Revised Regulatory Capital Rules, Part 324 (Basel III) – Job Aid for Examiners

This job aid summarizes many of the key changes with the Regulatory Capital Final Rule issued by the Federal Reserve Board on July 2, 2013. The rule was adopted as an interim final rule and codified at Title 12 of the CFR for the FDIC in Part 324. Generally, the revised capital rules require institutions to hold more and higher quality capital. Community banking organizations are subject to the new rule beginning January 1, 2015, though many aspects of it phase in over several years.

- Interagency Community Bank Guide to the New Capital Rule
- Expanded Community Bank Guide to the New Capital Rule for FDIC-Supervised Banks
- Part 324: September 3, 2014 Final Rule: Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio
- CSBS Brainshark Module: Revised Definition of Capital & Capital Conservation Buffer
- CSBS Brainshark Module: Standardized Approach to Risk Weighted Assets
- FDIC: Regulatory Capital page
- FDIC: Capital Estimation Tool

Capital Ratios and Prompt Corrective Action (PCA)

Ratios take effect January 1, 2015

<table>
<thead>
<tr>
<th>Category</th>
<th>Total RBC Ratio</th>
<th>Tier 1 RBC Ratio</th>
<th>CET1 RBC Ratio</th>
<th>Tier 1 Leverage Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well-capitalized</td>
<td>&gt;10%</td>
<td>&gt;8%</td>
<td>&gt;6.5%</td>
<td>&gt;5%</td>
</tr>
<tr>
<td>Adequately capitalized</td>
<td>&gt;8%</td>
<td>&gt;6%</td>
<td>&gt;4.5%</td>
<td>&gt;4%</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>&lt;8%</td>
<td>&lt;6%</td>
<td>&lt;4.5%</td>
<td>&lt;4%</td>
</tr>
<tr>
<td>Significantly undercapitalized</td>
<td>&lt;6%</td>
<td>&lt;4%</td>
<td>&lt;3%</td>
<td>&lt;3%</td>
</tr>
<tr>
<td>Critically undercapitalized</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Tier 1 Capital + outstanding non-Tier 1 perpetual preferred stock

Transition Schedule for New or Revised Capital Ratios

<table>
<thead>
<tr>
<th>Year (as of Jan.)</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Common Equity Tier 1 (CET1) Ratio</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Capital Conservation Buffer</td>
<td>N/A</td>
<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.5%</td>
</tr>
<tr>
<td>CET1 plus capital conservation buffer</td>
<td>4.5%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7%</td>
</tr>
<tr>
<td>Phase-in % of deductions from CET1—whereas 100% is fully phased-in</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Minimum Tier 1 Capital Ratio</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>Minimum Tier 1 Capital Ratio plus capital conservation buffer</td>
<td>N/A</td>
<td>6.625%</td>
<td>7.25%</td>
<td>7.875%</td>
<td>8.5%</td>
</tr>
<tr>
<td>Minimum Total Capital</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Minimum Total Capital plus capital conservation buffer</td>
<td>N/A</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

(*) Including threshold deduction items that are over the limits

New Concept - Capital Conservation Buffer

The Capital Conservation Buffer (CCB) requires all banks to hold additional capital or face restrictions on certain capital distributions, including dividends, discretionary payments on Tier 1 instruments, share purchases, and discretionary executive officer bonuses.

- The payout ratio is based upon a percentage of the previous four quarters’ combined net income (less any capital distributions not reflected in net income).

<table>
<thead>
<tr>
<th>Capital Conservation Buffer (as a % of RWA)</th>
<th>Maximum Payout Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 2.50%</td>
<td>No payout limitation</td>
</tr>
<tr>
<td>1.875% - 2.50%</td>
<td>60%</td>
</tr>
<tr>
<td>1.25% - 1.875%</td>
<td>40%</td>
</tr>
<tr>
<td>0.625% - 1.25%</td>
<td>20%</td>
</tr>
<tr>
<td>&lt; 0.625%</td>
<td>0%</td>
</tr>
</tbody>
</table>

- A bank’s CCB equals the smallest difference between each of the bank’s three risk-weighted capital ratios and their respective regulatory minimum (including the current CCB phase-in amount).
- Subchapter S banks that fail to meet CCB minimums may be prevented from paying shareholder taxation dividends. See FDIC FIL 40-2014 for information on these restrictions.

New Concepts – Common Equity Tier 1 Capital

- Common Equity Tier 1 Capital includes:
  - Common Stock;
  - Surplus;
  - Retained Earnings;
  - AOCI (if the bank did not opt out of this treatment);
  - Qualifying CET1 minority interests; and
  - Common stock issued as part of an ESOP.
- Less: Regulatory adjustments and deductions
  - Intangibles/goodwill;
  - Deferred tax assets arising from NOL and tax credit carry-forwards;
  - Any gain on sale in connection with securitizations; or
  - Aggregate amount of bank’s equity investment in its consolidated financial subsidiaries (if significant—see reverse).

