

### Introduction

On July 2, 2013, the Board of Governors of the Federal Reserve System approved final regulatory capital rules, which reflect the largest change to capital rules since the late 1980s. Community banking organizations become subject to the revised capital framework on January 1, 2015.<sup>1</sup> The recent financial crisis brought to light the need for larger amounts of loss-absorbing capital during times of stress. Indeed, a major goal of the revision is to improve the level and quality of capital, and to better reflect banking organizations' risk profiles. This *FedLinks* document will not address all elements of the new capital rule, but it will highlight some key changes and areas of supervisory focus.

The federal banking agencies<sup>2</sup> have prepared a *New Capital Rule: Community Bank Guide*.<sup>3</sup> The purpose of the guide is to help community bankers understand the major changes to the capital rules, highlighting the implications

for bank management and looking at areas of potential focus in bank supervision. Some of the changes have implications for on-going data collection and regulatory reporting, as well as for capital planning, including payment of dividends and capital issuance. In addition, the changes to the treatment of hybrid capital instruments may be significant for bank holding companies (BHCs) that are subject to consolidated capital rules and that are required to file the *Consolidated Financial Statements for Holding Companies* report (FR Y-9C).<sup>4</sup>

### Planning for the New Requirements

A banking organization's capital policies will need to reflect the changes in regulatory capital ratios and in the prompt corrective action (PCA) framework for insured depository institutions, as well as to introduce the capital conservation buffer. Reports used by a banking organization's board of directors and senior management for oversight will need to reflect these changes as well. To improve the quality of loss-absorbing capital there is a new component of tier 1 capital called common equity tier 1 (CET1), which must equal 4.5 percent of risk-weighted assets (RWAs). In addition, the minimum tier 1 risk-based capital ratio has been increased to 6 percent. The PCA framework incorporates the new CET1 ratio and the increase in the minimum tier 1 risk-based ratio.

The capital conservation buffer is intended to provide incentives for banking organizations to hold sufficient capital to reduce the risk that their capital levels would fall below their minimum requirements during a period of financial stress. A banking organization's ability to make capital distributions and discretionary bonus payments under the capital conservation buffer framework depends on the amount by which its capital buffer exceeds the three minimum risk-based capital requirements. A management report that shows the calculation of the buffer could be used for oversight and compliance purposes (illustrated in Table 1 on page 2). In this example, the capital conservation buffer is 1.0 percent.

- 1 The rule took effect for banking organizations subject to the advanced approaches capital rules on January 1, 2014. Community banks will need to indicate their accumulated other comprehensive income (AOCI) opt-out election choice in the March 31, 2015 Call Report. This election is to neutralize the effects of unrealized gains and losses from available-for-sale securities and other elements of the AOCI account.
- 2 The federal banking agencies include the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.
- 3 The *New Capital Rule: Community Bank Guide* is available at [www.federalreserve.gov/bankinforeg/basel/files/capital\\_rule\\_community\\_bank\\_guide\\_20130709.pdf](http://www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf).
- 4 The FR Y-9C report collects basic financial data from domestic bank holding companies, savings and loan holding companies, and securities holding companies on a consolidated basis in the form of a balance sheet, an income statement, and detailed supporting schedules, including a schedule of off balance-sheet items. The reporting form and instructions are available at [www.federalreserve.gov/apps/reportforms/default.aspx](http://www.federalreserve.gov/apps/reportforms/default.aspx).

*FedLinks* is intended to highlight the purpose of supervisory policy and guidance for community banking organizations. *FedLinks* does not replace, modify, or establish new supervisory policy or guidance.

Table 1: Capital Conservation Buffer Calculation Example

	CET1 /RWA	Tier 1 /RWA	Total Capital /RWA
Bank's Capital Ratios	7.5%	8.5%	9.0%
Subtract Minimum Capital Requirements	- 4.5%	- 6.0%	- 8.0%
Lowest Result is the Capital Conservation Buffer	= 3.0%	= 2.5%	<b>= 1.0%</b>

The interaction between the size of the buffer and the maximum payout of eligible retained income is illustrated in Table 2. In the example in Table 1, because the capital conservation buffer is 1.0 percent, the banking organization would have a maximum payout of 20 percent of its eligible retained income<sup>5</sup>.

