

U.S. Banking Agencies Propose to Delay the Phase-In of Certain Capital Rules for Non-Advanced Approaches Banking Organizations

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The U.S. banking agencies (the Federal Reserve, OCC and FDIC) propose to delay the last phase of the U.S. Basel III capital rules' transition provisions relating to certain deductions from capital and limitations on the recognition of minority interests, which are scheduled to become effective January 1, 2018, for banking organizations that are not advanced approaches banking organizations. On August 22, 2017, the U.S. banking agencies released an interagency [notice of proposed rulemaking](#) (the "Transitions NPR") that proposes in effect to freeze the currently applicable phase of the transition provisions for these items until a separate proposal aimed at simplifying certain capital requirements for community banking organizations is developed and finalized. The Transitions NPR does not apply to advanced approaches organizations.

Relationship to Ongoing Simplification Efforts

The Transitions NPR is related to efforts to simplify certain capital rules for community banking organizations. In particular, it relates to a March 2017 FFIEC [joint report to Congress](#) on the Economic Growth and Regulatory Paperwork Reduction Act (the "EGRPRA Report"), in which the U.S. banking agencies stated their support for simplifying certain capital requirements with the goal of reducing the regulatory burden on community banking organizations. The EGRPRA Report specifically discussed the simplification of the current treatment under the U.S. capital rules of:

- mortgage servicing assets (MSAs);
- deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks (Temporary Difference DTAs);
- significant and non-significant investments in the capital of unconsolidated financial institutions (UFIs); and
- the limitations on the recognition of minority interests in regulatory capital.

The Transitions NPR notes that the U.S. banking agencies expect to issue in the near term a proposal to substantively simplify certain capital requirements for community banking organizations (the "Simplifications NPR"), at which time the agencies will review the transition provisions for the items that are covered by the Transitions NPR.

Scope of Transitions NPR

The Transitions NPR applies only to banking organizations that are not advanced approaches banking organizations. An advanced approaches banking organization is generally defined as a banking organization that (1) has total consolidated assets of \$250 billion or more or (2) has total consolidated on-balance sheet foreign exposure of \$10 billion or more, regardless of whether it has completed its parallel run process and thus regardless of whether it calculates its regulatory capital ratios in accordance with both the advanced approaches and the standardized approach. This scope of application differs from the apparent scope of the forthcoming Simplifications NPR, which the U.S. banking agencies state would apply to "community banking organizations." This term does not have a well-defined size cut-off, but is

generally limited to banking organizations with \$10 billion or less in total consolidated assets, or at any rate less than \$50 billion in total consolidated assets.

Advanced approaches banking organizations would not benefit from the Transitions NPR and would continue to apply the U.S. capital rules' current transition provisions for the affected capital requirements, including those scheduled to become effective on January 1, 2018. As a result, advanced approaches banking organizations that have completed their parallel run process and that calculate their capital ratios under both the advanced approaches and the standardized approach, with the lower ratio in each case being its reported capital ratio, would not be permitted to calculate standardized approach capital ratios under the delayed phase-in provisions of the Transitions NPR.

Which Transition Provisions Would Be Delayed?

The Transitions NPR would delay the last phase of the transition provisions for the following capital requirements:

- **Deductions and Risk Weights for MSAs:** Under fully phased-in capital requirements, a banking organization must deduct from its common equity Tier 1 capital ("CET1 capital") MSAs to the extent they exceed certain thresholds (10% of CET1 capital for MSAs as an individual category, 15% of CET1 capital when aggregated with Temporary Difference DTAs and significant investments in UFI in the form of common stock) and must apply a 250% risk weight to any remaining MSAs that are not deducted. These requirements reflect the risk that MSAs may decrease in value and not be available to absorb losses under stressed conditions. Under the current transition provisions for these MSA requirements, as of January 1, 2017, banking organizations must deduct 80% of the amount of MSAs that exceed the relevant thresholds and the risk weight applicable to any remaining portion of MSAs is 100% rather than 250%. Effective January 1, 2018, under the current transition provisions, banking organizations will be required to deduct 100% of the amount of MSAs exceeding the relevant thresholds and the risk weight for the non-deducted portion of MSAs will increase to 250%. The Transitions NPR would freeze the phase-in deduction ratio for MSAs at 80% and freeze the risk weight for non-deducted MSAs at 100%.
- **Deductions and Risk Weights for Temporary Difference DTAs:** Under fully phased-in capital requirements, a banking organization must deduct from its CET1 capital Temporary Difference DTAs to the extent they exceed certain thresholds (10% of CET1 capital for Temporary Difference DTAs as an individual category, 15% of CET1 capital when aggregated with significant investments in UFI in the form of common stock) and must apply a 250% risk weight to any remaining Temporary Difference DTAs that are not deducted. This treatment reflects the fact that a banking organization's ability to realize the value of Temporary Difference DTAs is contingent on the banking organization generating future taxable income and therefore Temporary Difference DTAs may not be available to absorb losses if the banking organization were to experience financial stress. Under the current transition provisions for these Temporary Difference DTA requirements, as of January 1, 2017, banking organizations must deduct 80% of the amount of Temporary Difference DTAs that exceed the relevant thresholds and the risk weight applicable to any remaining portion of Temporary Difference DTAs is 100% rather than 250%. Effective January 1, 2018, under the current transition provisions, banking organizations will be required to deduct 100% of the amount of Temporary Difference DTAs exceeding the relevant thresholds and the risk weight for the non-deducted portion of Temporary Difference DTAs will increase to 250%. The Transitions NPR would freeze the phase-in deduction ratio for Temporary Difference DTAs at 80% and freeze the risk weight for non-deducted Temporary Difference DTAs at 100%.
- **Deductions and Risk Weights for Investments in the Capital of UFI:** Under fully phased-in capital requirements, a banking organization must deduct from its regulatory capital investments it has made in the capital of UFI ("UFI Capital Investments"), depending on the form of the capital instrument and the extent to which the investments exceed certain thresholds, and must apply a 250% risk weight to any remaining portion of significant UFI Capital Investments in the form of common stock.^[1] These requirements reflect the risk that, because of the extent of a banking organization's exposure to a UFI, if either entity were to experience financial stress, the capital investment in the UFI would not be available to absorb losses at the banking organization. Under the current transition provisions for these UFI Capital Investment requirements, as of January 1, 2017, banking organizations must deduct 80% of the amount of UFI Capital Investments that exceed the relevant threshold(s) and the risk weight applicable to any remaining portion of significant UFI Capital Investments in the form of common stock is 100% rather than 250%. Effective January 1, 2018, under the current transition provisions, banking organizations will be required to deduct 100% of the amount of UFI Capital Investments exceeding the relevant threshold(s) and the risk weight for the non-deducted portion of significant UFI Capital Investments in the form of common stock will increase to 250%. The Transitions NPR would freeze the phase-in deduction ratio for UFI Capital Investments at 80% and freeze the risk weight for non-deducted significant UFI Capital Investments in the form of common stock at 100%.
- **Recognition of Grandfathered Surplus Minority Interests:** Under the fully phased-in capital requirements, a banking organization may recognize qualifying minority interests in its consolidated subsidiaries in the appropriate tier of its consolidated regulatory capital subject to certain limitations. In general, these limitations on the recognition of minority interests reflect the risk that, in the event that the banking organization were to experience financial stress,

