CLIENT UPDATE

THE FINAL U.S. BASEL III CAPITAL FRAMEWORK: THE BANKING AGENCIES WRITE A "TALE OF THREE INDUSTRIES"

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The Board of Governors of the Federal Reserve System (the "Board"), the Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC," and together with the Board and the OCC, the "Banking Agencies") have published the final U.S. "Basel III" capital framework (the "Final Rules").[1] Like the proposed rules implementing the Basel III framework (the "Proposed Rules"),[2] the Final Rules address and, relative to the Basel I framework under which U.S. banking organizations have operated for several decades, generally make more burdensome all aspects of the banking book capital requirements. As discussed further below, among other things the Final Rules raise the required capital ratios (and add a new common equity ratio and capital buffers), and narrow what constitutes capital (the numerator of the capital ratios).

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[1] Board, OCC, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule* (July 2, 2013); FDIC, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule* (July 9, 2013) (Interim Final Rule).

[2] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012); Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52,888 (Aug. 30, 2012); Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule, 77 Fed. Reg. 52,978 (Aug. 30, 2012).

The Final Rules establish a comprehensive set of "standardized" risk weights for bank assets applicable to all insured or federally regulated U.S. banking organizations other than bank holding companies ("BHCs") with less than $500 million total consolidated assets, and modify risk weights for large banking organizations subject to the Basel II advanced approaches ("Advanced Approaches Banks").[3] Because of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the so-called "Collins Amendment," Advanced Approaches Banks will ultimately be required to calculate risk weights under <u>both</u> the standardized and advanced approaches, and apply the more stringent of the two calculations when evaluating capital adequacy. The Final Rules do not apply directly to non-U.S. banks (other than U.S. bank subsidiaries of non-U.S. banks), but may become more relevant to U.S. broker-dealers and other subsidiaries of non-U.S. banks if the Board finalizes a proposed rule implementing sections 165 and 166 of the Dodd-Frank Act for foreign banking organizations ("FBOs"), which may require certain FBOs to form U.S. intermediate holding companies that would be subject to the U.S. regulatory capital framework.[4]

Broadly speaking, the Final Rules confirm statements by senior members of the Banking Agencies throughout the rulemaking process that U.S. requirements would remain generally anchored to the international Basel III framework adopted by the Basel Committee on Banking Supervision (the "Basel Committee") in December 2010.[5] In this regard, despite having received over 2,500 comments on the Proposed Rules, the Banking Agencies left largely intact many aspects of the rules that mirror the international Basel III framework. In certain key respects, however, the Final Rules also evidence the Banking Agencies' evolving views since the issuance of the Proposed Rules with respect to three segments of the banking sector, both as to the applicability of the Final Rules and the implications for institutions subject to them.

INSURANCE COMPANIES WITH THRIFT AFFILIATES

Under the Proposed Rules, insurance companies that are savings and loan holding companies ("SLHCs") (after MetLife's disposal of its bank, no large insurance company remains a BHC) would have been subject to the same capital rules as traditional banking organizations. In response to substantial comments from the insurance industry about the

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3 Advanced Approaches Banks generally include banking organizations with $250 billion or more in total consolidated assets or $10 billion or more on-balance sheet foreign exposures.

4 *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (Dec. 28, 2012).

5 Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (revised June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf

inappropriateness of applying bank capital rules to insurers, the Final Rules do not apply to SLHCs in which the top-tier holding company (i) is an insurance underwriting company or (ii) holds 25% or more of its consolidated assets in insurance underwriting subsidiaries (other than assets associated with credit risk insurance) ("Excluded Insurance SLHCs"). The preamble to the Final Rules states, however, that the Board expects to implement a separate capital framework for Excluded Insurance SLHCs by 2015 (implying that the Board currently still considers these SLHCs to be subject to the Collins Amendment, but may engage in additional tailoring for these companies). The insurance industry will continue to seek an exemption from bank-centric capital rules.[6]

NON-ADVANCED APPROACHES BANKS

As to banking organizations not subject to the advanced approaches framework ("Non-Advanced Approaches Banks"), in the words of Board Governor Duke: "After hearing their concerns, numerous changes have been made to the [Proposed Rules] to reduce its complexity and to minimize the potential burden that would be placed on smaller and community banking organizations."[7] Changes in the Final Rules most relevant to Non-Advanced Approaches Banks include:

- Retaining the historical approach to capital requirements for residential mortgages, rather than applying the complex Type I/Type II loan-to-value ("LTV") ratio approach contemplated by the Proposed Rules;
- For banking organizations with less than $15 billion in total consolidated assets, permanently grandfathering trust preferred securities ("TruPS") issued prior to the enactment of the Dodd-Frank Act, rather than eliminating these instruments from regulatory capital;
- Permitting a one-time "opt out" from accumulated other cumulative income ("AOCI") rolling fully into regulatory capital; and
- Delaying implementation of the Final Rules until 2015.

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[6] Commercial entities that are grandfathered unitary SLHCs are not subject to the Final Rules so long as 50% or more of either the consolidated assets or consolidated revenues of the enterprise is attributed to or results from non-financial activities. As to these SLHCs, the Board indicates in the preamble to the Final Rules that it plans to issue a proposal in the near future that would implement the intermediate holding company ("IHC") provisions of Section 626 of the Dodd-Frank Act and apply the Board's capital requirements to such IHCs.

[7] Transcript of the Open Board Meeting (July 2, 2013), *available at* http://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20130702.pdf

ADVANCED APPROACHES BANKS

As to Advanced Approaches Banks, the Final Rules are less favorable. Advanced Approaches Banks with substantial mortgage activities may derive some incidental benefit from the changes to the treatment of mortgage exposure described above by virtue of the Collins Amendment, which requires them to use the more stringent of the advanced approaches rule or the standardized approach when determining capital adequacy. However, the other benefits set forth above for Non-Advanced Approaches Banks are not available to them. Rather, with the significant exception of also having to apply the standardized approach by virtue of the Collins Amendment, Advanced Approaches Banks will largely become subject to the Basel III framework adopted and modified by the Basel Committee. In addition, unlike under the Proposed Rules, Advanced Approaches Banks will have to use the worse of the advanced and the standardized approaches when applying the capital conservation buffer. The Banking Agencies have also made other technical changes to the advanced approaches framework, as described below.

Even more significant, Governor Tarullo stated during the open meeting adopting the Final Rules that the Board is currently developing certain additional proposals as a "complement" to the Final Rules. These additional proposals would apply to the eight U.S. banking organizations designated by the Financial Stability Board (the "FSB") as global systemically important banks ("G-SIBs"), and would include:[8]

- Supplementary leverage ratios above that set forth in the Final Rules;
  - In this regard, on July 9, 2013 the Banking Agencies proposed enhanced supplementary leverage ratios for banks (6% supplemental leverage ratio to be deemed "well capitalized") and BHCs (2% "leverage buffer" to avoid distribution/bonus limitations), in each case for BHCs with more than $700 billion of assets or $10 trillion in custody.[9]
- A requirement to maintain certain levels of holding company equity and debt, so as to facilitate the so-called "single point of entry" approach to resolving systemically important BHCs under Title II of the Dodd-Frank Act;

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[8] The FSB has designated Bank of America, Bank of New York Mellon, Citigroup, JPMorgan Chase, Goldman Sachs, Morgan Stanley, State Street and Wells Fargo as G-SIBs. *See* FSB, Press Release, *Update of group of global systemically important banks* (Nov. 1, 2012), *available at* http://www.financialstabilityboard.org/publications/r_121031ac.pdf

[9] Banking Agencies, *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions* (July 9, 2013).

- The G-SIB capital surcharges contemplated by the Basel Committee (the Basel Committee published a revised methodology for these surcharges on July 3, 2013);[10] and
- Additional measures for risks arising from short-term wholesale funding, including additional capital requirements for banks dependent on such funding.

While these measures are not unexpected, given prior comments from members of the Board, they underscore the Board's aggressiveness in setting capital requirements based on the Board's own perspective. Although the Final Rules may largely follow the international Basel III framework, the Board is willing to impose requirements beyond those required by Basel III particularly for the largest U.S. banks. By comparison, the CRD IV framework adopted by the European Union last month more closely follows Basel III. This approach poses competitive issues for U.S. banks as they will be subject to additional burdens not applicable to competitors outside of the United States. Moreover, on July 5, 2013, the Basel Committee published a comparison showing "considerable variation" in risk-weighted assets in the banking book across jurisdictions, which may also lead to additional regulatory initiatives.[11]

TIMING

The Final Rules require Advanced Approaches Banks to apply the higher capital ratios and restricted components of capital beginning January 1, 2014. Advanced Approaches Banks will treat the current Basel I approach to risk weighting of assets as the "generally applicable" capital rules for purposes of the Collins Amendment until January 1, 2015, at which time they will apply the standardized approach as set forth in the Final Rules for that purpose. For all other U.S. banking organizations subject to the Final Rule, the implementation period begins January 1, 2015.

Having summarized key differences in approach and substance between the Proposed and Final Rules, this Client Update provides a more comprehensive discussion as to the Final Rules. For ease of reference, this Client Update also provides the following summary appendices:

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[10] Basel Committee, *Basel III: Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* (July 2013), *available at* http://www.bis.org/publ/bcbs255.pdf

[11] Basel Committee, *Regulatory Consistency Assessment Program (RCAP): Analysis of risk-weighted assets for credit risk in the banking book* (July 2013), *available at* http://www.bis.org/publ/bcbs256.pdf

Appendix A – Regulatory Capital Levels; Implementation Schedule

Appendix B – Implementation of the Capital Conservation Buffer

Appendix C – Prompt Corrective Action Levels for Insured Depository Institutions

Appendix D – A Comparison of Current and Final Risk Weights

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I. THE NUMERATOR

A. The Quantity of Capital: Capital Ratios

Consistent with the Basel III framework, the Final Rules establish:

- A new minimum Common Equity Tier 1 ("CET1") capital ratio of 4.5%;
- A Tier 1 capital ratio, with a numerator consisting of the sum of CET1 and Additional Tier 1 capital, of 6% (increased from 4% under the current rules); and
- A Total Capital ratio, with a numerator consisting of the sum of CET1, Additional Tier 1 and Tier 2 capital, of 8% (unchanged from current rules).

The required minimum CET1 ratio of 4.5% is designed to ensure that banking organizations maintain larger amounts of core capital, consisting predominantly of common shares and retained earnings, than historically has been required. The concept of a CET1 ratio was introduced in Basel III, and arose from a general concern that the "hybrid" instruments allowed in Tier 1 historically did not provide significant support to banks during the financial crisis, and many banking organizations, particularly in Europe, had relatively little common equity capital.[12] The CET1 ratio is therefore designed to ensure that banking organizations have a minimum amount of the highest grade, highest support-providing capital, which in almost all circumstances will be common stock. In the preamble to the Final Rules, the Banking Agencies noted that mutuals, minority banks and many others had strongly resisted these enhanced capital requirements, but determined that the long-term benefits of these heightened standards outweighed the burdens imposed. The Banking Agencies also highlight that their own analyses indicate that the vast majority of U.S. banking organizations already meet these higher requirements.

