

U.S. Basel III: Guide for Community Banks

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Executive Summary: U.S. Basel III is the most complete overhaul of U.S. bank capital standards in nearly a quarter of a century. It comprehensively revises the regulatory capital framework for the entire U.S. banking sector and will have significant implications for community banks from a business, operations, M&A and regulatory compliance perspective. Using visuals and charts, this article provides an overview of the key aspects of U.S. Basel III for community banks.

Introduction to U.S. Basel III

U.S. Basel III is a highly complex, 1,000-page regulation published by the U.S. banking agencies (Federal Reserve, OCC and FDIC) to implement the international Basel III³ capital standards in the United States. In addition to implementing Basel III, U.S. Basel III also gives effect to key provisions in the Dodd-Frank Act, including the Collins Amendment and the prohibition on references to credit rating agency ratings in federal regulations. The U.S. Basel III final rule makes a number of important changes to the U.S. Basel III proposal that was issued by the U.S. banking agencies in June 2012.

U.S. Basel III Will Affect All Community Banks

U.S. Basel III will apply to **all** national banks, state member and non-member banks, state and federal savings associations and covered savings and loan holding companies (SLHCs)⁴ regardless of size.

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³ Basel III is an internationally agreed-upon set of reform measures to increase the quality and quantity of regulatory capital at banks. Developed in 2010, Basel III is the latest in a series of bank capital standards published by the Basel Committee on Banking Supervision (Basel Committee). The Basel Committee is a committee of central banks and bank regulators from 27 major industrialized countries that meet under the auspices of the Bank for International Settlements in Basel, Switzerland to develop bank capital and other regulatory standards and guidelines.

Although the Basel Committee's capital standards are not legally binding, they are backed by the commitments of the senior central bank and regulatory officials who are members of the committee to implement the standards in their home countries. The Basel Committee's capital standards are implemented in all major industrialized countries, including the United States. The first set of such standards, known as Basel I, was published by the Basel Committee in 1988 and implemented by the U.S. banking agencies in 1989. Basel II was published in 2004.

⁴ For purposes of U.S. Basel III, a covered SLHC is an SLHC *other than*: (1) a grandfathered unitary SLHC that is substantially engaged in commercial activities (applying a $\geq 50\%$ of assets or revenues test); (2) an SLHC that is an insurance underwriting (*cont.*)

The regulation will also apply to all bank holding companies (BHCs) other than certain small BHCs with less than \$500 million in total assets. However, the bank and thrift subsidiaries of these small BHCs will still be subject to U.S. Basel III.

U.S. Basel III: Key Takeaways for Community Banks

- The compliance date for community banks is January 1, 2015. The new capital conservation buffer and deductions will be phased in over several years.
- On top of the tougher new minimum capital ratios, community banks must maintain a common equity capital conservation buffer of greater than 2.5% of risk-weighted assets (RWAs) to avoid restrictions on dividends, redemptions and *executive bonus payments*.
- Compared with existing capital rules, U.S. Basel III will require community banks to deduct much more mortgage servicing assets (MSAs) and deferred tax assets (DTAs) from their common equity capital, shrinking their capital base.
- Community banks can opt out of including accumulated other comprehensive income (AOCI) in their common equity capital. In other words, they can elect to keep the existing AOCI filter.
- U.S. Basel III retains the existing capital treatment of residential mortgages and certain other types of exposures.
- BHCs with less than \$15 billion in total consolidated assets as of year-end 2009 can continue to treat existing trust preferred securities (TruPS) as Tier 1 capital, subject to certain conditions. M&A activity may affect the grandfathering of TruPS in Tier 1 capital.

How Will U.S. Basel III Increase Capital Requirements for Community Banks?

U.S. Basel III contains two types of capital ratio requirements: the risk-based capital ratio and the leverage ratio.

A bank's risk-based capital ratio is the ratio of its regulatory capital to its risk-weighted assets (RWAs). Under U.S. Basel III, regulatory capital is divided into different tiers: Common Equity Tier 1 (*e.g.*, common stock, related surplus and retained earnings), Additional Tier 1 (*e.g.*, certain preferred stock) and Tier 2 capital (*e.g.*, certain subordinated debt and other capital instruments). U.S. Basel III subjects banks to three different risk-based capital ratios requirements: Common Equity Tier 1 risk-based capital ratio; Tier 1 risk-based capital ratio (Tier 1 capital is sum of Common Equity Tier 1 and Additional Tier 1 capital); and total risk-based capital ratio (total capital is the sum of Tier 1 and Tier 2 capital).

