

Banking Agencies Propose To Simplify U.S. Basel III Capital Rules for Non-Advanced Approaches Firms

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The U.S. banking agencies this week released a proposal that would significantly amend the U.S. Basel III capital rules of all three agencies by simplifying the capital treatment of several items, primarily for non-advanced approaches banking organizations. The proposed rule represents the agencies' next step in the agencies' efforts, discussed in the March 2017 Economic Growth and Regulatory Paperwork Reduction Act Report, to "meaningfully reduce regulatory burden, especially on community banking organizations, while... maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system."

One of the key questions lingering after the EGRPRA Report was the scope of applicability for the simplifications discussed in the report. The report noted that the complexity of the existing capital rules is particularly burdensome for "community banking organizations," a category that lacks a generally understood meaning. The proposed rule resolves this uncertainty in favor of a more expansive scope of applicability, with the majority of the proposed simplifications applying to all banking organizations subject to the capital rules that are not subject to the advanced approaches for calculating risk-weighted assets and capital ratios (non-advanced approaches banking organizations). Non-advanced approaches banking organizations are those with total consolidated assets of less than \$250 billion and on-balance sheet foreign exposures of less than \$10 billion, other than those that have opted into or are otherwise subject to the use of the advanced approaches.

For non-advanced approaches banking organizations, the proposal would significantly simplify the capital treatment of capital deductions for mortgage servicing assets (MSAs), deferred tax assets arising from temporary differences that cannot be realized through net operating loss carrybacks (temporary difference DTAs), and significant and non-significant investments in the capital of unconsolidated financial institutions (UFI investments), and the recognition of minority interests in capital.

For all banking organizations subject to the capital rules, the proposal would replace the framework under the standardized approach for applying heightened risk weights to certain commercial real estate loans (high-volatility commercial real estate, or HVCRE, exposures), which is based in part on underwriting criteria for HVCRE loans, with a simpler framework (high-volatility acquisition, development or construction, or HVADC, exposures) that focuses instead on the use of proceeds for HVADC loans and would apply prospectively. Advanced approaches banking organizations would be required to apply the HVADC framework in calculating their risk-weighted assets under the standardized approach, but would continue to be required to apply the HVCRE framework in calculating their risk-weighted assets under the advanced approaches.

The proposal would also implement many technical amendments throughout the capital rules designed to clarify or correct the existing capital rules.

The table below summarizes the proposed changes and their scope of applicability.

Topic	Scope of Applicability for Proposed Change	Current Treatment (fully phased-in basis)	Proposed Treatment
Capital deductions for:			
MSAs	Non-advanced approaches banking organizations	10%/15% hybrid threshold deduction framework - Deduction from common equity tier 1 (CET1) capital - Non-deducted portion subject to 250% risk weight	25% individual threshold deduction framework - Deduction from common equity tier 1 (CET1) capital - Non-deducted portion subject to 250% risk weight
Temporary difference DTAs			
Significant UFI investments in the form of common stock			
Significant UFI investments other than in the form of common stock		- Fully deducted from capital - Deduction tier based on corresponding deduction approach	25% individual threshold deduction framework - Deduction tier based on corresponding deduction approach - Non-deducted portion risk weighted in usual manner (generally 100%, 300% or 400%)
Non-significant UFI investments		10% individual threshold deduction framework - Deduction tier based on corresponding deduction approach - Non-deducted portion risk weighted in usual manner (generally 100%, 300% or 400%)	
Recognition of minority interests in capital	Non-advanced approaches banking organizations	Subject to restrictions based on the <i>pro forma</i> amount of capital the subsidiary would need in order to avoid any restrictions on capital distributions and discretionary bonus payments under the capital buffer framework, determined as if the subsidiary were itself subject to such framework on a consolidated basis	Subject to 10% limitation on the amount of minority interest includable in each of CET1, tier 1 and total capital
Heightened risk weights for certain commercial real estate exposures	All banking organizations subject to U.S. Basel III capital rules (whether non-advanced approaches and advanced approaches) in calculating RWAs under the standardized approach	Under the standardized approach, a 150% risk weight applies to high-volatility commercial real estate (HVCRE) exposures, which are determined based on, among other things, conformance to specified prudential criteria	Under the standardized approach: - a 130% risk weight would apply to high-volatility acquisition, development or construction (HVADC) exposures, which are a new category based on simplified criteria relative to the HVCRE criteria; and - a 150% risk weight would continue to apply to grandfathered HVCRE exposures Under the advanced approaches: - the HVCRE framework would remain in effect and a 150% risk weight would continue to apply to all HVCRE exposures

Comments on the proposal will be due within 60 days from the date of publication in the federal register. We are continuing to analyze the proposed rule and will publish a visual memorandum in the near future.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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