Please refer to Appendix A for a table showing the regulatory capital levels banking organizations would generally need to meet during the transition period, including the timeline for implementation of the capital conservation buffer (discussed below).

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[12] For example, the FDIC in 2010 published a report asserting that TruPS provided inadequate capital support during the financial crisis. *See* FDIC, *Trust Preferred Securities and the Capital Strength of Banking Organizations: FDIC Supervisory Insights – Winter 2010, available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin10/trust.html

1. Capital Conservation and Countercyclical Buffers

(a) Capital Conservation Buffer – Applicable to All Banking Organizations

Despite substantial industry comment seeking to limit both its coverage and its severity, consistent with Basel III, the Final Rules retain for all covered banking organizations a "capital conservation buffer" of 2.5% above the regulatory minimum capital requirements for each of the CET1, Tier 1 and Total Capital ratios. The buffer must consist entirely of CET1 capital. As a result, if a banking organization does not have each of a CET1, Tier 1 and Total Capital ratio of at least 7%, 8.5% and 10.5%, respectively, its ability to make or commit to discretionary dividends and discretionary bonus payments to "executive officers" (as defined in the Final Rules), or engage in share repurchases or redemptions, generally will be restricted in accordance with the "maximum payout ratio." Moreover, as to Advanced Approaches Banks, the determination of whether adequate capital exists under the capital conservation buffer is worse than under the Proposed Rules. In the Proposed Rules, an Advanced Approaches Bank could determine whether it satisfied the buffer using solely the advanced approaches capital ratio calculation. Under the Final Rules, as with the capital determinations more generally, an Advanced Approaches Bank that has completed parallel run must make this determination using the more stringent of the capital ratios calculated under the standardized and advanced approaches.

The maximum payout ratio is determined by reference to the banking organization's capital ratios at the end of each calendar quarter. As a result, if a banking organization's capital levels fall within the buffer at the end of a quarter, a maximum payout ratio limitation will be imposed on the banking organization for the following quarter. The maximum payout amount is equal to the product of (i) eligible retained income (*i.e.*, net income for the four preceding quarters based on the banking organization's quarterly reports, net of any distributions or tax effects not reflected in net income), and (ii) the maximum payout ratio, as set forth in Appendix B.

The closer a banking organization's capital falls towards minimum capital levels, the more constrained its ability to make discretionary payments will be. In response to comments, however, the Final Rules do provide some additional flexibility, in that (i) a redemption or repurchase of shares is not deemed a "distribution," and thus is not subject to the conservation limits to the extent that the banking organization issues an instrument of the same or better quality during the same calendar quarter; and (ii) a banking organization may seek discretionary approval from its supervising Banking Agency to make a distribution that would otherwise be prohibited (the preamble provides an example of

paying a penny stock dividend to satisfy pension plans that can only invest in stocks paying a quarterly dividend).

Although the capital conservation buffer is not incorporated into the prompt corrective action ("PCA") rules applicable to insured depository institutions ("IDIs"), and thus whether or not a banking organization maintains the buffer will not affect its PCA category (meaning that it could still be well-capitalized without maintaining the capital conservation buffer), it is likely that the new buffer will be viewed as establishing an even higher *de facto* minimum capital requirement because it provides significant incentives to conserve capital in excess of the regulatory minimum.

(b) Implementation of the Capital Conservation Buffer

The capital conservation buffer will be phased in beginning January 1, 2016, beginning at 0.625% of risk-weighted assets and increasing by that amount each year until it becomes fully effective on January 1, 2019. The discretion to institute a countercyclical buffer (described immediately below) will be phased in at the same rate in tandem with the capital conservation buffer over the same period.

Please refer to Appendix B for a table showing the timeline for implementation of the capital conservation buffer and the maximum payout ratios associated with maintaining less than the full buffer.

(c) Countercyclical Buffer – Applicable to Advanced Approaches Banks Only

The Final Rules again track Basel III by providing the Banking Agencies, as well as the banking agencies of other jurisdictions, discretion to institute a "countercyclical buffer" applicable only to Advanced Approaches Banks (whether or not they have completed the parallel run process) if they perceive a greater system-wide risk to the banking system as the result of a build-up of excess credit growth. In the United States, it will initially be set at zero, and is anticipated to be implemented on only an infrequent basis, with twelve months' notice unless the Banking Agencies determine that economic conditions warrant a more aggressive timetable.

If implemented, the countercyclical buffer would, in effect, be added to the capital conservation buffer and restrict discretionary distributions by Advanced Approaches Banks, and incentivize retention of up to an additional 2.5% of CET1 capital, resulting in minimum CET1, Tier 1 and Total Capital ratios of up to 9.5%, 11% and 13%, respectively. An Advanced Approaches Bank operating in various countries imposing a countercyclical buffer would determine its surcharge by using the weighted average of the countercyclical

buffers being applied in jurisdictions to which it has private sector credit exposure (generally determined by the location of the borrower).

2. Leverage Ratio

One of Basel III's sharpest departures from the prior international capital accords was the introduction of a global leverage ratio as a "backstop" to the risk-based capital requirements, to prevent the building of excessive on- and off-balance sheet leverage and the associated economic damage resulting from deleveraging during difficult economic periods. U.S. banking organizations, however, have been required to comply with a minimum leverage measure of capital since the early 1980s.

(a) Generally Applicable Leverage Ratio

Consistent with the Proposed Rules, in the Final Rules the Banking Agencies apply a 4% leverage ratio requirement of Tier 1 Capital (as modified by the revised definition of Tier 1 Capital) to total on-balance sheet assets (net of amounts deducted from Tier 1 Capital) to all covered banking organizations (including highly rated banking organizations, which heretofore had benefited from an exception providing for a more permissive leverage ratio of 3%), while applying the more stringent Basel III formulation of the leverage ratio only to Advanced Approaches Banks as a new supplementary leverage ratio. As shown in Appendix C, the revisions to the PCA framework maintain a minimum leverage ratio of 5% in order for an institution to be well-capitalized.

(b) Supplementary Leverage Ratio – Applicable to Advanced Approaches Banks Only

The numerator of both leverage ratios would be based on Tier 1 Capital, but the denominator of the supplementary leverage ratio (which, again, would apply only to Advanced Approaches Banks), determined as of the last day of each quarter, would include certain off-balance sheet exposures. The measure of exposure for the supplementary leverage ratio would be the sum of (i) on-balance sheet assets net of deductions from Tier 1 Capital; (ii) potential future exposure arising from derivatives transactions; (iii) 10% of the notional amount of unconditionally cancellable commitments; and (iv) the notional amount of all other off-balance sheet exposures, (excluding securities lending, securities borrowing and reverse repos).

Significantly, under this formula, securities lending and other repo-style transactions would flow through to the denominator only when they constitute on-balance sheet assets (as in the generally applicable leverage ratio). The preamble to the Final Rules states that the Banking Agencies, together with the Banking Committee, are engaging in an ongoing

quantitative analysis of the exposure measure for such transactions, and depending on international determinations may modify the method of calculating leverage exposure (presumably to include off-balance sheet elements) in the future. In this regard, the Basel Committee in June 2013 published a consultative document regarding the treatment of securities finance transactions and derivatives for purposes of the leverage ratio.[13]

(c) Implementation

The supplementary leverage ratio would be calculated by Advanced Approaches Banks beginning January 1, 2015, but would not apply as a regulatory requirement until January 1, 2018.

(d) Proposed Enhanced Leverage Ratios

On July 9, 2013, the Banking Agencies proposed enhanced leverage ratios for banks and BHCs, in each case for BHCs with more than $700 billion of assets or $10 trillion in custody. As to the covered banking banks, the proposal would amend the PCA rules to require a 6% supplemental leverage ratio (rather than the Basel III 3% standard) for the bank to be deemed "well-capitalized." As to covered BHCs, the proposal requires a Tier 1 capital "leverage buffer" (calculated as the BHC's supplementary leverage ratio minus 3%) in an amount greater than 2% to not be subject to limitations on distributions and discretionary bonus payments that follow the same general mechanics as the capital conservation buffer described in I.A.1., above. The new requirements in the proposal would take effect on January 1, 2018. Comments on the proposal are due sixty days after it is published in the *Federal Register*.

3. Revisions to the Prompt Corrective Action Framework

The Final Rules amend the current PCA framework to include the new CET1 capital measure and higher minimums effective January 1, 2015. The minimum CET1, Tier 1 risk-based, and total risk-based measures required to be deemed "adequately capitalized" will be 4.5%, 6% and 8%, respectively, with the minimum required to be deemed "well-capitalized" in each case 2% higher. The minimum standard leverage ratio to be "adequately capitalized" is 4%, with the standard to be "well-capitalized" at least 5%. An Advanced Approaches Bank would have to meet or exceed the new supplementary leverage measure (discussed below) as of January 1, 2018 to be considered "adequately capitalized."

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[13] Basel Committee, *Revised Basel III leverage ratio framework and disclosure requirements* (June 2013), *available at* http://www.bis.org/publ/bcbs251.pdf

Please refer to Appendix C for a table comparing the current and revised risk-based and leverage capital thresholds for each of the PCA capital categories for IDIs.

B. The Quality of Capital: Capital Components

Having set forth the applicable ratios, this section of the Client Update discusses how the Final Rules define the applicable components of capital (and deductions therefrom) in greater detail.

1. Composition of Capital

Common Equity Tier 1 Capital. The Final Rules define CET1 capital as consisting of (i) common stock meeting specified requirements, as described below; (ii) retained earnings; (iii) AOCI; and (iv) CET1 minority interests, subject to limits described below. To be considered qualifying common stock, the Final Rules direct that a banking organization's capital instruments must, among other things: (i) be paid in, be issued directly by the banking organization, and represent the most subordinated claim in the organization's liquidation; (ii) have no maturity date and be redeemable via discretionary purchases only with regulatory approval; (iii) generally not create any expectation that the instrument will be bought back, redeemed or cancelled; and (iv) not be secured or guaranteed by the banking organization or any related entity. In response to industry comment, as an exception to (iii) above, the Final Rules permit banks to have employee stock ownership plans that establish mechanisms to repurchase non-publicly traded stock.