- Mortgage servicing assets, deferred tax assets, and investments in financial institutions, collectively, are limited to 15% of CET1; and 10% of CET1 individually.
Risk-Weighting Asset Changes (effective 1/1/15)

- Cash on Deposit at the bank or 3rd party custodian: 0%
- 1-4 Family Residential RE:
  - 50% (if first lien and not PD > 90 days, NA, or TDR)
  - 100% for everything else
- All Other Loans:
  - Unchanged (20%, 50%, 100%) depending on type
  - 150% if NA, PD > 90 days (less any portions federally-guaranteed or backed by financial collateral)
- High Volatility CRE (HVCRE): 150%
  - HVCRE does not include:
    - 1-4 Family Residential Projects
    - Loans for Agricultural Purposes
    - Community Development Loans
    - Certain ADC loans (*)
- Equity exposures: 0%-600% (depending on type)
  - Use the Simple Risk-Weight Approach (SRWA)
  - See table 8 in Expanded Community Bank Guide
- Structured Securities (TruPs, private label MBS, etc):
  - 20% – 1,250% depending on SSFA (more at right)
- Unused Commitments – credit conversion factors:
  - 0% for those that are unconditionally cancellable
  - 20% for those maturing in one year or less
  - 50% for those maturing in more than one year
- Non-Significant and Significant Investments in Capital Instruments of Financial Institutions (see discussion below).

(*) ADC loans that meet the following are not HVCRE:
- LTV is below supervisory limits; and
- Borrower has contributed 15% or more of “as completed” AV in cash or unencumbered readily marketable assets; and
- Borrower contributed capital is contractually committed until completion.

Investments in Capital Instruments of Other Financial Institutions

- See supplemental flowchart (p. 49 of the Final Rule).
- Banks must first determine if the investment in a capital instrument of an unconsolidated financial institution is ‘significant’ or ‘non-significant.’
- Non-significant: 10% or less of the issued and outstanding common stock. If so, investments in all types of capital instruments of the subject institution would be deemed non-significant.
- Significant: More than 10% of the issued and outstanding common stock. If so, investments in all types of capital instruments would be deemed significant.
- By statute, the following are not considered a financial institution:
  - Government Sponsored Entities (GSE)
  - Small Business Investment Companies (SBIC)
  - Community Development Financial Inst. (CDFI)
  - Mutual funds registered with SEC
  - Employee Stock Ownership Plans (ESOP)
- Capital treatment for Significant and Non-Significant investments differs.
  - Both are limited to 10% of CET1; any excess must be deducted from capital.
  - Risk weight remaining amounts according to the type of investment (refer to Section 22(c)(4)).

Risk-Weighting Approaches (effective 1/1/15)

- Subpart D, section 41 enhances due diligence requirements for banks that own, originate, or purchase securitization exposures, generally those exposures that involve tranches of credit risk. For these exposures, the ratings-based approach is no longer available, leaving three alternative approaches to risk-weighting:
  - Gross-up approach;
  - Simplified Supervisory Formula Approach (SSFA); and
  - Apply a 1,250% risk-weight.
- Important note: Mortgage-backed pass-through securities issued by FHLMC or FNMA do not meet the definition of a securitization exposure because they do not involve credit risk tranching. Other investments that do meet the definition of a securitization exposure but are guaranteed by the U.S. Government or GSEs are not rated differently under the revised rules:
  - Unconditionally guaranteed (GNMA): 0%
  - Conditionally guaranteed (FNMA/FHLMC): 20%
- Privately issued mortgage-backed securities and all other securitization exposures require risk-weighting using one of the approaches listed above.
- For any securitization exposure, the final rule provides that if management is unable to demonstrate understanding of an investment, regulators may require a risk-weight of 1,250% (also referred to as dollar-for-dollar capital).
- Banks using the FHLL’s MFP 100 program are creating a securitization exposure.
  - Banks in this program have a secondary loss interest. FHLL takes the first 2%, the bank takes the next 2%
  - Therefore, banks selling mortgage loans to FHLL under this program will need to hold capital against these exposures – possibly at 1,250%

More Information on the SSFA

- SSFA is a non-ratings-based formula that applies higher capital requirements for more junior tranches in a securitization. This approach calculates a risk-weight based on several criteria:
  - Weighted average risk of underlying collateral;
  - Relative size & seniority of a particular security in a structure;
  - Delinquency level of underlying securities; and
  - Attachment/detachment points for tranche cash flows.
- Values are entered into a SSFA formula calculator and it produces a risk-weight for the tranche.
- Data must be current and in no event more than 91 days old.
- The formula is described in detail in the final rule, so learning the formula is not necessary for most examiners. Banks using the SSFA will likely use one of the many available calculators online, or through their investment brokers.