RWAs constitute the denominator of the risk-based capital ratio. In summary, a community bank must calculate RWAs by multiplying the amount of an asset or exposure by the standardized risk weight (%) associated with that type of asset or exposure. The standardized risk weights prescribed in U.S. Basel III reflect regulatory judgment regarding the degree of risk of a type of asset or exposure. RWAs must be calculated for both on- and off-balance sheet assets and exposures. All else being equal, a higher risk weight results in a higher RWA amount which, in turn, gives rise to a lower risk-based capital ratio.

A bank's leverage ratio is the ratio of its Tier 1 capital to its average total consolidated on-balance sheet assets (minus amounts deducted from Tier 1 capital). Calculation of the leverage ratio does not

(cont.)

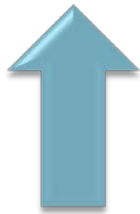
company; and (3) an SLHC that substantially engages in insurance underwriting activities (applying a $\geq 25\%$ of assets held in insurance underwriting subsidiaries test). The Federal Reserve expects to implement an "appropriate" capital framework for non-covered SLHCs by 2015.

involve assigning risk weights to assets. Thus, the leverage ratio is commonly referred to as a non-risk-based capital ratio. U.S. banks have been subject to the leverage ratio requirement for many years.

As **Figure 1** illustrates, U.S. Basel III makes changes to every aspect of the risk-based capital ratio, which has the overall effect of significantly increasing capital requirements for community banks.

Figure 1

Impact of U.S. Basel III on the Risk-Based Capital Ratio



- Higher minimum capital ratios
- Requires community banks to maintain a capital conservation buffer above the minimum requirements to avoid restrictions on capital distributions and executive bonus payments



- Narrows the eligibility criteria for regulatory capital instruments
- New regulatory adjustments to and deductions from capital that place the focus on tangible common equity



Risk-Based Capital Ratio (%) =

Regulatory Capital

Risk-Weighted Assets



Higher RWAs for:

- High volatility commercial real estate loans
- Certain securitization exposures
- Exposures to qualifying securities firms
- Certain OTC derivatives
- Cleared derivatives
- Past due exposures
- Certain equity exposures

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Higher Capital Ratios under U.S. Basel III

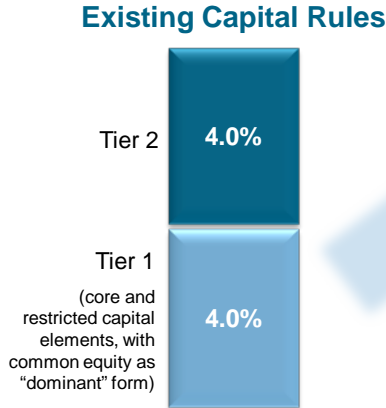
U.S. Basel III increases the minimum risk-based capital ratios for all U.S. banking organizations, including community banks. It also requires all U.S. banking organizations, including community banks, to maintain a capital conservation buffer above the minimum requirements to avoid restrictions on capital distributions and executive bonus payments. These aspects of U.S. Basel III are illustrated in **Figure 2**.

Figure 2

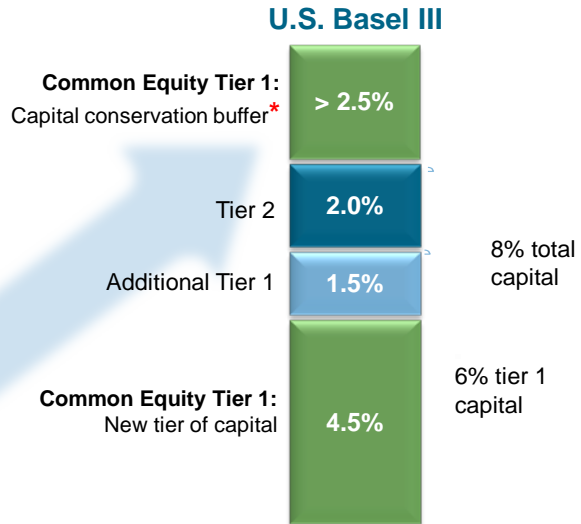
U.S. Basel III: Higher Capital Ratios

Leverage Capital Requirements

Leverage Ratio: Tier 1 capital to average total consolidated assets (minus amounts deducted from Tier 1 capital) must be at least 4%.



Risk-Based Capital Requirements



* Technically, the capital conservation buffer is not a minimum capital requirement. However, a banking organization that fails to maintain a Common Equity Tier 1 capital conservation buffer of greater than 2.5% of its risk-weighted assets will be subject to restrictions on capital distributions and executive bonus payments.