Additional Tier 1. The Final Rules define Additional Tier 1 capital to include: (i) capital elements meeting specified requirements, as defined below; and (ii) tier 1 minority interests, subject to limits described below. To qualify as Additional Tier 1 capital (which, along with CET1 capital, constitutes the numerator of the Tier 1 capital ratio), an instrument must, among other things: (i) be subordinated to depositors, general creditors and the banking organization's subordinated debt holders; (ii) not be secured or guaranteed by the banking organization or any affiliate; (iii) have no maturity date or any incentive to redeem (such as dividend step-ups); (iv) be callable only with regulatory approval, and only after at least five years, unless the instrument ceases to be included in Additional Tier 1 capital as the result of a regulatory event, or (in response to industry comments to the proposal) being required to register as an investment company, or (again in response to industry comments to the proposal) the occurrence of a rating agency event for securities issued prior to the effective date of the Final Rules; (v) provide the banking organization with the ability to cancel distributions at any time without any restrictions, except (per industry comments to the proposal) in relation to holders of common stock or

pari passu instruments; (vi) if classified as liabilities, have principal loss absorption through conversion to common shares or write-down at a pre-specified trigger point; and (vii) for Advanced Approaches Banks, disclose that the instrument holders may be fully subordinated to U.S. government interests.

Hybrids Grandfathered or Eliminated. As a result of the foregoing, many Tier 1 capital instruments with step-ups, dividend pushers or similar "innovative" or "exotic" traits will be phased out pursuant to the timing discussed below. However, in response to comments on the Proposed Rules, the Final Rules grandfather and treat as Additional Tier 1 capital TruPS and other cumulative perpetual preferred stock of holding companies with less than $15 billion of consolidated assets as of December 31, 2009 that were issued and included in Tier 1 capital prior to May 19, 2010. With the exception of this grandfathering and the limited exceptions added above, non cumulative perpetual preferred stock is the only type of existing widely distributed security clearly able to qualify under this category.

Minority Interests. Historically, the full amount of capital in consolidated subsidiaries with minority interests outstanding to third parties generally could be included in the parent entity's capital. However, the Basel Committee and the Banking Agencies expressed concern that during the financial crisis, capital of consolidated entities was not always available to absorb losses at the consolidated level. Accordingly, despite substantial industry protest as to the complexity and ramifications of the Proposed Rules, the Final Rules maintain the substantial limits on the inclusion of minority interests set forth in the proposed rule. Generally, the amount of a minority interest includible in capital (CET1, Additional Tier 1 or Tier 2, depending on the subsidiary and instrument) is limited to (i) the capital represented by the minority interest, minus (ii) the ratio of the minority interest owned by third parties to the entire amount of the minority interest of the subsidiary times the difference between (i) the amount of such capital the subsidiary actually holds, and (ii) the minimum capital required to be held by the subsidiary to avoid restrictions on distributions or discretionary bonus payments (or, if there is no such minimum, the amount that would be required to be held by the parent bank).

REIT. For years, banks have been able to treat shares of real estate investment trust ("REIT") subsidiaries issued to third parties as minority interests of consolidated subsidiaries and thereby treat them as tier 1 capital for bank capital purposes. Unlike other minority interests, however, in times of bank stress the relevant Banking Agency has the right to convert the shares held by third parties as noncumulative perpetual preferred stock of the bank. As a result, the industry commented strongly that REIT subsidiaries should be treated more favorably than other minority interests for regulatory capital purposes.

Notwithstanding this distinction, however, the Final Rules treat the minority interests in REIT subsidiaries identically to those of other subsidiaries. Moreover, even to obtain this less favorable treatment: (i) to qualify as Additional Tier 1 capital (these interests in a REIT cannot count as CET1 capital), the REIT must have the ability to cancel dividends (and pay a so-called "consent dividend" to satisfy the U.S. tax code REIT distribution requirements); and (ii) the REIT must be deemed actively managed for the purpose of earning a profit in its own right, rather than just a service entity of its parent banking organization (the actively managed requirement is a condition of the REIT being deemed an operating subsidiary of the bank, which in turn is required for minority interests in the REIT to count as any form of capital). As to the second point in particular, the Banking Agencies advise banking organizations to discuss their REIT with their primary Banking Agency to ensure it meets the operating subsidiary qualification before including minority interests in capital.

Tier 2. Tier 2 capital is the sum of Tier 2 capital elements and any related surplus, minus any applicable specified deductions. As to the capital elements, the instrument generally must (i) be subordinated to depositors and general creditors of the banking organization; (ii) not be secured or covered by a guaranty of the banking organization or an affiliate; (iii) have an original maturity of at least five years, with no incentive to redeem (including step-ups); (iv) provide the holder no contractual right to accelerate the payment of principal or interest, except in receivership, bankruptcy, liquidation or similar proceeding; (v) not have a credit-sensitive feature; (vi) be redeemed prior to maturity or repurchase only with regulatory approval; and (vii) if issued by an Advanced Approaches Bank after January 1, 2013, disclose that holders may be fully subordinated to U.S. government interests in the event of bankruptcy or a similar proceeding.

TruPS are specifically considered Tier 2 qualifying capital in the Final Rules. A Non-Advanced Approaches Bank holding more than $15 billion in consolidated assets can continue to include in Tier 2 capital TruPS that are phased out from Tier 1 capital. Advanced Approaches Banks, on the other hand, are required to phase out TruPS from Tier 2 capital by the end of 2021. (As stated above, banks with less than $15 billion in consolidated assets generally are permitted to treat TruPS issued before May 19, 2010 as Additional Tier 1 capital.)

2. Adjustments to and Deductions from Capital

Emphasizing the importance of maintaining a strong common equity base, regulatory adjustments to capital would be made for the most part at the CET1 level, rather than the less expensive Additional Tier 1 capital level.

(a) AOCI and Cash Flow Hedges

The Proposed Rules' expansive inclusion of AOCI adjustments into regulatory capital, so as to be consistent with generally accepted accounting principles ("GAAP"), was one of its most commented-upon provisions. Under the Proposed Rules, unrealized gains and losses on all available for sale ("AFS") securities would flow through to CET1 capital, including perhaps most significantly unrealized gains and losses on debt securities due to changes in valuations that result from fluctuations in benchmark interest rates (*e.g.*, Treasuries), rather than because of changes in credit risk.

The Final Rules provide greater flexibility to banking organizations, other than Advanced Approaches Banks, as to AOCI. More specifically, the Final Rules permit Non-Advanced Approaches Banks to make a one-time, permanent election to continue to treat AOCI for regulatory purposes as they do under the current capital rules. To exercise this opt-out, the bank must notify the Banking Agencies in the first Call Report or FR Y-9 series report after the bank becomes subject to the Final Rules (*i.e.*, for current banks, the first such report in 2015). Advanced Approaches Banks must comply with the AOCI adjustments, as set forth in the Final Rules, and incorporate all AOCI components, except accumulated net gains and losses on certain cash-flow hedges, into CET1 capital.

The Final Rules also seek to address the acquisition transactions between banking entities permitted to perform this "opt-out." If both banks engaging in a merger, acquisition or acquisition of substantially all (generally, at least 80%) assets have made the same election, that election will apply to the resulting institution. If they have made different elections prior to the transaction, the surviving entity must decide whether to "opt out" by its first regulatory reporting date following the consummation of the transaction.

As to cash flow hedges, the Final Rules follow the adjustments described above for AOCI. Advanced Approaches Banks, and other banks that do not "opt out" of AOCI rolling into CET1 capital, must subtract from that capital any accumulated net gain and add any accumulated net loss on cash-flow hedges related to AOCI that relate to the hedging of items not recognized at fair value on the balance sheet. Banks that have "opted out" of AOCI need not make these adjustments.

(b) Other Adjustments and Deductions

The Final Rules also address myriad other adjustments to and deductions from CET1 capital, and also clarify that banking organizations also may exclude amounts deducted from its total risk-weighted assets and leverage exposure. As to these deductions and adjustments, for example goodwill is deducted, as are equity investments and retained

earnings in financial subsidiaries, and thrifts must deduct investments in subsidiaries (*i.e.*, service organizations) not permissible for a national bank.

The Final Rules also address the treatment of non-significant (10% or less of the voting common stock) or significant investments in unconsolidated "financial institutions" not in the form of common stock. The Proposed Rules defined "financial institution" to include companies that are "predominantly engaged" in financial activities, *i.e.*, any company for which (i) 85% or more of the total consolidated annual gross revenues of the company in either of the two most recent calendar years were derived, directly or indirectly, by the company on a consolidated basis from financial activities; or (ii) 85% percent or more of the company's total consolidated assets as of the end of either of the two most recent calendar years were related to financial activities. In response to comments on the Proposed Rules and in order to "reduc[e] operational burden," the Banking Agencies have narrowed the definition such that only certain enumerated activities, *e.g.*, lending, underwriting and dealing will be considered "financial activities."

Mortgage servicing assets ("MSAs") net of associated deferred tax liabilities ("DTLs"), deferred tax assets arising from temporary differences that a banking organization cannot realize through net operating loss carrybacks, net of valuation allowances and DTLs, and significant investments in the common stock of unconsolidated financial institutions (defined as above), net of associated DTLs, may all to a limited degree be recognized as CET1 capital, with recognition of each capped at 10% of adjusted CET1 capital. Moreover, banking organizations must deduct from CET1 the amount by which the aggregate of these items exceeds 15% of CET1. The amount not deducted would be risk-weighted at 250%, further discouraging banking organizations from holding such assets. This 10% / 15% treatment is consistent with the Proposed Rules. However, in response to industry comments the Final Rules did make one concession to MSAs: eliminating the 90% MSA fair value limitation first imposed by a 1991 federal law, on the basis that the new 10% / 15% approach is more conservative.

The preamble to the Final Rules further notes that, once regulations implementing section 619 of the Dodd-Frank Act have been finalized, requiring covered banking organizations to deduct from Tier 1 capital the value of their investments in hedge and private equity funds, the Banking Agencies will revise the regulatory capital rules to reflect (and not double-count) those deductions.[14]

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[14] The Basel Committee recently issued a consultative document on banks' equity investments in funds. Basel Committee, *Capital requirements for banks' equity investments in funds* (July 2013), *available at* http://www.bis.org/publ/bcbs257.pdf

3. Implementation and Phase-in

As indicated throughout the Final Rules discussion, many capital instruments, adjustments and deductions are subject to specific phase-out provisions. Goodwill and investments in financial subsidiaries are immediately fully deductible as to banks from the effective date of the rules (2014, in the case of Advanced Approaches Banks, and 2015, in the case of other covered banking organizations). For Advanced Approaches Banks, many other deductions and adjustments generally begin to phase in at 20% yearly increments beginning in 2014. For other banking organizations, many other deductions and adjustments described above generally begin to phase in at 40% in 2015 and at 20% annual increments thereafter. The Final Rules also provide for transition phase-outs for non-qualifying capital, generally requiring the instruments to have been issued in 2010 in order to qualify.

