contributed at least 15% of “as completed” appraised value in cash or unencumbered readily marketable assets; and  
   - Borrower contributed capital and internally generated funds are contractually required to remain throughout the project life  
   - The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full.
HVADC under the **Simplifications NPR**

\[
\text{HVADC} = \frac{130\%}{\text{Risk Weight}} \times (\text{Total ADC Loans}^1 \text{ Less } \{\text{1-4 Family Residential Properties, Purchase or Development of Agricultural Land, Certain Community Development Loans}\})
\]

1. ADC loans mean all real estate acquisition, development, or construction loans.

**Simplifications NPR: HVADC (other changes)**

- **“Primarily finances” test:**
  - More than 50% of the loan proceeds go towards acquisition, development, or construction activities.
    - If **yes**, entire loan is HVADC unless the exemption criteria are met
    - If **no**, entire loan is not subject to HVDAC
Simplifications NPR: HVADC (other changes)

• HVADC definition of a permanent loan:
  – prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments aside from the sale of the property.
  – Bridge loans generally would not qualify

• HVCRE definition of permanent financing:
  – Loan that meets a bank’s underwriting criteria for long-term mortgage loans.

Simplifications NPR: HVADC/HVCRE

• Comment letters on HVADC/HVCRE
  – Generally did not support the new HVADC definition:
    • Large bank commenters said that two “high volatility” definitions (HVCRE/HVADC) applicable to them increased burden
    • Most bank commenters wanted a return of the 15% capital contribution exemption.
      – Many bank commenters wanted the appraised market value of land to count towards the 15% contribution
      – Only cost paid for land counts under current rule
Legislative Developments

• There is a proposed bill to amend the definition of HVCRE
  
  **Highlights:**
  - Collateral-based definition rather than purpose-based (loans secured by real estate)
  - Exempts loans to purchase or improve income-producing properties if sufficient cash flows to cover debt service and expenses
  - Appraised market value of land could count towards the 15% capital contribution requirement.

• Pending legislation
  - Passed in the House of Representatives
  - Awaiting a Senate vote

• Bill passage would govern any potentially new HVCRE definition

NCUA

• No identification of HVADC/HVCRE
• Risk-based capital regulation going into effect in 2019 requires a 150% risk weight on concentrations of commercial loans that exceed 50% of assets
  - Estimated to apply to about a dozen credit unions
Transitions and Simplifications NPRs

Treatment of MSAs, Timing Difference DTAs, Investments in Capital Instruments, and Minority Interest

Transitions NPR

August 2017: Issuance of interagency Transitions NPR.

• Scope: non-Advanced Approaches banking organizations.
• Overall intent: halt the automatic 2018 phase-in of certain, stricter aspects of the capital rule while the Agencies work on the Simplifications NPR.
• Specifically, the Transitions NPR proposed to maintain certain 2017 regulatory treatments:
  – Continue the deduction of only 80% of MSAs, timing difference DTAs, and investments in capital instruments of unconsolidated financial institutions (UFIs) above regulatory thresholds;
  – Maintain the 100% RW for MSAs, timing difference DTAs, and significant investments in the common stock of UFIs below regulatory thresholds (i.e., not deducted); and
  – Continue inclusion of up to 20% of excess capital instruments issued by subsidiaries (minority interest) in a banking organization’s consolidated capital.
Transitions NPR

Public Comment
• Main comment themes
  – General support for freeze of transitions provisions: reduces operational burden and cost, provides clarity at a time when further simplifications are under consideration, etc.;
  – Agencies should consider freezing additional transition provisions;
  – Scope of NPR does not go far enough to reduce burden; and
  – Expand scope of NPR to include all banks, including Advanced Approaches.

Final Rulemaking
• November 2017: agencies finalized Transitions rulemaking identical to NPR.
• Reporting instructions in 1Q2018 Call Report and Y-9C (Schedule R) amended for non-Advanced Approaches banks.

Simplifications NPR

September 2017: Issuance of interagency Simplifications NPR.
• Scope of numerator simplifications: non-Advanced Approaches banking organizations.
• Investments in capital instruments of UFIs:
  – Would eliminate distinctions and differing regulatory treatments for “significant” and “non-significant” investments; and
  – Would increase deduction threshold from 10% of CET1 to 25%.
• MSAs and timing difference DTAs:
  – Would increase deduction threshold from 10% of CET1 to 25%.
• Recognition of minority interest:
  – Would simplify calculation steps to determine recognizable amount, capped at a flat 10% of each tier of capital at the parent; and
  – Would potentially allow more minority interest to be recognized.
Simplifications NPR

General public comments on simplification efforts:

• General support for efforts to reduce regulatory burden and simplification of complex aspects of the capital framework.
• Do not finalize HVADC definition and risk weight as proposed.
• Split finalization of NPR into two steps:
  – First, quickly finalize numerator Simplifications;
  – Second, re-propose aspects related to HVCRE/HVADC and contemplate further reforms to other parts of the capital framework (e.g., leverage-only capital framework).