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Capital Conservation Buffer

U.S. Basel III introduces a capital conservation buffer of Common Equity Tier 1 capital above the minimum risk-based capital requirements. The buffer must be maintained to avoid:

- Limitations on capital distributions (e.g., repurchases of capital instruments or dividend or interest payments on capital instruments); and
- Limitations on discretionary bonus payments to executive officers such as CEO, president, CFO, CIO, CLO and heads of major business lines.

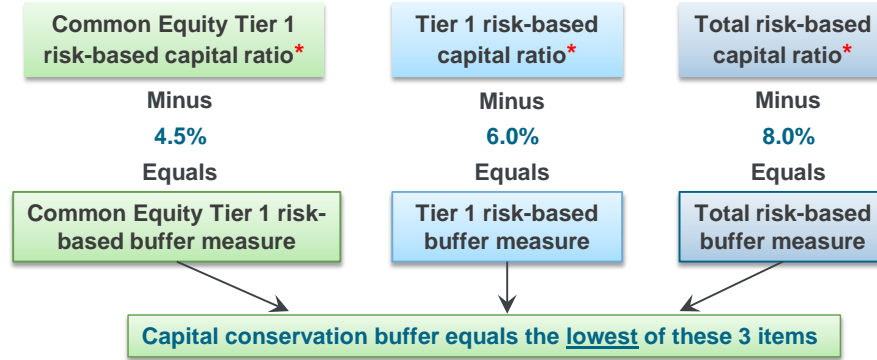
As a community bank dips further below its capital conservation buffer, it will be subject to increasingly stringent limitations on capital distributions and bonus payments, as illustrated by the table below. The capital conservation buffer will be phased in over three years, beginning on January 1, 2016.

Capital Conservation Buffer	Maximum payout ratio (as a % of eligible retained income)
Buffer > 2.5%	No limit imposed under capital conservation buffer framework
2.5% ≥ Buffer > 1.875%	Up to 60% of eligible retained income
1.875% ≥ Buffer > 1.25%	Up to 40% of eligible retained income
1.25% ≥ Buffer > 0.625%	Up to 20% of eligible retained income
0.625% ≥ Buffer	No capital distributions or discretionary bonus payments allowed

Although the capital conservation buffer can only be met with Common Equity Tier 1 capital, it must be calculated relative to each risk-based capital ratio, as illustrated by **Figure 3** below.

Figure 3

Calculating the Capital Conservation Buffer



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New Well-Capitalized Standard under U.S. Basel III

U.S. Basel III revises the capital thresholds of the prompt corrective action categories for insured depository institutions (IDIs), including the well-capitalized standard.⁵ The revised prompt corrective action thresholds will become effective on January 1, 2015.

Prompt Corrective Action Threshold	Risk-Based Capital Ratios			Leverage Ratio
	Total capital (unchanged)	Tier 1 capital	Common Equity Tier 1 capital	
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%			

⁵ As a result of the Dodd-Frank Act, in order to be a financial holding company, a BHC and all of its depository institution subsidiaries must be well-capitalized and well-managed. While U.S. Basel III does not specify the standard for determining whether a BHC is well-capitalized, the Federal Reserve may do so in future rulemaking.

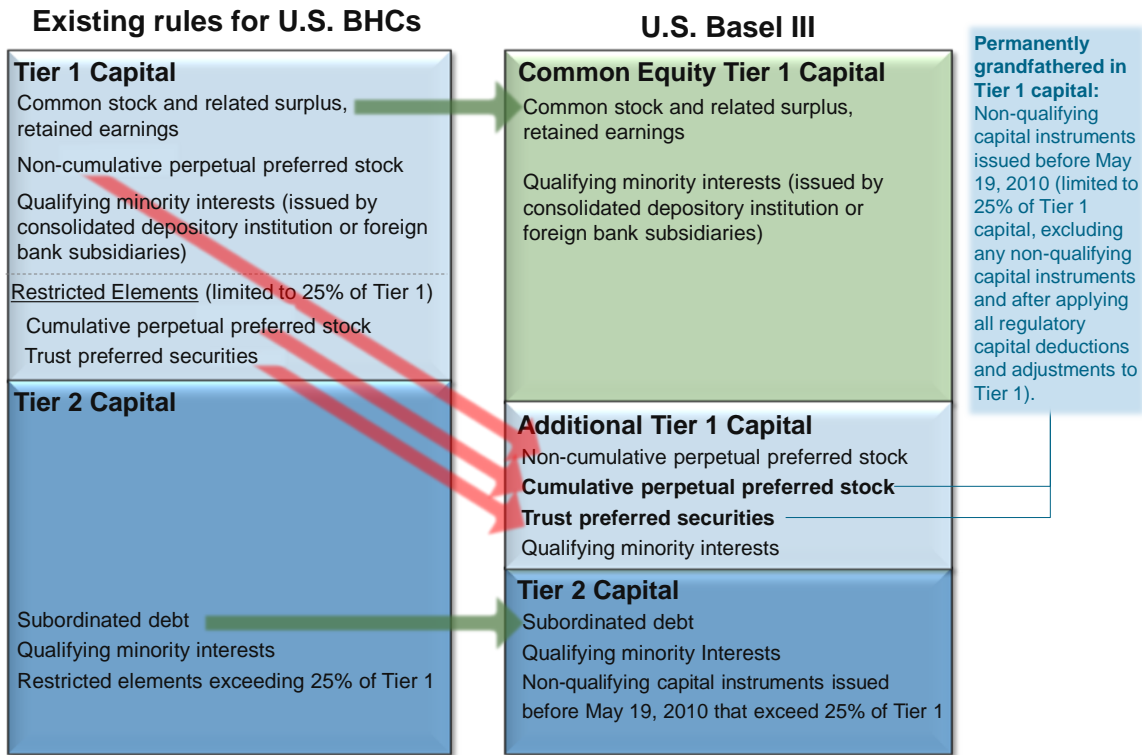
New Eligibility Criteria for Capital Instruments