Table 2: Capital Conservation Buffer and Maximum Dividend Payout

Capital Conservation Buffer (% of risk-weighted assets)	Maximum Payout (% of eligible retained income)
Greater than 2.5%	No payout ratio limitation applies
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

Table 3 compares the current capital requirements with the requirements that will be in effect on January 1, 2015, and the fully phased-in capital conservation buffer requirement as of January 1, 2019. It also compares PCA thresholds with the minimum capital requirements plus the capital conservation buffer, which is not part of the PCA framework.

Table 3: Minimum Capital Requirements and PCA Levels<sup>6</sup> - Comparison of Current and New Rules

Ratios (Column A)	2013 Current Rules Minimum Requirements = PCA Adequately Capitalized (Column B)	2013 Current Rules PCA Well Capitalized (Column C)	2015 New Rules Minimum Requirements = PCA Adequately Capitalized (Column D)	2015 New Rules PCA Well Capitalized (Column E)	2019 New Rules Minimum Requirements + 2.5% Capital Conservation Buffer (Column F)
Leverage Ratio	3.0% / 4.0%	5.0%	4.0%	5.0%	N/A
Minimum CET1 Capital	N/A	N/A	4.5%	6.5%	7.0%
Minimum Tier 1 Capital	4.0%	6.0%	6.0%	8.0%	8.5%
Minimum Total Capital	8.0%	10.0%	8.0%	10.0%	10.5%

<sup>5</sup> Table 1 uses the fully phased-in capital conservation buffer. Table 4 on page 3 illustrates the transition schedule for the buffer. See also Attachment 1. Subpart G to the new rule provides maximum payout ratios during the transition period. The final capital rule is at [www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf](http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf).

<sup>6</sup> This table applies to banking organizations that are not subject to the advanced approaches rule. PCA applies solely to insured depository institutions.

PCA minimums for adequately capitalized

Capital ratios required to avoid limitations on capital distributions

**Table 4: Transition Schedule for New Ratios and Capital Definitions**

<b>Ratios</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
Leverage Ratio	4.0%	4.0%	4.0%	4.0%	4.0%
Minimum CET1 Capital Ratio	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer (composed of CET1)	N/A	0.625%	1.25%	1.875%	2.5%
Minimum CET1 + Capital Conservation Buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of Most Deductions from CET1	40%	60%	80%	100%	100%
Minimum Tier 1 Capital	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Tier 1 Capital + Capital Conservation Buffer	6.0%	6.625%	7.25%	7.875%	8.5%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital + Capital Conservation Buffer	8.0%	8.625%	9.25%	9.875%	10.5%

*Shading indicates transition periods – all dates are as of January 1.*

While banking organizations subject to consolidated capital rules must meet the minimum requirements on January 1, 2015, certain deductions and adjustments to the calculations are phased in over time,<sup>7</sup> as illustrated in Table 4. The calculations will require good internal controls and supporting documentation. A banking organization’s management will need to review the calculations for accuracy and compliance with the revised capital framework. For capital planning, the banking organization’s management will need to be aware of the changes in calculations during the transition periods and understand the implications of the revised framework for capital issuances and distributions.

An example of the deductions from capital that change during the transition period is the deduction from CET1 of deferred tax assets (DTAs) that arise from operating loss and tax credit carry-forwards, which is phased in over three years. In 2015, a bank would deduct 40 percent of this amount from CET1 and 60 percent from tier 1 capital. Between January 1, 2015, and January 1, 2018, the percentage deducted from CET1 will gradually increase each year, while the percentage deducted from tier 1 capital will decrease, until the full amount will be deducted from CET1. Another example is mortgage servicing as-

sets (MSAs), which will be subject to a 10 percent individual/15 percent aggregate of the CET1 threshold limit.<sup>8</sup> The amount over these limits that must be deducted from CET1 is phased in over time. In 2015, 40 percent of the amount above the 10 percent/15 percent limit will be deducted from CET1. Also, the amount that is within the 10 percent/15 percent limit is risk-weighted at 100 percent until 2018, at which time it will be risk-weighted at 250 percent.