II. THE STANDARDIZED APPROACH

The Final Rules modify the calculation of risk-weighted assets that apply to all banking institutions covered by the capital ratios described above. The Final Rules require a banking organization to calculate risk-weighted assets for on- and off-balance sheet exposures and, for market risk banks only, to apply standardized market risk weights as set forth under the rules.

A. Calculation of Risk-Weighted Assets

The exposure amount for on-balance sheet assets is generally the carrying value of the exposure as determined under GAAP. If a Non-Advanced Approaches Bank has elected to "opt out" of AOCI, the exposure amount for AFS or held-to-maturity debt securities and AFS preferred stock not treated as GAAP equity is the carrying value (including accrued but unpaid interest and fees) of the exposure, less any net unrealized gains plus any unrealized losses. For AFS preferred stock treated as equity, the exposure is the carrying value, less any net unrealized gains reflected in the carrying value but excluded from regulatory capital.

As to off-balance sheet exposures, in most cases risk weights are determined by multiplying the exposure amount by the appropriate credit conversion factor ("CCF"), as set forth below. However, the Final Rules treat over-the-counter ("OTC") derivatives contracts, repo-style transactions and margin loans differently, as set forth below.

1. Sovereign Exposures

The Final Rules retain the current risk-weighting rules for exposures to debt directly and unconditionally guaranteed by the U.S. Government and its agencies. Such exposures, including portions of deposits insured by the FDIC, receive a 0% risk weight.[15]

To address the requirement of Section 939A of the Dodd-Frank Act that credit ratings not be used (which the General Counsel of the Board has referred to as his greatest regret about the Dodd-Frank Act), the Final Rules (like the Proposed Rules) establish risk weights for exposures to non-U.S. sovereigns (and indeed the risk weights for many foreign debt obligations) based on Country Risk Classifications ("CRC") of the Organization for Economic Co-Operation and Development ("OECD"). The CRC methodology, established in 1999, assigns one of eight risk categories (0-7) to each country, with countries assigned to the 0 category having the lowest possible risk assessment and countries assigned to the 7 category having the highest possible risk assessment.[16]

The Final Rules provide a conversion chart to determine how the CRC translates into risk weights. For OECD countries with CRCs, the risk weights vary from 0% (for 0-1 CRC countries) to 150% (for 4-7 CRC countries). Moreover, since the issuance of the Proposed Rules, some OECD countries have lost their CRCs, such that they no longer have any CRC. Based on the fact that the OECD considers these countries to nonetheless retain the same risk as a 0 rated CRC, OECD countries without a CRC also receive a 0% risk weight. Non-OECD countries, on the other hand, which have no CRC, are assigned a 100% risk weight for their sovereign obligations.

As a significant exception to these classifications, if a sovereign has gone into default (as defined below), or has been in default during the previous five years, the risk-weighting of its sovereigns increases to 150%. For these purposes, "sovereign default" means noncompliance by a sovereign with its external debt service obligations or the inability or unwillingness of the sovereign to service an existing loan according to its original terms, as evidenced by failure to pay principal and interest, arrearages or (voluntary or involuntary) restructuring.

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[15] Exposures conditionally guaranteed by the U.S. Government, its central bank or a U.S. Government agency would receive a 20% risk weight.

[16] The distribution of CRCs for European countries and territories is as follows: 49% Classification 0; 12% No Classification; 8% Classification 4; 8% Classification 5; 8% Classification 6; 8% Classification 7; 0% Classification 1; 0% Classification 2.

2. Exposures to Certain Supranational Entities and Multilateral Development Banks

The current risk-based capital rules apply a 20% risk weight to supranational entities and multilateral development banks. Consistent with the Basel III framework, the Final Rules apply a 0% risk weight to exposures of the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund and certain multilateral development banks ("MDBs") listed in the Final Rules. Exposures to regional development banks and multilateral lending institutions that are not listed as MDBs in the Final Rules, on the other hand, are generally assigned a 100% risk weight.

3. Exposures to Government-Sponsored Entities

The Final Rules assign a 20% risk weight to non-equity exposures to government-sponsored entities ("GSEs") and a 100% risk weight to preferred stock issued by a GSE (the current rules assign only a 20% risk weight to such stock).[17] The Final Rules define a GSE as an entity established or chartered by the U.S. Government to serve public purposes but whose debt obligations are not "explicitly guaranteed" by the full faith and credit of the U.S. Government.

4. Exposures to Depository Institutions, Foreign Banks and Credit Unions

The current risk-based capital rules provide for a 20% risk weight to exposures to U.S. depository institutions and credit unions and foreign banks incorporated in an OECD country, while exposures to foreign banks in non-OECD countries receive a 20% risk weight for short-term obligations and a 100% risk weight for long-term obligations. The Final Rules continue this treatment as to U.S. banks and credit unions. As to foreign banks, the risk-weighting for exposures would correlate to the CRC rating (or lack thereof) of the sovereign, in accordance with a chart. As a general matter, 0% and 20% risk weights for sovereigns convert to 20% and 50% for their banks, respectively, and the rest of the risk weights are identical to those of their sovereign country.

5. Exposures to Public Sector Entities

Banking organizations must assign a 20% risk weight to general obligations of a public sector entity ("PSE") (i.e., a state, local authority or other governmental subdivision below the sovereign level) that is organized under the laws of the United States and a 50% risk weight for a revenue obligation of such an entity. Exposures to foreign PSEs would be

[17] The current risk-based capital rules call for a 20% risk weight for preferred stock issued by GSEs.

based on the CRC assigned to the PSE's home country and whether the obligation is either a general obligation or a revenue obligation, with the latter higher than the former.

6. Corporate Exposures

The Final Rules treat corporate exposures in a manner consistent with the current risk-based capital rules, *i.e.*, banking organizations would be required to assign a 100% risk weight to all corporate exposures. Corporate exposure would be defined as exposures to a company that is not otherwise provided for in the rules.[18] In the preamble, the Banking Agencies concede that this 100% risk weight "may overstate the credit risk associated with some high-quality bonds." However, given their inability to use credit ratings to differentiate corporate debt, they were unable to develop an alternative to provide more granular risk weights.

Perhaps the most significant change in this area from the current rules is that while the Basel III capital framework treats certain exposures to securities firms like exposures to depository institutions, the Final Rules require banking organizations to treat such exposures to securities firms as corporate exposures (and thus subject to a 100%, rather than a 20% risk weight). Given the size of exposures of U.S. and foreign banks to securities firms, this unilateral decision by the Banking Agencies could place U.S. banks at a material competitive disadvantage to their foreign counterparts, particularly in counterparty-based activities.

7. Residential Mortgage Exposures

The treatment of residential mortgages under the Final Rules represents one of the most significant positive changes from the Proposed Rules. In response to substantial industry comments about the complexity and burden imposed by the multi-dimensional matrix in the Proposed Rules, the Final Rules rejected that approach and generally returned to the treatment under the current capital rules.

A bank may assign a 50% risk weight to a first-lien residential mortgage exposure that (i) is secured by property that is owner-occupied or rented; (ii) is made in accordance with "prudent underwriting standards" (undefined in the Final Rules, but defined generally in a footnote to the current rules); (iii) is not 90 days or more past due or in nonaccrual status;

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[18] A sovereign, the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, an MDB, a depository institution, a foreign bank or a credit union, a PSE, a GSE, a residential mortgage exposure, a pre-sold construction loan, a statutory multifamily mortgage, a high volatility commercial real estate exposure or a cleared transaction, a default fund contribution, a securitization exposure, an equity exposure or an unsettled transaction.

and (iv) is not restructured or modified (loans modified or restructured solely pursuant to the U.S. Home Affordable Modification Program are not considered modified or restructured for these purposes). Other first-lien residential exposures, as well as junior-lien exposures, are assigned a 100% risk weight. While many banking organizations may find the Final Rules superior to the Proposed Rules in this area, it should be noted that FBOs generally assign a 35% risk weight to residential mortgage exposures under the regulatory capital framework applicable to them, and the Final Rules provide no explicit recognition for private mortgage insurance.

8. Pre-sold Construction Loans and Statutory Multifamily Mortgages

The Final Rules maintain the current risk-based capital rules that assign a 50% risk weight to certain one-to-four family residential pre-sold construction loans (unless the purchase contract is cancelled, in which case a 100% risk-weighting applies) and multifamily residential loans. The Final Rules define both "pre-sold construction loan" and "statutory multifamily mortgage" for this purpose, including by referencing Section 618 of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (the "RTCRRA Act"). Multifamily mortgage loans not meeting the criteria in the Final Rules are treated as corporate exposures.

9. High Volatility Commercial Real Estate Exposures

Despite industry objections, the Final Rules retain a 150% risk weight for high volatility commercial real estate ("HVCRE") exposures. Generally, HVCREs are defined as a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development or construction of real property. In response to industry concerns about the scope of the Proposed Rules, however, the Final Rules exempt (in addition to one-to-four family residential properties and commercial real estate projects meeting certain LTV and other requirements, as in the Proposed Rules) additional exposures, including those relating to investments in community development and the purchase or development of agricultural land. A commercial real estate loan that is not an HVCRE exposure is treated as a corporate exposure and assigned a 100% risk weight.

B. Over-the-Counter Derivative Transactions

Under the Final Rules, a banking organization is required to hold risk-based capital for counterparty credit risk for OTC derivative contracts. To determine the risk-weighted asset amount for an OTC derivative contract, a banking organization must first determine its exposure amount for the contract and then apply to that amount a risk-weight based on

the counterparty, eligible guarantor, or recognized collateral. Consistent with the Basel III framework, the risk weight for OTC derivatives contracts is not subject to a specific ceiling.

The Final Rules define "OTC derivatives contract" broadly to capture all common types of derivatives and include transactions with a contractual settlement or delivery lag that is longer than the lesser of the market standard for the particular underlying instrument or five business days. Cleared derivatives transactions are not treated as OTC derivatives contracts; however, an OTC derivatives contract includes exposure of a banking organization that is a clearing member banking organization to its clearing member client where the clearing member banking organization is acting as a financial intermediary and enters into an offsetting transaction with a clearing house or where the clearing member banking organization provides a guarantee to the clearing house on the performance of the client.

For a single OTC derivative contract that is not subject to a qualifying master netting agreement, the rule requires the exposure amount to be the sum of (i) the banking organization's current credit exposure, which is the greater of the fair value or zero, and (ii) the potential future exposure ("PFE"), which is calculated by multiplying the notional principal amount of the OTC derivative contract by the appropriate conversion factor set forth in the Final Rules. Conversion factors range from 0 to 0.15 based on the type of the OTC derivatives contracts and its remaining maturity.