In addition to increasing minimum risk-based capital ratios and introducing the capital conservation buffer, U.S. Basel III also defines new eligibility criteria for capital instruments within each tier of regulatory capital. As a result of the new eligibility criteria, certain types of capital instruments that qualified as Tier 1 capital under existing capital rules will no longer qualify, subject to grandfathering or phase-out arrangements for certain existing instruments.

Figure 4 illustrates the impact of the new eligibility criteria for BHCs with less than \$15 billion in total consolidated assets as of December 31, 2009. **Figure 5** illustrates the impact of the new eligibility criteria for BHCs with \$15 billion or more in total consolidated assets as of December 31, 2009.

Figure 4

Eligible Capital Instruments for < \$15 Billion* BHCs

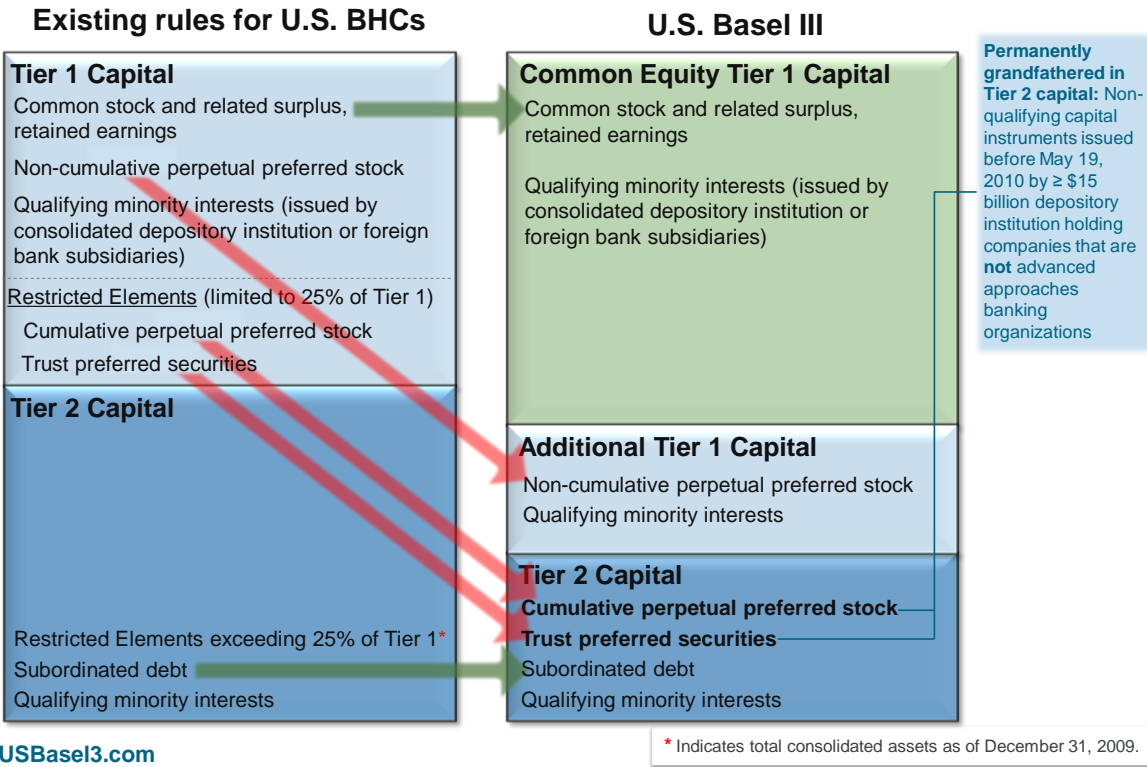


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* Indicates total consolidated assets as of December 31, 2009.

