Basel III - Capital Planning for Financial Institutions

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The banking industry has been dealing with the imposition of international standards for bank capital since the 1988 capital accord known formally as the "International Convergence of Capital Measurement and Capital Standards" and informally as "Basel I." Basel II, or the "International Convergence of Capital Measurement and Capital Standards; A Revised Framework," was adopted in 2004 and followed by revisions in 2005, 2009 and 2010.

"Basel III; A Global Regulatory Framework for More Resilient Banks and Banking Systems" was adopted in December 2010, and formed the basis for several far-reaching capital proposals by federal banking agencies in June 2012, referred to herein generally as "Basel III."

Most bankers paid little serious initial attention to Basel III, assuming that it was focused on large multinational "systemic risk" financial institutions. However, upon the release of federal agency notices of proposed rulemakings in June (the NPRs) relating to implementation of Basel III, it became clear that Basel III, if adopted, would have a far-reaching impact on all U.S. banks, thrifts and holding companies. Mutuals would have special challenges in meeting the new requirements if they are adopted.

The initial comment date for the NPRs was September 7, 2012. Given the strong response by the industry and by certain bank regulators, including the Conference of State Bank Supervisors, the comment date was extended to October 22, 2012. Commentaries generally focused on the potential impact on community bank organizations in terms of capital management, access to capital, compliance costs, the impact on products and services and a number of possibly unintended consequences of the NPRs on community banks and thrifts.

The NPRs would replace the federal banking agencies' existing general risk-based capital rules, establish consolidated regulatory capital requirements for bank and savings and loan holding companies and restructure the capital rules into a more standardized regulatory capital

framework. While the NPRs would not apply (at least initially) to bank holding companies that are subject to the Federal Reserve Board's Small Bank Holding Company Policy Statement (generally non-complex holding companies with less than $500 million in consolidated assets), they would apply to all banks, savings associations and savings and loan holding companies, irrespective of size or complexity.

So what is Basel III and what is the potential impact of the NPRs on financial institutions generally?

New Definitions and Levels of Capital. The NPRs would change capital standards to increase the quantity and quality of regulatory capital through a new common equity tier 1 (CET1) ratio, an increase in the minimum tier 1 capital ratio and a more strict set of minimum eligibility criteria for regulatory capital instruments. It would also establish a new "capital conservation buffer," and update the "prompt corrective action" (PCA) thresholds accordingly.

CET1. Under the NPRs, CET1 would be composed primarily of common stock and retained earnings. Deductions from CET1 would include goodwill and other intangibles except mortgage servicing assets, deferred tax assets that arise from operating losses and tax credit carry-forwards, certain defined benefit pension fund assets and investments in own stock. Amounts individually exceeding 10% of CET1 as well as amounts that collectively exceed 15% of CET1 would be deducted. The deductions would be phased-in from 2014 to 2018.

Additions to Tier 1 Capital. The NPRs would effectively remove cumulative preferred and trust-preferred-like instruments from Tier 1 capital. Acceptable additional Tier 1 capital would be primarily non-cumulative perpetual preferred issues. Phase-out of non-qualifying capital instruments by 2016 for holding companies with at least $15 billion in assets, and by 2022 for all others.

Leverage Ratios. All banks would be required to maintain a 4% minimum tier 1 leverage ratio using the new definition of tier 1 capital. The current 3% minimum for 1-rated institutions would be eliminated.

Minimum Risk-based Capital Ratios. The proposed minimum risk-based capital ratios (capital to risk-weighted assets; RWAs) slated for phase in from 2013 to 2015 are:

- CET1 to total RWAs; 4.5% (new requirement)
- Tier 1 capital to total RWA; 6% (increased from present 4%)
- Total capital to total RWA; 8% (no change)

Capital Conservation Buffer. The NPRs would implement a new concept intended to incent institutions to remain above capital minimums in stress situations called a "capital conservation buffer" (CCB). A CCB of more than 2.5% CET1 would be required, in addition to minimum risk-based capital ratios, to avoid restrictions on capital distributions and discretionary bonus payments to executive officers. In short it would be a stipulated "safety net" below which institutions will be restricted with regard to dividends and executive compensation. The CCB proposal does not establish a "cliff" below which none of the foregoing is permitted, but rather provides a gradient scale which will adversely impact the foregoing if the CCB is below 2.5%.

An institution's CCB would be the lowest of the institution's; (1) CET1 capital ratio minus the minimum CET1 capital ratio of 4.5%; (2) tier 1 capital ratio minus the minimum tier 1 capital ratio of 6%; and (3) total capital ratio minus the minimum total capital ratio (8%).

