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Capital and Capital Planning Under Basel III

FIG Partners

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I. Preliminary Comments

- After reading the entire 1,000-plus page proposal, I would encourage the Basel Committee and the international regulatory community to step back and rethink the Basel capital standards.

- Basel III is intended to be a significant improvement over earlier rules. It does attempt to increase capital, but it does so using highly complex modeling tools that rely on a set of subjective, simplifying assumptions to align a firm's capital and risk profiles. This promises precision far beyond what can be achieved for a system as complex and varied as that of U.S. banking. It relies on central planners' determination of risks, which creates its own adverse incentives for banks making asset choices.

- Directors and managers will have a steep learning curve as they attempt to implement these expanded rules. They will delegate the task of compliance to technical experts, and the most brazen and connected banks with the smartest experts will game the system.

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I. Preliminary Comments (cont'd)

- Basel III will not improve outcomes for the largest banks since its complexity reduces rather than enhances capital transparency. Basel III will not improve the condition of small- and medium-sized banks. Applying an international capital standard to a community bank is illogical, particularly when models have not supplanted examinations in these banks. To implement Basel III suggests we have solved measurement problems in the global industry that we have not solved. It continues an experiment that has lasted too long.

- We would be wise to acknowledge our limits, to simplify the system, to confine the subsidy, and to reduce the taxpayers' exposure to an enormous future liability. It is time for international capital rules to be simple, understandable and enforceable.

Thomas M. Hoenig, FDIC Vice-Chairman, "*Back to Basics: A Better Alternative to Basel Capital Rules*", American Banker Regulation Forum (Sept. 14, 2012).

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II. What Does Basel III Do?

- Revises the definition and categories of capital for banks, thrifts, bank holding companies and thrift holding companies, and other nonbank financial companies supervised by the Federal Reserve

  - Dodd-Frank Act, Section 171 (the "Collins Amendment") requires holding companies to maintain the same types and levels of leverage capital and risk based capital as banks.

- A new Common Equity Tier 1 Risk-Based Capital Ratio ("CET1")

- A capital conservation buffer of 2.50% where noncompliance reduces capital distributions and management bonuses.

III. Potential Effects of Basel III

- Capital Minimums are increased.
- Types of capital are more limited:
  - No new trust preferred with phase out of existing trust preferred
  - Common stock and perpetual noncumulative preferred stock are most valuable under the regulations
  - Voting common stock should be a majority of CET1
  - The terms of capital instruments, especially subordinated debt, are changed
  - Potentially all buyback and redemptions of capital will be subject to prior regulatory scrutiny and approval
- The Prompt Corrective Action ("PCA") Rules of FDI Act, Section 38 are revised to reflect the new capital measures.
- Prompt corrective action may be taken sooner.

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III. Potential Effects of Basel III (cont'd)

- Risk weightings of assets and off-balance sheet exposures are revised in various cases.

- The amounts and risk weights of certain assets will require better capital planning, and may cause capital to be reallocated internally to seek better returns on investment.

- The changes in treatment of deferred tax assets and the increased risk weights on NPAs will cause problem banks to be resolved or recapitalized faster.

  - The value of DTAs will be diminished.

- Banks will need continuing better access to the capital markets.

- Returns and shareholder value will depend on improved capital planning.

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IV. Capital

- CET1
  - Common equity, retained earnings, accumulated other comprehensive income ("AOCI") and "common equity minority interest"
  - Reduced by:
    - Goodwill and intangibles (excluding mortgage servicing rights ("MSAs"))
    - Deferred tax assets ("DTAs") arising from tax loss and tax credit carryforwards net of allowances and deferred tax liabilities ("DTLs")
    - Gains on sale from any securitization exposure
    - Defined benefit pension fund net asset (i.e. excess plan assets)

IV. Capital (cont'd)

- Adjusted for:
  - Unrealized gains and losses on cash flow hedges included in AOCI that relate to hedging of items *not* recognized at FMV on the balance sheet
  - Unrealized gains and losses due to changes in the fair values of liabilities resulting from changes to the bank's credit risk
- Reduced further by these "threshold deductions" of the following that are individually greater than 10% of CET1 or collectively greater than 15% of CET1 (after above deductions):
  - MSAs
  - DTAs
  - Significant common stock investments in unconsolidated financial institutions

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IV. Capital (cont'd)