## Capital Planning and Business Strategy

The changes in the capital rules will affect capital planning and business strategy in various ways. The introduction of the new component of tier 1 capital, CET1, and the change in allowable tier 1 instruments do not represent large changes at the bank level, where, for many community banks, the majority of tier 1 capital is comprised of common stockholders’ equity. The new rule does, however, require a change at the BHC level for those BHCs that are subject to consolidated capital requirements. While certain hybrid capital instruments are grandfathered in tier 1 capital for BHCs under a certain size, for future capital issuances, BHCs will need to consider new definitions for CET1, tier 1, or tier 2 capital instruments. Trust preferred securities (TruPS) were the most common type of hybrid capital issued in the past by BHCs. TruPS and cumulative perpetual preferred stock issued prior to May 19, 2010, by BHCs with total consolidated assets of less than \$15 billion as of December 31, 2009, are grandfathered in tier 1 capital.

<sup>7</sup> Subpart G of the final capital rule discusses all of the transition provisions. The final capital rule is at [www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf](http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf).

<sup>8</sup> MSAs in aggregate with DTAs arising from timing differences and significant investments in the capital of unconsolidated financial institutions are subject to the 15 percent of CET1 threshold limit.

When planning for an acquisition, banking organizations need to consider the treatment of non-qualifying capital instruments that have been grandfathered as tier 1 capital, as the grandfathering may be lost under certain acquisition scenarios. For example, if an acquisition results in an organization with total consolidated assets of \$15 billion or more, these non-qualifying instruments will be subject to phase out.<sup>9</sup> Likewise, when making dividend payments and other distributions of capital, such as repurchase of capital instruments, an institution will need to take into account the capital conservation buffer framework.

Changes in certain risk weights also have the potential to affect a banking organization's balance sheet strategy. One example is investments in securitizations, such as non-agency mortgage-backed securities, where the risk weight is no longer based on external credit ratings. This is discussed in more detail below.

## Risk-Weighting Changes and Data Requirements

The revised capital framework creates a subset of commercial real estate (CRE) loans called high-volatility CRE (HVCRE). HVCRE loans are acquisition, development, or construction (ADC) loans, with the following exclusions:

- ADC loans for 1-4 family residential properties;
- The purchase or development of agricultural land for agricultural purposes;
- Loans that would qualify as community development or as a “qualified investment;” or,
- ADC loans where:
  - Loan-to-value (LTV) is at or below the maximum supervisory LTV;
  - Borrower has contributed capital of at least 15 percent of the “as completed” appraised value; and,

- Borrower capital is required to remain throughout the project life.

Banking organizations that have ADC loans will have to review their portfolios to determine whether any loans fall into the new HVCRE category, which will receive a risk weight of 150 percent. Banking organizations with such loans will also need to conduct ongoing monitoring of their characteristics to determine whether the loans migrate into the HVCRE category over time. This will likely entail collecting and reviewing for accuracy additional data about CRE loans.

Another significant change in risk weights will affect past-due exposures for loans, other than loans for 1-4 family residential mortgages, and HVCRE loans, which will already be risk-weighted at 150 percent. Assets that are 90 days or more past-due or on non-accrual will be risk-weighted at 150 percent. That portion of the loan that has a certain type of guarantee or collateral, such as cash on deposit, is not subject to the higher risk weight.

The revised capital framework eliminates the use of external credit ratings to assign risk weights, which will have the most significant effect on securitizations.<sup>10</sup> A banking organization must decide to use either the simplified supervisory formula approach (SSFA) or the gross-up approach to assign a risk weight to its securitization portfolio, such as its investments in non-agency mortgage-backed securities. A banking organization also has the option of applying a risk weight of 1,250 percent. The SSFA and the gross-up approach require the use of current data about the securitization. Investments in securitizations will also require ongoing due diligence based upon the complexity of the investment and materiality in relation to capital.

<sup>9</sup> Subpart G of the final rule discusses non-qualifying capital instruments and mergers and acquisitions.

<sup>10</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 directed the banking agencies to eliminate reliance on external credit ratings from their regulations.