For multiple OTC derivatives contracts subject to a qualifying master netting agreement, a banking organization must calculate the exposure amount by adding (i) the net current credit exposure, which is the greater of zero and the net sum of all positive and negative mark-to-fair values of the individual OTC derivatives contracts subject to such netting agreement and (ii) the adjusted sum of the PFE amounts for all OTC derivatives contracts subject to such netting agreement. A qualifying master netting agreement is defined as any written, legally enforceable netting agreement that creates a single legal obligation for all individual transactions covered by it upon an event of default. To recognize the benefit of a master netting agreement, a banking organization may rely on legal review of an in-house counsel instead of an external or internal legal opinion on the enforceability of the netting agreement. However, the legal review must be sufficient for the banking organization to conclude with a well-founded basis that, among other things, the netting agreement would be found legal, binding and enforceable under the law of the relevant jurisdiction and satisfy certain other conditions, including the banking organization's right to terminate the agreement and liquidate the relevant collateral.

When an OTC derivatives contract is collateralized by financial collateral, the banking organization must first determine the exposure amount as described above, then (i) use the "simple approach" for collateralized transactions or (ii) adjust the exposure amount using the "collateral haircut approach" if the collateral is marked-to-market on a daily basis and subject to daily margin maintenance requirement. Both approaches are discussed in detail below.

Under the Final Rules, if a banking organization purchases a credit derivatives contract that is recognized as a credit risk mitigant for an exposure that is not a covered position under the market risk rules, it is not required to calculate a separate counterparty credit risk capital requirement for that credit derivatives contract as long as it does so consistently for all applicable credit derivatives contracts. When a banking organization sells protection via a credit derivatives contract that is not a covered position under the market risk rules, it must treat such contract as an exposure to the underlying reference asset and calculate a risk-weighted asset amount in accordance with the Final Rules, but is not required to calculate a counterparty credit risk capital requirement as long as it does so consistently for all applicable credit derivatives contracts. However, when a banking organization sells protection via a credit derivatives contract that is a covered position under the market risk rules, it must compute a supplemental counterparty credit risk capital requirement. In either case, the PFE of the protection selling banking organization is capped at the net present value of the amount of unpaid premiums of the credit derivatives contracts.

A banking organization must treat an equity derivatives contract as an equity exposure and calculate the related risk-weighted asset amount in accordance with the simple risk-weight approach (the "SRWA") described below, unless such contract is a covered position under the market risk rules. If a banking organization uses the SRWA, it may elect not to hold risk-based capital against the counterparty risk of the equity derivatives contract as long as it does so consistently with all applicable equity contracts.

C. Cleared Transactions

The Final Rules establish a framework for the regulatory capital treatment of cleared transactions, i.e., exposures associated with derivatives or repo-style transactions entered into with a central counterparty ("CCP"). The Final Rules reflect several Basel Committee consultative documents on cleared transactions, including the Basel Committee's interim framework for the capital treatment of bank exposures to CCPs, which was issued after the

Proposed Rules (the "Interim CCP Framework").[19] Consistent with the Proposed Rules and the Interim CCP Framework, the Final Rules seek to incentivize banking organizations to enter into cleared transactions with "qualified" CCPs that meet certain regulatory and risk management standards ("QCCPs"), and establish lower capital requirements for exposures to QCCPs than non-QCCPs.

1. Risk Weighting for Cleared Transactions

Consistent with the Proposed Rules, the Final Rules require a banking organization to calculate risk-weighted assets for cleared transactions when acting as a clearing member or clearing member client, and to determine the risk-weighted asset amount for a cleared transaction by multiplying the trade exposure amount of the transaction by the appropriate risk weight. A banking organization that is a clearing member must apply a 2% risk weight to trade exposure amounts to a QCCP, while a banking organization that is a clearing member client may apply a 2% risk weight to trade exposure amounts only if it determines that the collateral posted to the QCCP or clearing member client is bankruptcy-remote. If the banking organization cannot make this determination, it must apply a risk weight of 4% to the trade exposure amount.

2. Default Fund Contribution Exposures

The Proposed Rules provided for a single methodology for a clearing member banking organization to calculate risk-weighted asset amounts for funds contributed or commitments made to a CCP's mutualized loss-sharing arrangement ("Default Fund Contributions"). Consistent with the Interim CCP Framework, the Final Rule provides for two alternative methodologies for calculating risk-weighted asset amounts for Default Fund Contributions to a QCCP.[20] Banking organizations must calculate the risk-weighted asset amount for Default Fund Contributions at least quarterly, or more frequently, if there is a material change in the financial condition of the QCCP.

Alternative 1. Under the first alternative for calculating Default Fund Contributions to a QCCP, a banking organization must apply a three-step process. First, the banking organization must calculate the QCCP's hypothetical capital requirement. If the QCCP has already disclosed this amount, the banking organization must rely on the disclosed

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[19] Basel Committee, *Capital Requirements for bank exposures to central counterparties* (July 2012), *available at* http://www.bis.org/publ/bcbs227.pdf

[20] If the CCP is not a QCCP, the banking organization's risk-weighted asset amount for its Default Fund Contribution is either (i) the sum of the Default Fund Contribution multiplied by 1,250%, or (ii) in cases where Default Fund Contributions may be unlimited, an amount determined by the banking organization's primary supervisor.

amount unless it determines a higher amount is appropriate. Second, the banking organization must compare the hypothetical capital requirement to the funded portion of the QCCP's default fund and calculate the total of all clearing members' capital requirements. The banking organization may be required to allocate additional capital depending on the results of these calculations. Third, the banking organization must allocate capital to each individual clearing member on a proportional basis, and multiply its allocated capital requirement by 12.5 to determine its risk-weighted asset amount.

Alternative 2. Under the second alternative, a banking organization's risk-weighted asset amount is equal to its Default Fund Contribution multiplied by 1,250%, subject to an overall cap based on the trade exposure amount of all of the banking organization's transactions with the QCCP.

D. Guarantees and Credit Derivatives

The Final Rules permit banking organizations to recognize the risk-mitigation effects of guarantees and credit derivatives, and provide for a "substation approach" to the recognition of the credit risk mitigation effects of eligible guarantees, pursuant to which a banking organization must substitute the risk weight of the guarantor for the risk weight of the guaranteed exposure. Guarantees must be provided by "eligible guarantors," which include certain enumerated entities (e.g., BHCs and SLHCs) as well as entities that are not special purpose entities and have issued and outstanding unsecured debt securities without credit enhancement that are investment grade and meet certain other requirements. The Banking Agencies note that the use of credit risk mitigants may increase operational, liquidity, market and other risks, and indicate that banking organizations should have "robust procedures and processes" in place to control such risks.

E. Collateralized Transactions

1. Eligible Collateral

Banking organizations may reduce the risk-based capital requirements associated with collateralized transactions by recognizing the credit risk mitigation benefits of eligible financial collateral. Consistent with the Proposed Rules, the Final Rules recognize an expanded range of financial collateral as eligible credit risk mitigants. Under the Final Rules, eligible financial collateral includes: (i) cash on deposit with the banking organization or held for the banking organization by a third-party custodian or trustee; (ii) gold bullion; (iii) short-term debt instruments that are not resecuritization exposures and are investment grade; (iv) publicly traded equity securities; (v) publicly traded

convertible bonds; and (vi) money market fund shares and other mutual fund shares, if a price for the shares is publicly quoted daily. A banking organization must adhere to certain risk management standards in order to recognize the benefits of financial collateral.

2. Simple Approach

The Final Rules provide for a "simple approach" to collateralized transactions, which the Banking Agencies have adopted without substantive change from the Proposed Rules. Under the simple approach, the collateralized portion of an exposure receives the risk weight applicable to the financial collateral. The risk weight assigned to the collateralized portion of the exposure must generally be at least 20%, with the exception of specific types of OTC derivatives transactions and sovereign- or cash-collateralized transactions that may be assigned a 0% risk weight. To qualify for the simple approach, financial collateral must be (i) subject to a collateral agreement for at least the life of the exposure; (ii) revalued at least every six months; and (iii) other than gold, be denominated in the same currency as the exposure.

3. Collateral Haircut Approach

Consistent with the Proposed Rules, the Final Rules permit a banking organization to use the "collateral haircut" approach to recognize the credit risk mitigation benefits of financial collateral securing derivatives, repo-style or eligible margin loan transactions. Under the collateral haircut approach, the transaction exposure amount is equal to the sum of the (i) value of the exposure less the value of the collateral; (ii) absolute value of the net position in a given instrument multiplied by the market price volatility appropriate to the instrument; and (iii) absolute value of the net position of instruments and cash in a currency that is different from the settlement currency multiplied by a haircut appropriate to the currency mismatch.

The collateral haircut approach requires a banking organization to apply standard supervisor haircuts or, with prior approval of the appropriate federal banking agency, its own estimates of haircuts for market price and foreign currency volatility when calculating the exposure amount. In response to comments on the Proposed Rules, the Banking Agencies have reduced the standard supervisory haircut for financial collateral issued by non-sovereign issuers, but have retained the standard supervisory haircut for currency mismatches.

The collateral haircut approach requires a banking organization to assume a holding period of 20 business days for collateral for certain transactions covered by netting sets, including netting sets where the number of trades exceeds 5,000 per quarter. In response

to comments on the Proposed Rules, the Banking Agencies clarify in the preamble to the Final Rules that the 5,000 trade threshold applies on a counterparty-by-counterparty, rather than an aggregate basis. The Banking Agencies also clarify that for indemnified securities lending transactions, a "trade" arises if there is an order by a securities borrower, and that a number of securities lenders providing shares to fulfill an order or a number of shares underlying such order does not constitute a "trade" for purposes of the threshold.

4. Simple Value-at-Risk and Internal Models Methodology

Banking organizations subject to the general risk-based capital rules currently are permitted to use simple Value-at-Risk ("Simple VaR") and internal models methodology ("IMM") approaches to calculate risk-based capital requirements for certain types of repo-style transactions.[21] In the Proposed Rules, the Banking Agencies sought comment on whether to continue to permit the use of these models-based approaches. In the preamble to the Final Rules, the Banking Agencies state that the "increased complexity and limited applicability of these models-based approaches is inconsistent with the [A]gencies' overall focus . . . on simplicity, comparability, and broad applicability of methodologies for U.S. banking organizations." The Final Rules therefore do not permit standardized approach banking organizations to use the Simple VaR or IMM approaches.

F. Unsettled Transactions

Consistent with the Proposed Rules, the Final Rules require a banking organization to hold additional capital against the risks of unsettled transactions involving securities, foreign exchange instruments and commodities. Certain transactions would not be subject to these additional capital requirements, including (i) cleared transactions that are marked to market daily and subject to daily receipt and payment of variation margin; (ii) repo-style transactions; (iii) one-way cash payments on OTC derivatives contracts; and (iv) transactions with a contractual settlement period longer than normal settlement periods.