- Additional Tier 1 Capital
  - Noncumulative perpetual preferred stock
  - Tier 1 minority interest not in CET1, subject to limits
  - Current Tier 1 capital instrument issued under TARP and SBLF

- Tier 2 Capital
  - Preferred stock and most current subordinated debt
  - Total capital minority interest not included in Tier 1 capital, subject to limits
  - ALLL, up to 1.25% of total risk-weighted assets ("<u>RWA</u>")
  - Tier 2 capital instruments issued under TARP and SBLF

V. Capital Ratios

	2013	Fully Phased in 2019
Minimum CET1	3.50%	4.50%
CET1 Conservation Buffer	—	2.50%
Total CET1	3.50%	7.00%
Deductions and threshold deductions[1]	—	100.00%
Minimum Tier 1 Capital[2]	4.50%	6.00%
Minimum Tier 1 Capital *plus* capital conservation buffer[3]	—	8.50%
Minimum Total Capital	8.00%	8.00%
Minimum Total Capital *plus* conservation buffer[4]	8.00%	10.50%

[1] 20% per year phase in starting 2014.

[2] Increases to 5.50% and 6.00% in 2014 and 2015, respectively.

[3] 6.625%, 7.25%, 7.875% for 2016, 2017 and 2018, respectively.

[4] 8.625%, 9.25% and 9.875% in 2016, 2017 and 2018, respectively.

VI. Minimum Capital Levels

	Current	Basel III
CET1	—	4.5%
Leverage	4.0%	4.0%
Tier 1 capital/RWA	4.0%	6.0%
Total capital/RWA	8.0%	8.0%
Capital conservation buffer	—	2.50%

VII. Prompt Corrective Action Categories

Effective January 1, 2015

	Minimums	
	Current	**Basel III**
Well capitalized		
CET1	—	6.5%
Tier 1 risk-based capital	6.0%	8.0%
Total risk-based capital	10.0%	—
Tier 1 leverage ratio	5.0%	5.0%
Undercapitalized		
CET1	—	< 4.5%
Tier 1 risk-based capital	< 4.0%	≤ 6.0%
Total risk-based capital	< 8.0%	< 8.0%
Tier 1 leverage ratio	< 5.0%	< 4.0%
Critically undercapitalized	Tangible equity to total assets ≤ 2.0%	Tier 1 capital plus non-Tier 1 preferred stock ≤ 2.0%

VIII. Capital Conservation Buffer Effects

- The capital conservation buffer amount does not affect PCA levels.

- Capital conservation buffer deficiencies restrict dividends, share buy-backs and distributions on Tier 1 capital instruments ("capital actions") and discretionary bonuses based on the amount of "eligible retained earnings."

- "Eligible retained earnings" means the most recent 4 quarters of net income less capital distributions (net of certain tax effects, if the distributions are expenses for federal income taxes).

VIII. Capital Conservation Buffer Effects (cont'd)

- Calculation of the capital conservation buffer:
  - Subtract the Basel III minimum ratios for each of CET1 (4.5%), Tier 1 Risk-Based Capital (6.0%) and Total Risk-Based Capital Ratio (8.0%) from the bank's actual capital under each of these measures.
  - The actual buffer used to determine capital actions and discretionary bonuses is the lowest buffer percentage for all 3 capital ratios.

VIII. Capital Conservation Buffer Effects (cont'd)

- Fully phased in buffer limits on capital actions and discretionary bonus are subject to regulatory discretion in light of bank risk, CCAR, enforcement actions, etc.

Buffer %	Buffer % Limit
More than 2.50%	None
> 1.875% - 2.50%	60.0%
> 1.250% - 1.875%	40.0
> 0.625% - 1.250%	20.0
≤ 0.625	- 0 -

IX. Selected Standardized Approach Risk Weights

- One-to-Four Family Residential Mortgages

  - Risk weights are based on terms of loan, and LTVs in 2 categories.