Figure 5

Eligible Capital Instruments for ≥ \$15 Billion* BHCs

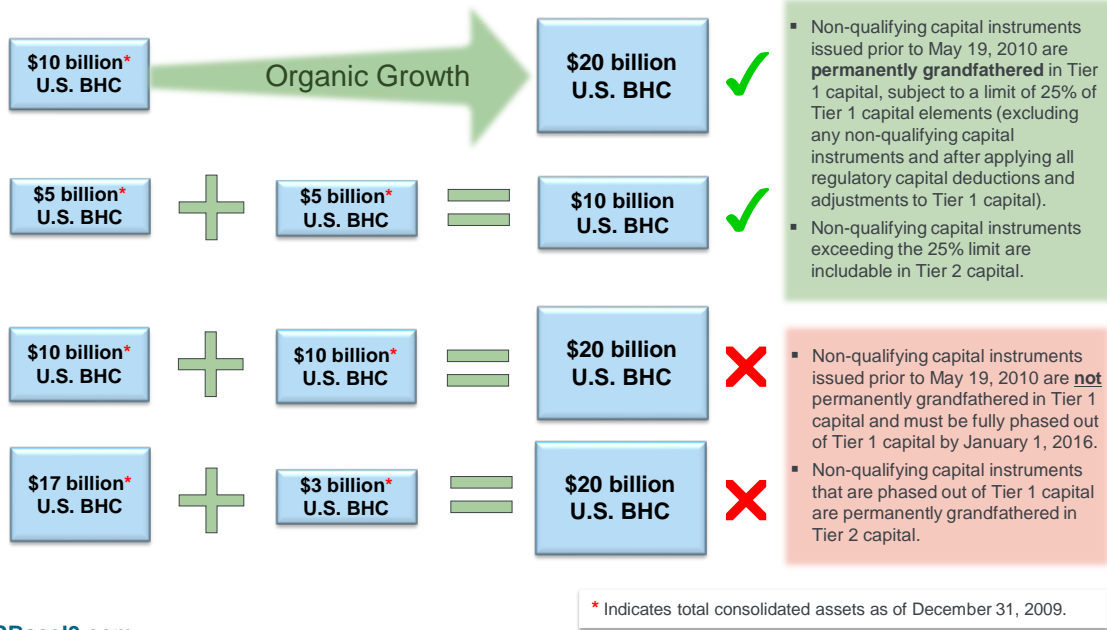


Impact of M&A on Non-Qualifying Capital Instruments Grandfathered in Tier 1 Capital

As noted above, BHCs with less than \$15 billion in total consolidated assets as of year-end 2009 can continue to treat existing non-qualifying capital instruments such as TruPS and cumulative perpetual preferred stock as Tier 1 capital, subject to certain conditions, including an aggregate limit for non-qualifying capital instruments of 25% of Tier 1 capital. U.S. Basel III contains specific rules addressing the impact of M&A activity on the ability of a BHC to continue to benefit from the permanent grandfathering of existing non-qualifying capital instruments in Tier 1 capital. As **Figure 6** illustrates, these rules can create disincentives for community banks to expand through M&A transactions instead of organic growth.

Figure 6

Impact of M&A on Non-Qualifying Capital Instruments Grandfathered in Tier 1 Capital



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Regulatory Adjustments to and Deductions from Capital

On top of increasing minimum risk-based capital ratios, introducing the capital conservation buffer and defining new eligibility criteria for capital instruments, U.S. Basel III will also require banks to make several new deductions from and adjustments to regulatory capital. Most of these will apply to Common Equity Tier 1 capital and have the effect of focusing bank regulatory capital on tangible common equity. The new deductions for mortgage servicing assets (MSAs) and deferred tax assets (DTAs) are much more stringent than under existing capital rules and will reduce community banks' equity capital base.

U.S. Basel III's deductions from Common Equity Tier 1 capital include, among other items:

- Goodwill and other intangibles, other than MSAs, net of associated deferred tax liabilities (DTLs);
- DTAs that arise from operating loss and tax credit carryforwards, net of associated DTLs; and
- Defined benefit pension fund net assets, net of associated DTLs⁶

U.S. Basel III provides for limited recognition in Common Equity Tier 1 capital of the following items, subject to a 10% individual threshold and a 15% aggregate threshold based on a banking organization's Common Equity Tier 1 capital (after applying certain regulatory adjustments and deductions):

⁶ IDIs are not required to deduct defined benefit pension fund net assets.

- DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of any related valuation allowances and net of DTLs;
- MSAs net of associated DTLs; and
- Significant investments in unconsolidated financial institutions in the form of common stock, net of associated DTLs.

AOCI Opt-out for Community Banks

AOCI includes unrealized gains and losses on available-for-sale (AFS) securities. Under existing capital rules, unrealized gains and losses on AFS debt securities are not included in regulatory capital, *i.e.*, these unrealized gains and losses are filtered out of regulatory capital.⁷ This feature of the existing capital rules is referred to as the AOCI filter. One of the perceived benefits of the AOCI filter is that it reduces volatility in a bank's capital levels, especially during periods of interest rate movements. In the June 2012 U.S. Basel III proposal, the U.S. banking agencies proposed to remove the AOCI filter. This was one of the most contentious aspects of the proposal.

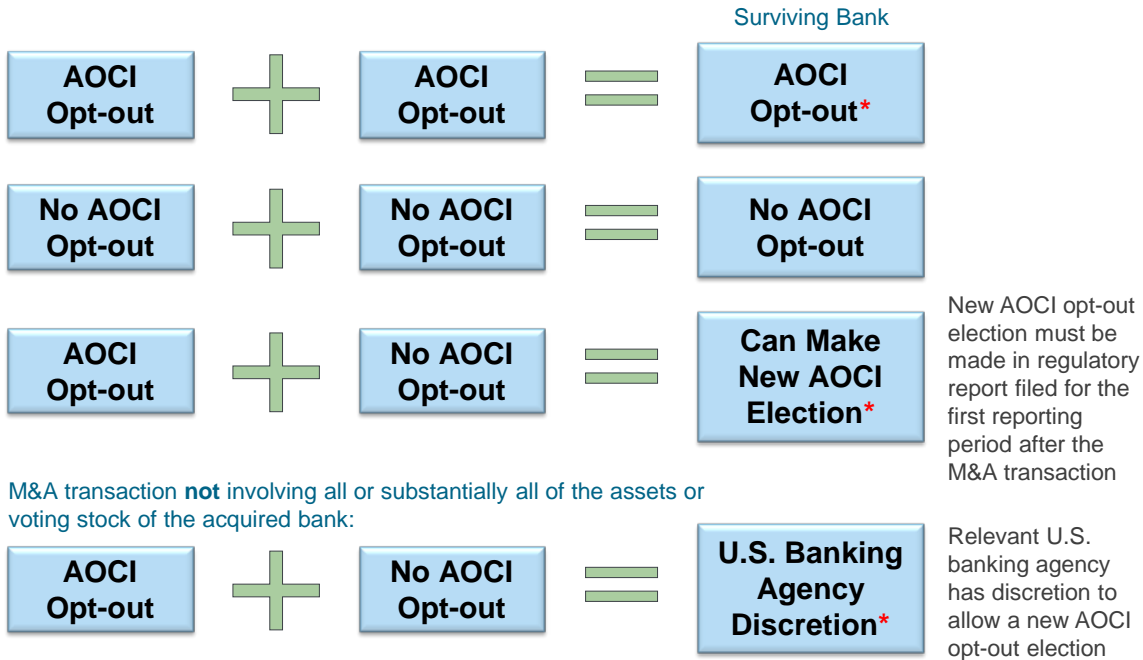
In a significant change from the June 2012 proposal, the U.S. Basel III final rule permits community banks and many other U.S. banking organizations to make a one-time, **permanent** election to retain the AOCI filter. This feature of the final rule is referred to as the AOCI opt-out election because the banking organization would be electing to opt-out of the removal of the AOCI filter. An opt-out election must be made in the regulatory report filed for the first reporting period after the banking organization becomes subject to U.S. Basel III. If a top-tier banking organization makes an election, any consolidated banking organization subsidiary must make the same election as its parent. We expect that many community banks will opt out of the removal of the AOCI filter.

As **Figure 7** illustrates, U.S. Basel III contains specific rules addressing the impact of M&A activity on a banking organization's AOCI opt-out election.

⁷ Under existing capital rules, unrealized losses on AFS equity securities are included in Tier 1 capital and up to 45% of any unrealized gains on AFS equity securities are included in Tier 2 capital.