G. Securitization Exposures

The Final Rules implement substantial revisions to the regulatory capital treatment of securitization exposures. The revised framework differs from the ratings-based approach to the treatment of securitizations under the Basel framework because of the prohibition against the use of credit ratings under Section 939A of the Dodd-Frank Act. The Final

[21] *See, e.g.*, Board Letter to Gregory J. Lyons (Nov. 8, 2005); Board Letter to Gregory J. Lyons (May 14, 2003); OCC Interpretive Letter No. 1105 (Sept. 18, 2008); OCC Interpretive Letter No. 1066 (Nov. 8, 2005).

Rules define a "securitization exposure" as an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arise from a traditional or synthetic securitization (including a resecuritization), or an exposure that directly or indirectly references a securitization exposure.

Banking organizations subject to the market risk rule may apply the simplified supervisory formula approach (the "SSFA") to assign risk weights to securitization exposures. The SSFA formula is composed of (i) a baseline derived from the capital requirements that apply to the exposures underlying the securitization and (ii) risk weights based on the subordination level of the exposure. The Banking Agencies acknowledge that the SSFA may lead to differences in capital requirements for securitization exposures as compared to the Basel framework, and state that they will monitor implementation of the SSFA and consider modifications as necessary in the future.

Banking organizations not subject to the market risk rule may apply a gross-up approach (similar to the existing approach under the general risk-based capital rules) that assigns risk-weighted asset amounts for securitization exposures based on the full amount of the credit-enhanced assets for which the banking organization directly or indirectly assumes credit risk. A banking organization applying the gross-up approach is generally required to do so for all of its securitization exposures, subject to certain specific exceptions.

H. Equity Exposures

1. Equity Exposure Risk Weights

The Final Rules generally follow the same approach to assigning risk weights to equity exposures as the Proposed Rules. Specifically, the Final Rules generally require a banking organization to apply the SRWA to equity exposures that are not exposures to investment funds, and certain "look-through" approaches to equity exposures to investment funds. Under the SRWA, a banking organization must determine the risk-weighted asset amount for the equity exposure by multiplying the adjusted carrying value of the exposure by the applicable risk weight, which depends on the underlying equity exposure. For example, equity exposures to PSEs or Federal Home Loan Banks are assigned a 20% risk weight and publicly traded equity exposures are assigned a 300% risk weight.

2. Equity Exposures to Investment Funds

The Final Rules require a banking organization to risk weight equity exposures to investment funds using the Full, Simple Modified or Alternative Modified Look-Through

Approaches, and clarify that the risk weight for an equity exposure to an investment fund must be no less than 20%.

Full Look-Through Approach. A banking organization may use the Full Look-Through Approach only if it can calculate the risk-weighted asset amount for each of the underlying exposures held by the investment fund. Under the Full Look-Through Approach, a banking organization calculates the risk-weighted asset amount of its proportionate ownership share of each of the exposures held by the fund, as if each underlying exposure were held directly by the banking organization.

Simple Modified Look-Through Approach. Under the Simple Modified Look-Through Approach, the risk-weighted asset amount of an equity exposure to an investment fund is equal to the adjusted carrying value of the exposure, multiplied by the highest risk weight applicable to any exposure the fund is permitted to hold under the prospectus, partnership agreement, or similar agreement defining the fund's permissible investments.

Alternative Modified Look-Through Approach. Under the Alternative Modified Look-Through Approach, the risk-weighted asset amount of an equity exposure to an investment fund is assigned on a pro rata basis to different risk weight categories based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments.

I. Insurance-related Activities

As discussed previously, the Final Rules do not apply to Excluded Insurance SLHCs, which mitigates the overall impact of the Final Rules on insurance activities. With respect to BHCs and SLHCs that conduct insurance activities but are not Excluded Insurance SLHCs, the Final Rules, similar to the Proposed Rules, continue to include special provisions relating to the determination of risk-weighted assets for nonbanking exposures unique to insurance activities.

Policy Loans. The Proposed Rules assigned a 20% risk weight to policy loans. Commenters suggested that policy loans be assigned a 0% risk weight, arguing that policy loans are analogous to cash-collateralized loans because the insurance company generally retains a right of setoff of the value of the principal and interest payments of the policy loan against related policy benefits. The Board rejected these comments and continues to assign a 20% risk weight to policy loans in the Final Rules.

Separate Accounts. The Proposed Rules distinguished between "guaranteed" and "non-guaranteed" separate accounts, and assigned a 0% risk weight to assets held in non-

guaranteed separate accounts. The Proposed Rules defined a "non-guaranteed separate account" as a separate account for which, inter alia, an insurance company is not required to hold reserves for separate account assets pursuant to its contractual obligations on the associated insurance policies. Commenters argued that this prong of the proposed definition was overly broad because state laws generally require insurance companies to hold reserves for all contractual commitments, meaning that many separate accounts held by insurance companies would fail to meet the definition of non-guaranteed separate account. The Board rejected these comments in the Final Rules, stating that the definition of non-guaranteed separate account "ensure[s] that a [0%] risk weight is applied only to those assets for which contracts holders, and not the consolidated banking organization, would bear all the losses." The preamble to the Final Rules states, however, that the Board is "consider[ing] whether and how to provide a unique [regulatory capital] treatment to guaranteed separate accounts," indicating that the Board is still considering this issue and may revisit the regulatory capital treatment of separate accounts in the future.

Commenters also argued that insurance company separate accounts should not be included in the denominator of the leverage ratio, noting that separate account assets generally are not available to satisfy claims of general creditors and do not affect the actual leverage position of an insurance company. While the Final Rules continue to include separate account assets in the denominator of the leverage ratio, the Board states in the preamble that it is "continu[ing] to consider this issue together with other issues raised by commenters regarding the regulatory capital treatment of insurance companies."

<u>Deduction for Investments in Insurance Underwriting Subsidiaries</u>. Consistent with the treatment of insurance underwriting subsidiaries under the current advanced approaches rule, the Proposed Rules would have required covered BHCs or SLHCs to consolidate and deduct the minimum regulatory capital requirement of insurance underwriting subsidiaries (generally 200% of the subsidiary's authorized control level as established by the appropriate state insurance regulator) from the BHC's or SLHC's total capital to reflect the capital needed to cover insurance risk. Commenters argued that it was inappropriate to apply the deduction approach in the existing advanced approaches rule, which was implemented with traditional banking organizations in mind, to holding companies that are predominantly engaged in insurance activities where insurance underwriting companies constitute the predominant amount of regulatory capital and assets. Commenters also noted that any proposed deduction should not cover capital related to asset-specific risks to avoid in effect double counting of regulatory capital. These commenters suggested that the proposed deduction be eliminated or modified to include only insurance regulatory capital for non-asset risks, such as insurance risk and business risk for life insurers and underwriting risk for property and casualty insurers. In response

to these comments, the Board has modified the deduction in the Final Rules to require, for companies using the life risk-based capital formula, a deduction of the regulatory capital requirement related to insurance risk and business risk and, for companies using the property and casualty risk-based formula, a deduction of the regulatory capital requirement related to underwriting risk – reserves and underwriting risk – net written premiums.

AOCI. As discussed previously, the Final Rules permit Non-Advanced Approaches Banking Organizations to "opt out" from removal of the AOCI filter. Because insurance companies often hold more significant amounts of AFS securities on their balance sheets than traditional banking organizations, the option for retaining the AOCI filter is a particularly welcome development for BHCs and SLHCs engaged in insurance activities. Excluded Insurance SLHCs (other than Excluded Insurance SLHCs that become subject to the advanced approaches) will presumably be able to retain the AOCI filter to the same extent as BHCs and SLHCs subject to the Final Rules when the rules for Excluded Insurance SLHCs are ultimately established.

J. Market Discipline and Disclosure Requirements

Consistent with the Proposed Rules, the Final Rules establish enhanced disclosure requirements for banking organizations with $50 billion or more in total consolidated assets that are not consolidated subsidiaries of Advanced Approaches Banks or subject to comparable disclosure requirements in their home jurisdictions. The required disclosures must be made publicly available for each of the last three years, or such shorter time period beginning when the banking organization becomes subject to the disclosure requirement. The Banking Agencies state their belief in the preamble to the Final Rules that covered banking agencies should be able to provide the required disclosures "without revealing proprietary and confidential information."

III. THE ADVANCED APPROACHES

The Final Rules revise the advanced approaches to incorporate certain aspects of Basel III, as well as the 2009 enhancements to the Basel framework and other Basel Committee consultative documents, and implement Section 939A of the Dodd-Frank Act. The advanced approaches generally apply to U.S. banking organizations with $250 billion or more in total consolidated assets or on-balance sheet foreign exposures of $10 billion or more.

A. Counterparty Credit Risk

1. Recognition of Financial Collateral

The Final Rules modify the definition of "financial collateral" for purposes of calculating Exposure at Default ("EAD") under the advanced approaches to exclude re-securitizations, conforming residential mortgages and non-investment grade debt securities. In doing so, the Banking Agencies rejected commenters' suggestions to include additional types of collateral within the definition. The Final Rules also revise the supervisory haircuts for specific types of financial collateral for purposes of EAD calculations, including securitizations and certain investment grade corporate debt securities.

2. Holding Periods and Margin Period of Risk

The Banking Agencies state in the preamble to the Final Rules that during the recent financial crisis, many financial institutions experienced significant delays in settling or closing out collateralized derivatives and repo-style transactions. To address this issue, and consistent with Basel III and the Proposed Rules, the Final Rules incorporate adjustments to the assumed holding periods for collateral in the collateral haircut and Simple VaR approaches and the margin period of risk in the IMM approach, but do not adjust the assumed holding period or margin period of risk for exposures to CCPs.

3. Internal Models Methodology

Consistent with Basel III, the Final Rules define the capital requirement for repo-style transactions, eligible margin loans, and OTC derivatives contracts for which an Advanced Approaches Bank calculates EAD using the IMM approach as equal to the larger of the capital requirement for those exposures using data from the most recent three-year period and data from a three-year period that contains a period of stress reflected in the credit default spreads of the banking organization's counterparties. In addition, and consistent with Basel III and the Proposed Rules, the Final Rules require an Advanced Approaches Bank using the IMM approach to establish risk management procedures to identify, monitor and control wrong-way risk throughout the life of an exposure.

Basel III increases correlation factors used in formulas to calculate an Advanced Approaches Bank's wholesale exposures to financial institutions. The Final Rules implement these increases, but have been modified in several respects in response to comments on the Proposed Rules. First, the multiples for wholesale exposures to both regulated and unregulated financial institutions have been changed from .18 to .12 to be consistent with Basel III. Second, the definition of "unregulated financial institution" has

been modified to incorporate changes to the definition of "financial institution" for purposes of deductions of investments in the capital of unconsolidated financial institutions, as discussed in Section I.B.2(b) above.