Therefore, risk-based capital ratios plus the minimum CCB would then be; (1) CET1 Capital/RWAs of 7.0%, (2) Tier 1 Capital/RWAs of 8.5%, and (3) Total Capital/RWAs of 10.5%.

The CCB would be phased in from 2016 to 2019.

Revisions to Prompt Corrective Action Requirements. Regulatory "prompt corrective action" (PCA) thresholds would be revised for consistency with the new capital requirements. PCA thresholds are those capital thresholds which, by statute, require agency enforcement and other actions. The revised PCA requirements would be effective in 2015.

New Standards for RWAs. The NPRs would involve new and more risk-sensitive qualifications for RWAs to take effect by 2015, with the option to adopt earlier. Current risk weightings would remain for some exposures including government issues, most corporate issues, most commercial mortgages and retail. However, important changes would involve residential mortgage exposures with a range of risk weight categories from 35% to 200% based on LTV ratios, performance and mortgage product features. CRE exposures classified as highly volatile and related to acquisition, construction and development financing would have a risk weight of 150% as would exposures more than 90 days past due or on nonaccrual. Most short-term off-balance sheet commitments would be rated at 20% as opposed to the current zero percent. Securitizations where the institution is unable to demonstrate a certain level of due diligence and understanding of the material risks would carry a risk weighting of 1,250%. Equity exposures would be weighted at 300% or 400%. Interestingly, sovereign debt has a 0% risk weighting.

The NPRs would recognize certain mitigating factors such collateral and guarantees in assessing RWAs, and special treatment for derivatives and repos with central counterparties. There are special provisions with regard to insurance underwriting activities with policy loans weighted at 20%.

Reactions to Basel III. The industry reaction to Basel III and the relevant NPRs has been strong and adverse, particularly in regard to non-systemically important institutions. Industry participants have complained that the proposals are reactionary and punitive, and have pointed out the unintended consequences on the availability of credit in the community due to the adverse impact on products and funding from residential and commercial mortgage lending and HELOCs to significantly increased compliance complexity and costs, additional difficulties in attracting capital, forced industry consolidation, reduction in competition, reduction in access to credit generally, formula volatility and the adverse impact on short-term funding.

The Conference of State Bank Supervisors objected to the proposals in a letter dated October 3, 2012, and a bipartisan group of 53 members of the U.S. Senate voiced objections to the agencies in a September letter. State and national trade associations (and their members) have also voiced their collective objections, as well as a number of other industry participants. The Comptroller of the Currency and Chairman Hoenig of the FDIC have also voiced concerns over the universal applicability of the NPRs.

In light of the industry outcry and over 2,000 comment letters, Congressional and Senate committees have set hearings on the impact of Basel III. On November 9, the three federal banking agencies issued a guidance stating that they do not expect that any of the rules proposed will be effective on January 1, 2013.

At a Senate Banking Committee hearing on November 14, 2012, representatives of the Federal Reserve, FDIC and OCC promised additional review and analysis of the proposals prior to any further action, particularly with respect to the impact on smaller community banks. The regulators cautioned, however, that the need for stronger capital requirements remains.

As a result, as of the date hereof the imposition of Basel III through the NPRs is temporarily "on hold" pending further study.

Practical Capital Planning. No matter what ultimately happens with the Basel III NPRs, institutions need to consider capital planning seriously and anticipate further upward pressure on capital. Mandatory stress testing, the Federal Reserve's capital retention supervisory guidances of November 17, 2010, and March 27, 2009 impact payment of dividends, stock redemptions and stock repurchases for institutions and other agency initiatives all point to generally higher capital expectations going forward, although perhaps not as complex and structured so as to deter certain types of lending and discourage investment.

Conclusions. As a practical matter, the agencies have been "unofficially" imposing heightened capital requirements on institutions where they feel capital may not be adequate through the examination and enforcement process for several years, setting what some have argued are higher de facto capital requirements already. Careful capital planning will continue to be closely watched by banking agencies and the markets going forward, and will be a "must" for all banking institutions including through the results of "stress tests." Agencies will be looking for evidence of capital planning in the examination process, and will impose additional requirements in that respect, as they have been, for institutions where the agencies have concerns.

Regardless of the outcome of the Basel III NPRs, expectations of more and higher "quality" capital have been on the radar scope for some time, and institutions which choose not to plan for increased capital requirements and document that planning do so at their peril.