Figure 7

Impact of M&A on AOCI Opt-out Election



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* Unless the surviving bank is an advanced approaches banking organization

Note: An advanced approaches banking organization is one that: (i) has \$250 billion or more in total consolidated assets; (ii) has \$10 billion or more of on-balance sheet foreign exposures; or (iii) chooses, with approval by its primary federal banking regulator, to use supervisor-approved internal models under the advanced approaches capital rules to calculate RWAs. Community banks are not advanced approaches banking organizations.

New Risk Weights under U.S. Basel III

In addition to making significant changes to the numerator of the risk-based capital ratio (regulatory capital), U.S. Basel III makes important changes to the calculation of RWAs, the denominator of the risk-based capital ratio. Among other things, U.S. Basel III:

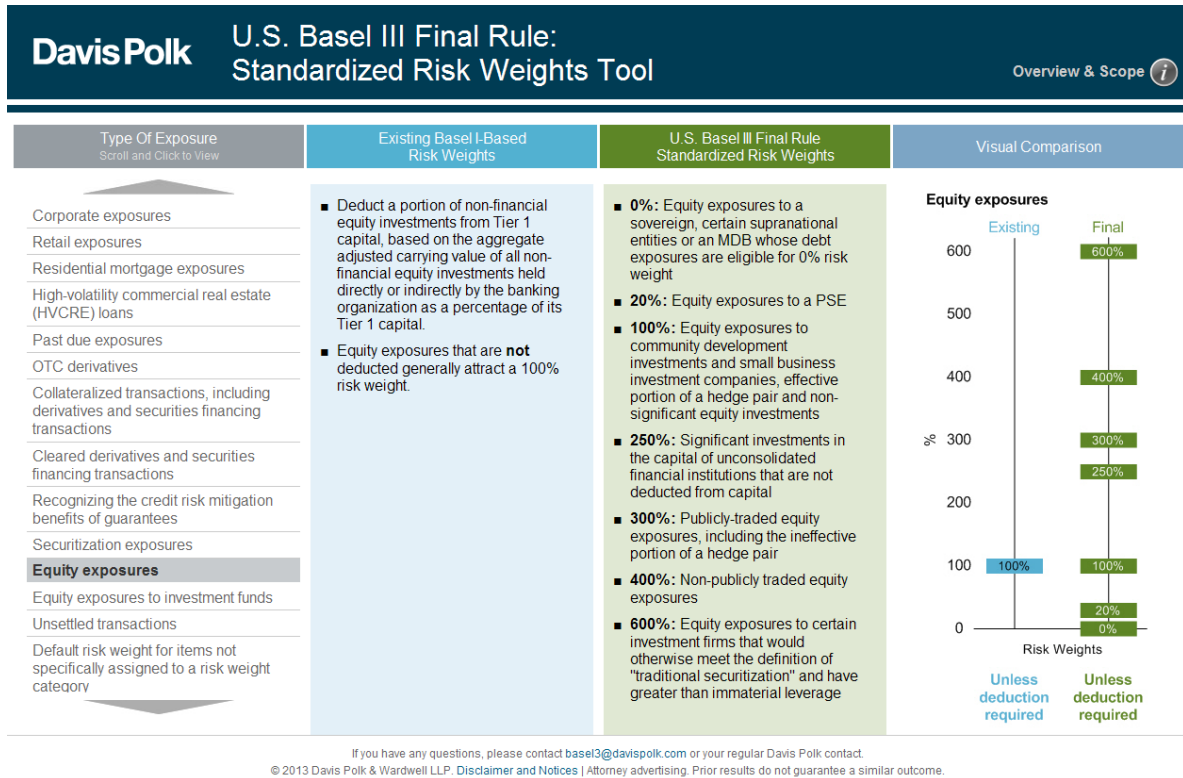
- Retains existing risk weights for residential mortgages, *i.e.*, assigns a 50% risk weight to prudently underwritten first-lien exposures that are performing according to their original terms and a 100% risk weight to other residential mortgage exposures;
- Assigns a 100% risk weight to most commercial real estate loans; and a 150% risk-weight for high volatility commercial real estate loans;
- Assigns a 150% risk weight to past due exposures (except sovereign exposures and residential mortgages);
- Retains the existing 100% risk weight for corporate and retail loans;
- Increases the risk weight for exposures to qualifying securities firms from 20% to 100%;
- Introduces new methods for calculating RWAs for OTC and centrally cleared derivatives;
- Introduces new methods for calculating RWAs for securitizations;
- Establishes new methods for calculating RWAs for equity exposures;

- Introduces new rules for recognizing collateral and guarantees as credit risk mitigants; and
- Removes references to credit rating agency ratings in methods for calculating RWAs.