4. Credit Valuation Adjustments

The Banking Agencies state in the preamble to the Final Rules that the Basel Committee reviewed the treatment of counterparty credit risk and found that roughly two- thirds of counterparty credit risk losses arose from Credit Valuation Adjustments ("CVA"), i.e. failure value adjustments to reflect counterparty credit risks in the valuation of OTC derivatives contracts. To address this finding, Basel III and the Final Rules include an explicit capital requirement for CVA risk, and provide for a simple and an advanced approach to calculating the CVA capital requirement. An Advanced Approaches Bank must receive prior approval to use the advanced CVA approach, and any Advanced Approaches Bank not approved to use the advanced approach must use the simple CVA approach.

5. Stress Period for Internal Estimates

Consistent with Basel III and the Proposed Rules, the Final Rules require Advanced Approaches Banks to base internal estimate of haircuts on a historical observation period that reflected a continuous 12-month period of significant financial stress appropriate to the security or category of securities. The Banking Agencies retain the discretion to require an Advanced Approaches Bank to use a different period of significant financial stress in the calculation of internal estimates.

B. Removal of References to Credit Ratings

The Final Rules make a number of changes to the advanced approaches rules to implement Section 939A of the Dodd-Frank Act. For example, the Final Rules replace the use of credit ratings in certain provisions of the current advanced approaches rule with an "investment grade" standard that does not rely on credit ratings. "Investment grade" is defined to mean that the entity or reference entity to which the banking organization has an exposure has adequate capacity to meet financial commitments for the projected life of the asset or exposure. An entity or reference entity is deemed to have "adequate capacity to meet financial commitments" if the risk of its default is low and the full and timely repayment of principal and interest is expected.

1. Eligible Guarantor

The current advanced approaches rules recognize credit risk mitigation benefits provided by "eligible securitization guarantors," which must have, *inter alia*, issued and outstanding an unsecured long-term debt security without credit enhancement in one of the three highest investment grade rating categories. Pursuant to Section 939A of the Dodd-Frank Act, the Final Rules replace the term "eligible securitization guarantor" with "eligible guarantor," which includes entities that have issued and outstanding "investment grade" debt securities, as defined above.

2. Removal of Money Market Fund Approach

An Advanced Approaches Bank may assign a 7% risk weight to exposures to money market funds ("MMFs") subject to the SEC's Rule 2a-7 and that have an applicable external rating in the highest investment grade category. The Final Rules eliminate this preferential treatment for MMF exposures, and require an Advanced Approaches Bank to risk weight MMF exposures according to one of the three Look-Through Approaches.

C. Technical Amendments to the Advanced Approaches

The Final Rules make certain technical amendments to the advanced approaches.

1. Eligible Guarantees and Contingent U.S. Government Guarantees

Advanced Approaches Banks currently may recognize the credit risk mitigation benefits of "eligible guarantees," which must be, *inter alia*, "unconditional." The Banking Agencies note that the "unconditional" requirement could exclude certain contingent obligations of the U.S. Government and its agencies from the definition of "eligible guarantee," and clarify that these contingent obligations are included in the definition.

2. Calculation of Foreign Exposures for Applicability of the Advanced Approaches – Insurance Underwriting Subsidiaries

The advanced approaches generally apply to banking organizations with total consolidated assets of $250 billion or more or total consolidated on-balance sheet foreign exposures of $10 billion or more, but permit a BHC to exclude assets held by insurance underwriting subsidiaries for purposes of the $250 billion asset threshold calculation. The Final Rules have been revised to extend both of these exclusions to assets held by insurance underwriting subsidiaries of BHCs and SLHCs.

3. Calculation of Foreign Exposures for Applicability of the Advanced Approaches – Changes to Federal Financial Institutions Economic Council 009

The Banking Agencies have revised the Final Rules to align with changes made to the Federal Financial Institutions Examination Council Country Exposure Report ("FFIEC 009"). Specifically, in order for a banking organization to determine whether it meets the $10 billion foreign exposure threshold, it must add adjusted cross-border claims, local country claims and cross-border revaluation gains in accordance with FFIEC 009.

4. Applicability of the Advanced Approaches

Consistent with the Proposed Rules, the Final Rules clarify that once a banking organization becomes subject to the advanced approaches, it will remain so until its primary Federal supervisor determines that application of the advanced approaches is inappropriate in light of the banking organization's asset size, complexity, risk profile or scope of operations.

5. Change to the Definition of Probability of Default Related to Seasoning

The advanced approaches currently require upward adjustments to estimated probability of default for retail exposure segments for which seasoning effects are material. Consistent with the Proposed Rules, the Final Rules eliminate this seasoning requirement, and state that the Banking Agencies will consider seasoning when evaluating a firm's assessment of its capital adequacy from a supervisory perspective.

6. Cash Items in Process of Collection

The advanced approaches currently do not assign a specific risk weight to cash items in the process of collection; these items are therefore subject to a 100% risk weight. The Final Rules risk weight cash items in the process of collection at 20%.

7. Change to the Definition of Qualifying Revolving Exposure

The Final Rules modify the definition of "Qualifying Revolving Exposure" ("QRE") such that certain unsecured and unconditionally cancellable exposures where an Advanced Approaches Bank consistently imposes in practice an upper limit of $100,000 and requires payment in full every cycle will qualify as QRE.

8. Trade-related Letters of Credit

Consistent with the Basel framework and the Proposed Rules, the Final Rules remove the one-year maturity floor for trade-related letters of credit.

9. Defaulted Exposures That Are Guaranteed by the U.S. Government

The current advanced approaches rules require an Advanced Approaches Bank to apply an 8% capital requirement to the EAD for wholesale exposures to defaulted obligors and each segment of defaulted retail exposures. The Final Rules amend this requirement for wholesale exposures to defaults obligors and segments of defaulted retail exposures covered by an eligible guarantee from the U.S. government, and assign a 1.6% capital requirement to the portion of the EAD for these exposures.

10. Stable Value Wraps

The Final Rules clarify that a banking organization providing stable value protection must treat the exposure as an equity derivative on an investment fund and determine the adjusted carrying value of the exposure as if it were an equity exposure.

11. Treatment of Pre-Sold Construction Loans and Multi-family Residential Loans

Consistent with the general risk-based capital rules, the standardized approach and the RTCRRA Act, the Final Rules apply either a 50% or 100% risk weight to certain one-to-four family residential pre-sold construction loans.

D. Pillar 3 Disclosure Requirements

Consistent with the Basel framework and the Proposed Rules, Advanced Approaches Banks are required to provide certain enhanced qualitative and quantitative disclosures on a quarterly, or in some cases, annual basis. Required disclosures relate to various aspects of an Advanced Approaches Bank's capital condition and policies, including its approach to assessing capital adequacy, accounting and regulatory consolidation practices and structure and organization of relevant risk management functions.

IV. CONCLUSION

The Final Rules represent the culmination of a significant and concerted effort by the Banking Agencies to implement the international Basel III framework and increase capital requirements for U.S. banking organizations in the wake of the financial crisis. As such, the Final Rules are a significant milestone in the post-crisis regulatory reform process and

for the historical development of the U.S. bank regulatory framework. Despite the issuance of the Final Rules, the policy debate is ongoing, as the Banking Agencies consider, analyze and implement additional capital-related reforms for the largest U.S. banking organizations. It is currently unclear how and to what extent the Final Rules will interact with these additional reforms, and the extent to which the Final Rules will impact the fundamental structure of the U.S. banking sector is also unclear. What is clear, however, is that the post-crisis U.S. regulatory reform process is far from concluded, at least with respect to regulatory capital requirements for U.S. banking organizations.

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Please do not hesitate to contact us with any questions.

July 10, 2013

Appendices

Appendix A – Regulatory Capital Levels; Implementation Schedule

Appendix B – Implementation of the Capital Conservation Buffer

Appendix C – Prompt Corrective Action Levels for Insured Depository Institutions

Appendix D – A Comparison of Current and Final Risk Weights

Appendix E – Capital Treatment of Insurance Assets and Activities

Appendix A – Regulatory Capital Levels; Implementation Schedule

Advanced Approaches Banking Organizations

	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Capital conservation buffer			0.625%	1.25%	1.875%	2.5%
Minimum common equity tier 1 capital ratio + capital conservation buffer	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum tier 1 capital ratio + capital conservation buffer	5.5%	6.0%	6.625%	7.125%	7.875%	8.5%
Minimum total capital ratio + capital conservation buffer	8.0%	8.0%	8.625%	9.125 %	9.875%	10.5%
Maximum potential countercyclical capital buffer			0.625%	1.25%	1.875%	2.5%

Non-Advanced Approaches Banking Organizations

	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Capital conservation buffer			0.625%	1.25%	1.875%	2.5%
Minimum common equity tier 1 capital ratio + capital conservation buffer		4.5%	5.125%	5.75%	6.375%	7.0%
Minimum tier 1 capital ratio + capital conservation buffer		6.0%	6.625%	7.125%	7.875%	8.5%
Minimum total capital ratio + capital conservation buffer		8.0%	8.625%	9.25 %	9.875%	10.5%

Appendix B – Implementation of the Capital Conservation Buffer

Transition Period	Capital conservation buffer (assuming a countercyclical capital buffer of zero)	Maximum payout ratio (as a percentage of eligible retained income)
Calendar year 2016	Greater than 0.625 percent	No payout ratio limitation applies
	Less than or equal to 0.625 percent, and greater than 0.469 percent	60 percent
	Less than or equal to 0.469 percent, and greater than 0.313 percent	40 percent
	Less than or equal to 0.313 percent, and greater than 0.156 percent	20 percent
	Less than or equal to 0.156 percent	0 percent
Calendar year 2017	Greater than 1.25 percent	No payout ratio limitation applies
	Less than or equal to 1.25 percent, and greater than 0.938 percent	60 percent
	Less than or equal to 0.938 percent, and greater than 0.625 percent	40 percent
	Less than or equal to 0.625 percent, and greater than 0.313 percent	20 percent
	Less than or equal to 0.313 percent	0 percent
Calendar year 2018	Greater than 1.875 percent	No payout ratio limitation applies
	Less than or equal to 1.875 percent, and greater than 1.406 percent	60 percent
	Less than or equal to 1.406 percent, and greater than 0.938 percent	40 percent
	Less than or equal to 0.938 percent, and greater than 0.469 percent	20 percent
	Less than or equal to 0.469 percent	0 percent

Appendix C – Prompt Corrective Action Levels for Insured Depository Institutions

Requirement	Total RBC measure (%)		Tier 1 RBC measure (%)		Common Equity Tier 1 RBC measure (%)		Leverage Measures: Leverage ratio (%)		Leverage Measures: Supplementary Leverage Ratio* (%) (Advanced Approaches Banks only)	PCA Requirements (unchanged from current rule)
	Current	Final Rules	Current	Final Rules	Current	Final Rules	Current	Final Rules		
Well-capitalized	≥ 10	≥ 10	≥ 6	≥ 8	N/A	≥ 6.5	≥ 5	≥ 5	N/A	None.
Adequately-capitalized	≥ 8	≥ 8	≥ 4	≥ 6	N/A	≥ 4.5	≥ 4 (or ≥ 3)	≥ 4	≥ 3	May limit nonbanking activities at DI's FHC and includes limits on brokered deposits.
Undercapitalized	< 8	< 8	< 4	< 6	N/A	< 4.5	< 4 (or < 3)	< 4	< 3	Includes adequately capitalized restrictions, and also includes restrictions on asset growth; dividends; requires a capital plan.
Significantly Undercapitalized	< 6	< 6	< 3	< 4	N/A	< 3	< 3	< 3	N/A	Includes undercapitalized restrictions, and also includes restrictions on sub-debt payments.
Critically Undercapitalized	Tangible Equity (defined as Tier 1 Capital plus non-tier 1 perpetual preferred stock) to Total Assets ≤ 2								N/A	Generally receivership/ conservatorship within 90 days.