  - Category 1
    - Term of 30 years or less
    - Regular periodic payments, no balloons
    - No increases in principal, and no deferrals
    - Underwritten based on documented income, maximum interest rate in first 5 years, with 2% annual and 6% lifetime caps on rate increases, and underwritten ability of borrower to pay principal, interest, taxes and insurance
    - Loans cannot be 90 days or more past due or on nonaccrual

IX. Selected Standardized Approach Risk Weights (cont'd)

- Category 2
  - all other loans, certain junior liens, and "nontraditional mortgage loans"

- Residential Mortgage Risk Weights

	Category	
LTV	**1**	**2**
≤ 60%	35%	100%
> 60% ≤ 80%	50	100
> 80% ≤ 90%	75	150
> 90%	100	200

IX. Selected Standardized Approach Risk Weights (cont'd)

- High Volatility CRE
  - Includes ADC loans, except where the LTV is less than regulatory maximums and the borrower has contributed before the loan is made and maintains at all times equity of 15% of the project's "as completed" value
  - 150% risk weight
- Past due assets – 150% risk weight
  - Does not apply to HVCRE and 1-to-4 family residential mortgages
- Structured securities, including private label mortgage securities, trust preferred CDOs and ABS – up to 1,250%

IX. Selected Standardized Approach Risk Weights (cont'd)

- 1-to-4 Family Residential Mortgages that have been sold
  - All early payment default and premium refund exposures are off-balance sheet exposures for their lives
  - 100% credit conversion and risk weights of 35% - 200% depending on whether the loans are Category 1 or 2
- Credit Commitments
  - 0% risk weight where lender can unconditionally cancel
  - 20% - original maturity of one year or less
  - 50% - commitments of one year or more

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IX. Selected Standardized Approach Risk Weights (cont'd)

- Substitutions for risk weights
  - Collateral (U.S. government securities or cash) – may decrease risk weight from 20% to 0%
  - Guarantees may reduce risk weights to that of an applicable guarantor

- DTAs not deducted from capital

- MSAs – 250% risk weight to extent not deducted from capital subject to the 10% / 15% of CET1 maximums

- DTAs – 250% risk weight to the extent not deducted from capital subject to the 10% / 15% of CET1 maximums

- Equity exposures other than FRB, FHLB and CDFIs – 250% to 600% risk weight

X. Capital Planning

- Federal Reserve

  - SR 09-4 Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions and Stock Repurchases at Bank Holding Companies (Rev'd. Mar. 27, 2009) plus FAQs, Temporary Addendum and Attachments A and B

  - Comprehensive Capital Analysis and Review 2012: Methodology for Stress Scenario Projections (Mar. 12, 2012) ("CCAR")

  - CCAR FAQs (Mar. 21, 2012)

  - CCAR Q&A (Nov. 22, 2011)

  - Tarullo, "Developing Tools for Dynamic Capital Supervision" (Apr. 10, 2012)

  - Tarullo, "The Evolution of Capital Regulation" (Nov. 9, 2011)

X. Capital Planning (cont'd)

- OCC
  - Guidance for Examining Capital Planning and Adequacy, OCC 2012-16 (June 7, 2012)
  - MacDonald, TARP and SBLF Repayments by Bank Holding Companies (Dec. 2011) http://www.jonesday.com/tarp_and_sblf/
- Capital Planning Considerations
  - Basel III, with its new CET1 capital measure and new risk weights, will require better allocations of capital to business lines and products to achieve targeted returns and to continue to attract capital
  - Capital Planning will affect shareholder value and returns, and can distinguish banks from their peers

X. Capital Planning (cont'd)

- Dividends and other capital actions. Regulators and Basel III require more and better planning, or these creators of shareholder value may become less consistent and less valuable to investors.

- Regulatory capital rules do not encompass all risks, including operational risks, interest rate risks and the "amplification of risks through correlations, concentrations and the business cycle"

- Capital planning is a responsibility of the board of directors and part of directors' duties

- Banking organizations contemplating expansion need capital well above regulatory minimums for "well capitalized" organizations

X. Capital Planning (cont'd)

- More risks, including concentrations and correlated assets and funding, require more capital

- Capital planning and capital levels are affected by:
  - Corporate governance
  - Risk management
  - Internal controls
  - The complexity and risks of product lines
  - Earnings
  - Access to capital

- Liquidity is part of capital planning

- Asset/liability mismatches create risk

- Planning varies with size and complexity

X. Capital Planning (cont'd)

- Use of stress tests, even for under $10 billion organizations
- Failure to properly plan for capital may be an unsafe and unsound practice
- Basel III will require updates to existing shelf registration statements and changes to instruments registered
- If you do not have a shelf registration statement, you need one!
- Organizations with TARP, SBLF and trust preferred outstanding need to be especially proactive