U.S. Basel III Interactive Risk Weights Tool

We have developed an interactive web tool to help you navigate key differences between the new risk weights under U.S. Basel III and the risk weights under the existing bank capital rules. This interactive web tool is available at www.USBasel3.com, where you can also access our webcasts, visual memos and other materials on U.S. Basel III.

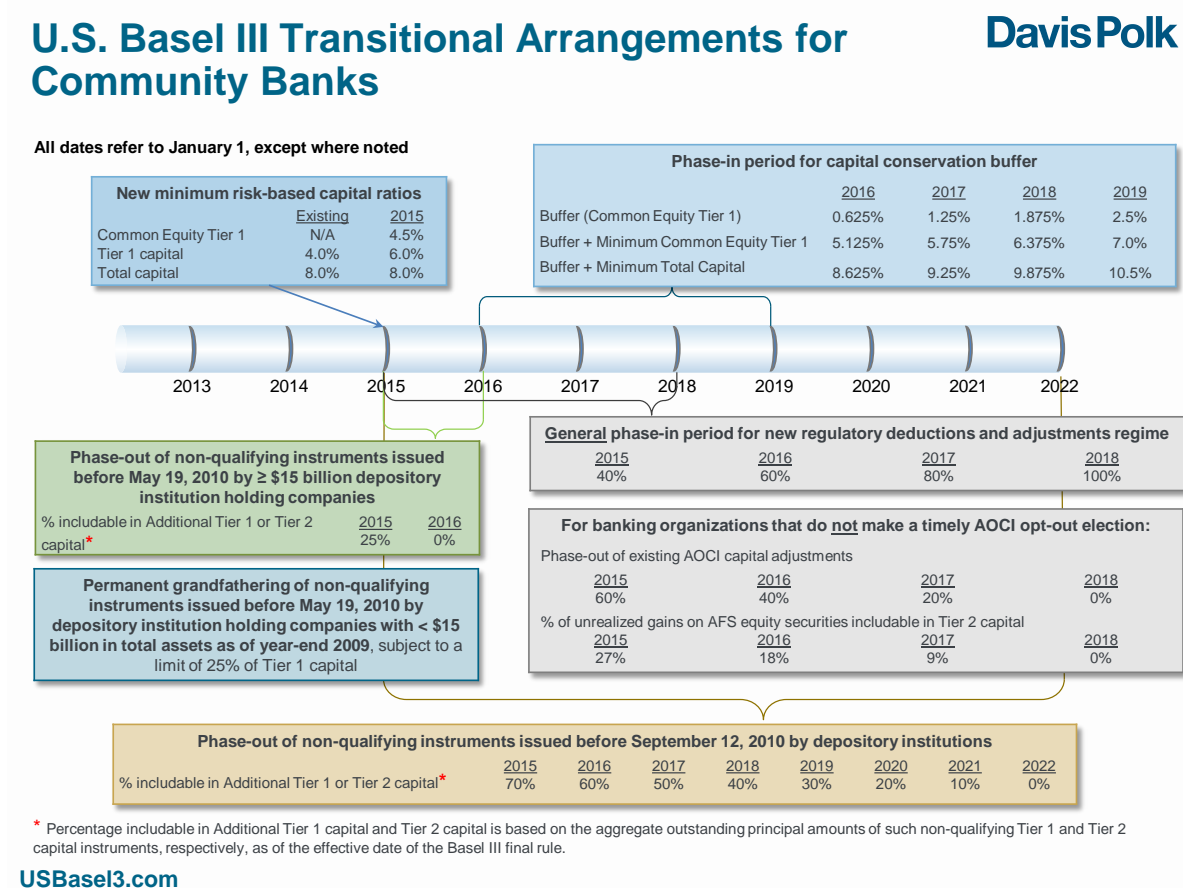
Screenshot of U.S. Basel III risk weights tool



Effective Date and Transitional Arrangements

Community banking organizations will become subject to U.S. Basel III beginning on January 1, 2015. Certain aspects of U.S. Basel III will take effect immediately on that date, including new minimum risk-based capital ratios, revisions to the capital thresholds in the prompt corrective action framework and the new risk weights regime. Other aspects of U.S. Basel III will be phased in over several years, including new deductions from and adjustments to regulatory capital and the new capital conservation buffer. **Figure 8** provides an overview of the key transitional arrangements for community banks under U.S. Basel III.

Figure 8



Learning More About U.S. Basel III

If you are interested in learning more about U.S. Basel III and its impact on your bank, we invite you to visit Davis Polk’s Basel III resources website, www.USBasel3.com, where you can access our webcasts, visual memos, web tools and other materials on U.S. Basel III and other capital-related topics.