



Alerts

FRB, FDIC and OCC Issue Proposals Revising Bank Regulatory Capital Requirements and the Risk-Weighted Asset Rules

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Hinshaw Alert

On June 7, 2012, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (the Agencies) issued proposed rules (<http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm>) that would revise bank regulatory capital requirements and the risk-weighted asset rules. These rules represent the most extensive changes to bank capital requirements in recent memory.

The rules will extend large parts of a regulatory capital regime to all U.S. banks and their holding companies, other than the smallest bank holding companies (generally, those with less than \$500 million in consolidated assets).

Comments on the rules are due by September 7, 2012. The rules are expected to go into effect on January 1, 2013. However, in some situations full compliance with the rules would not be required until January 1, 2019.

This memo briefly highlights some of the more important changes proposed by these two rules. A more detailed discussion may be found [here](#).

The first rule (the Capital Rule) would, among other things:

- revise the definition of regulatory capital components and related calculations, which would include conservative guidelines for determining whether an instrument could qualify as regulatory capital;
- add common equity Tier 1 capital as a new regulatory capital component;
- increase the minimum Tier 1 capital ratio requirement;
- create a capital conservation buffer that would limit payment of capital distributions and certain discretionary bonus payments to executive officers if the institution does not hold enough common equity Tier 1 capital;
- provide for a transition period for several aspects of the rule; and
- incorporate the new and revised regulatory capital requirements into the prompt corrective action rules.

The second rule (the Risk-Weighted Asset Rule) would expand the number of risk-weighted categories and increase the required capital for certain categories of assets, including higher-risk residential mortgages and higher-risk construction real estate loans. This rule would, among other things:

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- revise risk weights for residential mortgages based on loan-to-value (LTV) ratios and certain loan characteristics, assigning risk weights between 35 and 200 percent;
- increase capital requirements for past-due loans from 100 to 150 percent and set the risk weight for high volatility commercial real estate loans at 150 percent; and
- revise the risk-weighted percentage for unused commitments with an original maturity of one year or less from 0 to 20 percent unless the commitment is unconditionally cancelable by the bank.

The Risk-Weighted Asset Rule will apply to all U.S. banks and savings banks and almost all of their holding companies, although smaller, “noncomplex” banking organizations will not need to comply with some of the rule’s requirements. The rule would be effective on January 1, 2015.

Important Changes

The Capital Rule

The Capital Rule proposes definitions of common equity Tier 1 capital, additional Tier 1 capital, and total capital. Under the proposed definitions, noncumulative perpetual preferred stock, which now qualifies as Tier 1 capital, would not qualify as common equity Tier 1 capital, but would qualify as additional Tier 1 capital. Cumulative preferred stock and trust preferred securities would not qualify as Tier 1 capital of any kind but may qualify as Tier 2 capital. Generally, an instrument that allows the accumulation of interest would not be considered Tier 1 capital. The revision may impact outstanding trust preferred securities in that it may permit or require a call or redemption of these securities.

Under the Capital Rule revisions, other hybrid or innovative capital instruments will probably not qualify as common equity Tier 1 capital. Some of these instruments may qualify as additional Tier 1 capital.

Instruments that are accounted for as liabilities under Generally Accepted Accounting Principles (GAAP) would not qualify as additional Tier 1 capital. For an instrument to qualify as additional Tier 1 capital, it must be accounted for as equity under GAAP.

Capital Conservation Buffer. The Capital Rule creates a “capital conservation buffer.” The buffer would limit an institution’s ability to make “capital distributions” and “discretionary bonus payments” to executive officers unless the organization has sufficient capital over and above its minimum capital requirements. In effect, this provision requires that an institution maintain the following ratios in order to be able to make such payments: common equity Tier 1 – 7 percent; Tier 1 capital – 8.5 percent; and Tier 1 leverage ratio – 10.5 percent.

Risk-Weighted Asset Rule

1-4 family Residential Mortgages. Under the Risk-Weighted Asset Rule, residential mortgages 1-4 would be separated into two risk categories based on certain product and underwriting characteristics:

- “category 1 residential mortgage exposures” and
- “category 2 residential mortgage exposures.”

Category 1 residential mortgage exposures would generally include traditional, first-lien, prudently underwritten mortgage loans. Category 2 residential mortgage exposures would generally include junior liens and nontraditional mortgage products.

Category 1 mortgages would be assigned risk weights from 45 to 100 percent, while category 2 mortgages would be assigned risk weights of 50 to 200 percent.

HVCRE. The rule would assign a 150 percent risk weight to high-volatility commercial real estate loans (HVCRE). An HVCRE is defined as a credit facility that finances or has financed the acquisition, development or construction (ADC) of real property, unless the facility finances:



- One- to four-family residential properties; or
- Commercial real estate projects in which:
 - The LTV ratio is less than or equal to the applicable maximum supervisory LTV ratio;
 - The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised "as completed" value; and
 - The borrower contributed the amount of capital required by this definition before funds have been advanced under the credit facility, and the capital contributed by the borrower—or internally generated by the project—is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Permanent financing may be provided by the organization that provided the ADC facility as long as the permanent financing conforms with the organization's underwriting criteria for long-term mortgage loans.

Past Due Loans. A 150 percent risk weight would be assigned to loans and other exposures that are 90 days or more past due or on nonaccrual status that are not guaranteed or secured as provided in the rule. This would apply to all loans except for the following:

- 1-4 family residential exposures (1-4 family loans over 90 days past due and are in Category 2 and would be risk-weighted as described above in **Risk-Weighted Asset Rule – 1-4 Family Residential Mortgage Loans.**)
- A sovereign exposure where the sovereign has experienced a sovereign default.

Unused Commitments. The risk-weighted percentage for unused commitments would increase from 0 to 20 percent unless the commitment is unconditionally cancelable by the bank.

For further information, please contact [Tim Sullivan](#), [Michael D. Morehead](#) or your regular [Hinshaw attorney](#).

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