minority interests issued by a particular subsidiary would only be available to absorb losses of the subsidiary and not those incurred elsewhere within the banking organization. Under the current transition provisions for these minority interest requirements, as of January 1, 2017, a banking organization may recognize in its consolidated regulatory capital 20% of the amount, if any, by which its minority interests outstanding as of January 1, 2014 exceed the amount of its qualifying minority interests recognizable under the fully phased-in capital requirements ("grandfathered surplus minority interests"). Effective January 1, 2018, under the current transition provisions, a banking organization will not be able to recognize any amount of grandfathered surplus minority interests. The Transitions NPR would freeze the amount of any grandfathered surplus minority interests includable in a banking organization's consolidated regulatory capital at 20%.[2]

Since the Transitions NPR merely freezes the currently applicable phase of the transition provisions for the items described above, the U.S. banking agencies estimate that the impact of the Transitions NPR on the capital requirements of affected banking organizations would be relatively limited. For example, the Federal Reserve has estimated that implementing the last phase of the deduction for MSAs, Temporary Difference DTAs and UFI Capital Investments would reduce CET1 capital by an average of 0.01% for "all covered small bank holding companies, savings and loan holding companies and state member banks" (which we assume refers to a subset of non-advanced approaches banking organizations subject to the Federal Reserve's U.S. Basel III capital rules). The Federal Reserve has also estimated that implementing the last phase of the limitations on grandfathered surplus minority interests would reduce total regulatory capital by 0.04% and implementing the increase in risk weights for the non-deducted portion of MSAs and Temporary Difference DTAs from 100% to 250% would increase risk-weighted assets by 0.64% for the same set of banking organizations.[3]

Next Steps

The U.S. banking agencies have requested comments on the Transitions NPR by September 25, 2017. Obviously, the effective date for a final rule implementing the Transitions NPR must be no later than December 31, 2017 for the U.S. banking agencies' proposal to have its intended effect.

Law Clerk Greg Swanson contributed to this post.

[1] Separate deduction thresholds apply for (1) non-significant UFI Capital Investments, (2) significant UFI Capital Investments in the form of common stock and (3) significant UFI Capital Investments not in the form of common stock. For significant UFI Capital Investments in the form of common stock, the deduction is made from CET1 capital and the deduction thresholds are 10% of CET1 capital for significant UFI Capital Investments as an individual category and 15% of CET1 capital when aggregated with MSAs and Temporary Difference DTAs. The 250% risk weight for the non-deducted portion of UFI Capital Investments only applies to significant UFI Capital Investments in the form of common stock; for the other two categories of UFI Capital Investments subject to deduction, the risk weight applicable to the portion not deducted is determined in the usual manner, which could result in a risk weight that is either higher or lower than 250%, depending on the type of financial institution and the form of the investment.

[2] The Transitions NPR does not propose freezing the currently applicable transition provisions for the recognition in a banking organization's Tier 1 or total regulatory capital of minority interests consisting of capital instruments not meeting the criteria for Additional Tier 1 capital or Tier 2 capital and outstanding as of January 1, 2014.

[3] The Federal Reserve's estimate appears not to quantify the impact of increasing the risk weights for the non-deducted portion of significant UFI Capital Investments in the form of common stock.

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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