## What Will Happen on a Bank Examination

Examiners who are evaluating capital will review the banking organization's Call Report work papers. If a potential capital deduction or risk-weighting is material or complex, there may be more in-depth review to ensure both accuracy and compliance with the capital guidelines. Those deductions and risk weights that have been changed in the revised capital framework may also receive the attention of an examiner who will want to ensure the banking organization is aware of the changes and is implementing them correctly. To ensure accuracy, examiners will also evaluate the bank's process for regulatory reporting of capital, including internal controls.

DTAs and MSAs are an example of a change in capital treatment that could be complex for a banking organization to implement. If a banking organization has material DTAs, especially DTAs resulting from a net operating loss, an examiner may review the capital treatment. The current capital rules do limit DTAs that are dependent on future taxable income to the lesser of those DTAs that the banking organization is expected to realize within one year or 10 percent of tier 1 capital. Under the new rules, DTAs that arise from net operating loss and tax credit carry-forwards net of any related valuation allowances and net of deferred tax liabilities (in other words, DTAs that are dependent on future taxable income) are deducted from CET1. DTAs arising from temporary differences that cannot be realized through net operating loss carrybacks are limited to 10 percent of CET1. A banking organization is not required to deduct from CET1 DTAs arising from timing differences that it can realize through net operating loss carrybacks.

If a banking organization does ADC lending, examiners will look at the process for determining whether the loan falls into the HVCRE category at origination and over time. A credit may not be HVCRE at origination, but could migrate over time as LTV changes, or if the borrower extracts capital from a project.

Material investments in securitizations will likely attract examiner attention. If the banking organization uses either the SSFA or gross-up approach, the examiner will review the accuracy of the calculation and the use of current data. An examiner will also review the banking organization's process for ongoing monitoring of the credit quality of a securitization.

## Resources

FFIEC 041 Call Report forms and instructions, including proposed forms and instructions are available at:

[www.ffiec.gov/forms041.htm](http://www.ffiec.gov/forms041.htm).

FR Y-9 forms and instructions proposed for public comment, pending review of public comment, and recently implemented are available at:

[www.federalreserve.gov/apps/reportforms/review.aspx](http://www.federalreserve.gov/apps/reportforms/review.aspx).

Existing FR Y-9 forms and instructions are available at:

[www.federalreserve.gov/apps/reportforms/default.aspx](http://www.federalreserve.gov/apps/reportforms/default.aspx).

**Transition Provisions for the Capital Conservation Buffer and Payout Ratio**

<b>2016</b>	
<b>Capital Conservation Buffer (CCB) (as a % of RWA)</b>	<b>Maximum Payout Ratio (as a % of eligible retained income)</b>
CCB > 0.625	No limitation
$0.625 \geq \text{CCB} > 0.469$	60%
$0.469 \geq \text{CCB} > 0.313$	40%
$0.313 \geq \text{CCB} > 0.156$	20%
$0.156 \geq \text{CCB}$	0%

<b>2017</b>	
<b>Capital Conservation Buffer (CCB) (as a % of RWA)</b>	<b>Maximum Payout Ratio (as a % of eligible retained income)</b>
CCB > 1.25	No limitation
$1.25 \geq \text{CCB} > 0.938$	60%
$0.938 \geq \text{CCB} > 0.625$	40%
$0.625 \geq \text{CCB} > 0.313$	20%
$0.313 \geq \text{CCB}$	0%

<b>2018</b>	
<b>Capital Conservation Buffer (CCB) (as a % of RWA)</b>	<b>Maximum Payout Ratio (as a % of eligible retained income)</b>
CCB > 1.875	No limitation
$1.875 \geq \text{CCB} > 1.406$	60%
$1.406 \geq \text{CCB} > 0.938$	40%
$0.938 \geq \text{CCB} > 0.469$	20%
$0.469 \geq \text{CCB}$	0%

<b>2019</b>	
<b>Capital Conservation Buffer (CCB) (as a % of RWA)</b>	<b>Maximum Payout Ratio (as a % of eligible retained income)</b>
CCB > 2.5	No limitation
$2.5 \geq \text{CCB} > 1.875$	60%
$1.875 \geq \text{CCB} > 1.25$	40%
$1.25 \geq \text{CCB} > 0.625$	20%
$0.625 \geq \text{CCB}$	0%