Simplifications NPR

Public comments on numerator simplifications

• General support for efforts to reduce regulatory burden and simplification of complex aspects of the capital framework.
• Apply numerator provisions of Simplifications NPR to all banking organizations, including Advanced Approaches.
• Threshold deductions:
  – Increase deduction threshold to 50% of CET1;
  – MSAs: lower from 250% RW to 100% RW;
  – Timing difference DTAs: impose flat 10% RW; and
  – Investments in capital instruments: impose flat 100% RW for all exposures.
• Accumulated other comprehensive income (AOCI):
  – Allow all banks, including Advanced Approaches, to exclude unrealized gains and losses on AFS securities from regulatory capital calculations.
• Capital conservation buffer (CCB) restriction exemption:
  – Allow subchapter S-Corps to issue dividends to shareholders to cover tax liabilities.
Simplifications NPR


• Threshold items: Investments in UFFIs, MSAs, Timing Difference DTAs

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>13</td>
<td>LESS: Represents investments in the capital of unconsolidated financial institutions in the form of common stock, net of associated DTAs, that exceed the 10 percent common equity tier 1 capital deduction threshold.</td>
<td>P831</td>
</tr>
<tr>
<td>14</td>
<td>LESS: MSAs, net of associated DTAs, that exceed the 15 percent common equity tier 1 capital deduction threshold.</td>
<td>P834</td>
</tr>
<tr>
<td>15</td>
<td>LESS: DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTAs, that exceed the 15 percent common equity tier 1 capital deduction threshold.</td>
<td>P835</td>
</tr>
<tr>
<td>16</td>
<td>LESS: Amount of significant investments in the capital of unconsolidated financial institutions in the form of common stock, net of associated DTAs, MSAs, net of associated DTAs, and DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTAs, that exceed the 15 percent common equity tier 1 capital deduction threshold.</td>
<td>P836</td>
</tr>
</tbody>
</table>

Minority Interest – focus on instructional changes

4. Common equity tier 1 minority interest includable in common equity tier 1 capital

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>Tier 1 minority interest not included in common equity tier 1 capital</td>
<td>P892</td>
</tr>
<tr>
<td>29</td>
<td>Total capital minority interest that is not included in tier 1 capital</td>
<td>P868</td>
</tr>
</tbody>
</table>

• Advanced Approaches vs. Non-Advanced Approaches
  – How to reconcile potential different definitions of capital?
NCUA Risk-Weight on MSA

- No deduction from capital for higher amounts of MSAs
- Current risk weight is 100% - applies to a limited number of credit unions
- Beginning January 2019 the risk weight will be 250% - applies to all credit unions with assets greater than $100 million

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**Basel Update**
**Basel Update Overview:**

- **Background**
  - Basel Committee
  - 2017 Reform Package

- **Overview of the 2017 Basel Reforms**

- **U.S. Implementation of Basel Standards**

- **Pillar 3 Disclosures**

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**Background**

**Basel Committee (BCBS)**

- The BCBS is comprised of 27 member jurisdictions
- BCBS reports to Governors and Heads of Supervision (GHOS)
- BCBS Role:
  - Develop capital, liquidity and other standards
  - Develop guidance and principles
  - Share supervisory experiences

**2017 Basel Reform Package**

- Complement the Basel III reforms announced in 2010.
- Announced on December 7, 2017 with implementation date beginning January 1, 2022.
- Objective:
  - Address unwarranted variability in risk-weighted assets (RWAs)
  - Improve the comparability of banks’ capital ratios
Overview of the 2017 Basel Reforms

**Improve the Treatment of Credit Risk**
- Enhance risk sensitivity of the Standardized Approach Framework while balancing simplicity.
- Restrict use of, and impose additional constraints on, the internal ratings-based (IRB) approaches and establishes an output floor of 72.5%.
- Reduce reliance on external credit ratings - which was done in the U.S. with the finalization of the 2013 Capital Rule.

**Streamline the Treatment of Operational Risk**
- Simplify the framework by replacing models-based approaches with a single standardized approach.
- Make the framework more risk-sensitive by combining a refined measure of gross income with a bank's own internal loss history over 10 years.

**Leverage ratio surcharge for G-SIBs**
- Leverage ratio G-SIB surcharge set at 50% of a G-SIB's surcharge for risk-based capital purposes.

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**U.S. Implementation**

- The federal banking agencies determine whether the Basel standard is appropriate and how it should be applied in the U.S.
- Any proposed changes are subject to the notice and comment process of the Administrative Procedure Act.
- Timeline of any rulemakings related to the 2017 Reform Package has not been finalized.
Pillar 3 Disclosures

- Seeks to promote market discipline - improve consistency and comparability

- Three Phases of the Pillar 3 framework
  - Phase I – Finalized in January 2015
  - Phase II – Finalized in March 2017
  - Phase III – Consultative document
    - Published February 27, 2018
    - Comment period ends May 25, 2018

- Phase III CD focuses on the 2017 Basel reforms with disclosures on:
  - Key prudential metrics
  - Benchmark a bank’s risk-weighted assets - internal models vs. standardized approach
  - Credit risk (including provisions for prudential treatment of assets)
  - Operational risk
  - Leverage ratio
  - Credit valuation adjustment (CVA)
  - Asset encumbrance
  - Capital distribution constraints

- The federal banking agencies will have to issue a NPR or FRN to implement the revised disclosure requirements in the U.S.

Questions?