* The supplementary leverage ratio as a PCA requirement applies only to advanced approaches banking organizations that are insured depository institutions. The supplementary leverage ratio also applies to advanced approaches bank holding companies, although not in the form of a PCA requirement.

Appendix D – A Comparison of Current and Final Risk Weights

Category	Current Risk Weight (in general)	Final Rules	Comments
Cash	0%	0%	
Direct and unconditional claims on the U.S. Government, its Agencies, and the Federal Reserve	0%	0%	
Claims on certain supranational entities and multilateral development banks	20%	0%	Claims on supranational entities include, for example, claims on the International Monetary Fund.
Cash items in the process of collection	20%	20%	
Conditional claims on the U.S. Government	20%	20%	A conditional claim is one that requires the satisfaction of certain conditions, for example, servicing requirements.
Claims on government-sponsored entities (GSEs)	20% 100% on GSE preferred stock (20% for national banks).	20% on exposures other than equity exposure or preferred stock.	
Claims on U.S. depository institutions and credit unions	20% 100% risk weight for an instrument included in the depository institution's regulatory capital.	20% 100% risk weight if the exposure is an equity exposure, a significant investment in the capital of an unconsolidated financial institution in the form	Instruments included in the capital of the depository institution may be deducted or treated under the equities section below.

Category	Current Risk Weight (in general)	Final Rules	Comments
		of common stock, or deducted from regulatory capital.	
Claims on U.S. public sector entities (PSEs)	20% for general obligations. 50% for revenue obligations.	20% for general obligations. 50% for revenue obligations.	
Industrial development bonds	100%	100%	
Claims on qualifying securities firms	20% in general.	100% See commercial loans and corporate exposures to financial companies section below.	Instruments included in the capital of the securities firm may be deducted or treated under the equities section below.
1-4 family loans	50% if first lien, prudently underwritten, owner-occupied or rented, current or <90 days past due. 100% otherwise.	50% if first lien, prudently underwritten, owner-occupied or rented, current or < 90 days past due. 100% otherwise.	
1-4 family loans modified under HAMP	50% and 100%. The banking organization must use the same risk weight assigned to the loan prior to the modification so long as the loan continues to meet other applicable prudential criteria.	50% and 100%.	HAMP loans are not treated as modified or restructured loans.
Loans to builders secured by 1-4 family properties	50% if the loan meets all criteria in the regulation; 100% if the contract	50% if the loan meets all criteria in the regulation; 100% if the	

Category	Current Risk Weight (in general)	Final Rules	Comments
presold under firm contracts	is cancelled; 100% for loans not meeting the criteria.	contract is cancelled; 100% for loans not meeting the criteria.	
Loans on multifamily properties	50% if the loan meets all the criteria in the regulation; 100% otherwise.	50% if the loan meets all the criteria in the regulation; 100% otherwise.	
Corporate exposures	100%	100%	
High volatility commercial real estate (HVCRE) loans	100%	150%	The proposed treatment would apply to certain facilities that finance the acquisition, development or construction of real property other than 1-4 family residential property.
Consumer loans	100%	100%	
Past due exposures	Generally the risk weight does not change when the loan is past due. However, 1-4 family loans that are past due 90 days or more are 100% risk weight.	150% for the portion that is not guaranteed or secured (does not apply to sovereign exposures or 1-4 family residential mortgage exposures).	
Assets not assigned to a risk weight category, including fixed assets, premises, and other real estate owned	100%	100%	
Claims on foreign governments and their central banks	0% for direct and unconditional claims on OECD governments; 20% for conditional claims on OECD governments; 100% for claims on	Depends on CRC applicable to the sovereign and ranges between 0% and 150%.	

Category	Current Risk Weight (in general)	Final Rules	Comments
	non-OECD governments that entail some degree of transfer risk.	0% for sovereigns that do not have a CRC but are in the OECD. 100% for sovereigns that do not have a CRC and are not in the OECD. 150% for a sovereign that has defaulted within the previous five years.	
Claims on foreign banks	20% for claims on banks in OECD countries. 20% for short-term claims on banks in non-OECD countries. 100% for long-term claims on banks in non-OECD countries.	Risk weight depends on home country's CRC rating and ranges between 20% and 150%. 20% for a foreign bank in a country that does not have a CRC but is a member of the OECD. 100% for a foreign bank in a non OECD member country and does not have a CRC. 150% in the case of a sovereign default in the bank's home country. 100% for an instrument included in a bank's regulatory capital (unless that instrument is an equity exposure or is deducted).	
Claims on foreign PSEs	20% for general obligations of states and political subdivisions of	Risk weight depends on the home country's CRC and ranges	

Category	Current Risk Weight (in general)	Final Rules	Comments
	OECD countries. 50% for revenue obligations of states and political subdivisions of OECD countries. 100% for all obligations of states and political subdivisions of non-OECD countries.	between 20% and 150% for general obligations; and between 50% and 150% for revenue obligations. 20% for exposures to a PSE general obligation in a home country that does not have a CRC but is in the OECD and 50% for revenue obligations. 100% for exposures to a PSE general obligation in a home country that does not have a CRC and is not in the OECD and 100% for revenue obligations. 150% for a PSE in a home country with a sovereign default.	
MBS, ABS, and structured securities	Ratings Based Approach: 20%: AAA & AA. 50%: A-rated. 100%: BBB. 200%: BB-rated. [Securitizations with short-term ratings – 20, 50, 100, and for unrated positions, where the banking organization determines the credit rating – 100 or 200]. Gross-up approach: the risk-	Deduction for the after-tax gain-on-sale of a securitization. 1,250% risk weight for a CEIO. 100% for interest-only MBS that are not credit-enhancing. Banking organizations may elect to follow a gross-up approach, similar to existing rules. SSFA: the risk weight for a position is determined by a formula and is based on the risk weight applicable to the	

Category	Current Risk Weight (in general)	Final Rules	Comments
	weighted asset amount is calculated using the risk weight of the underlying assets amount of the position and the full amount of the assets supported by the position (that is, all of the more senior positions). Dollar for dollar capital for residual interests. Deduction for CEIO strips over concentration limit. 100% for stripped MBS (IOs and POs) that are not credit enhancing.	underlying exposures, the relative position of the securitization position in the structure (subordination), and measures of delinquency and loss on the securitized assets. 1,250% otherwise.	
Unsettled transactions	Not addressed.	100%, 625%, 937.5%, and 1,250% for DvP or PvP transactions depending on the number of business days past the settlement date. 1,250% for non-DvP, non-PvP transactions more than five days past the settlement date. The proposed capital requirement for unsettled transactions would not apply to cleared transactions that are marked-to-market daily and subject to daily receipt of variation margin.	DvP (delivery vs. payment) transaction means a securities or commodities transaction in which the buyer is obligated to make payment only if the seller has made delivery of the securities or commodities and the seller is obligated to deliver the securities or commodities only if the buyer has made the payment. PvP (payment vs. payment) transaction means a foreign exchange transaction in which each counterparty is obligated to make the final transfer of one or more currencies only if the other counterparty has made a final transfer of one or more currencies.

Category	Current Risk Weight (in general)	Final Rules	Comments
Equity Exposures	100% of incremental deduction approach for nonfinancial equity investments.	0%: Equity exposures to a sovereign, certain supranational entities, or an MDB whose debt exposures are eligible for 0% risk weight. 20%: Equity, exposures to a PSE, a FHLB, or Farmer Mac. 100%: Equity exposures to community development investments and small business investment companies and non-significant equity investments. 250%: Significant investments in the capital of unconsolidated financial institutions not deducted from capital. 300%: Most publicly traded equity exposures. 400%: Equity exposures that are not publicly traded. 600%: Equity exposures to certain investment funds.	MDB = multilateral development bank.
Equity exposures to investment funds	There is a 20% risk weight floor on mutual fund holdings. General rule: Risk weight is the same as the highest risk weight investment the fund is permitted to	Full look-through: Risk weight the assets of the fund (as if owned directly) multiplied by the banking organization's proportional ownership in the	

Category	Current Risk Weight (in general)	Final Rules	Comments
	hold. Option: A banking organization may assign risk weights *pro rata* according to the investment limits in the fund's prospectus.	fund. Simple modified look-through: Multiply the banking organization's exposure by the risk weight of the highest risk weight asset in the fund. Alternative modified look-through: Assign risk weight on a *pro rata* basis based on the investment limits in the fund's prospectus. For community development exposures, risk-weighted asset amount = adjusted carrying value.	
Credit Conversion Factors Under Current and Final Rules			
Conversion Factors for off-balance sheet items	0% for the unused portion of a commitment with an original maturity of one year or less, or which is unconditionally cancellable at any time. 10% for unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less. 20% for self-liquidating trade-related contingent items.	0% for the unused portion of a commitment that is unconditionally cancellable by the banking organization. 20% for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable. 20% for self-liquidating trade-related contingent items.	

Category	Current Risk Weight (in general)	Final Rules	Comments
	50% for the unused portion of a commitment with an original maturity of more than one year that are not unconditionally cancellable. 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit). 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.	50% for the unused portion of a commitment over one year that is not unconditionally cancellable. 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit). 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements.	
Derivative contracts	Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors. *50% risk weight cap.*	Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors. *No risk weight cap.*	
Credit Risk Mitigation Under Current and Final Rules			
Guarantees	Generally recognizes guarantees provided by central governments, GSEs, PSEs in OECD countries, multilateral lending institutions, regional development banking organizations, U.S. depository institutions, foreign banks, and	Recognizes guarantees from eligible guarantors: sovereign entities, BIS, IMF, ECB, European Commission, FHLBs, Farmer Mac, a multilateral development bank, a depository institution, a BHC, an SLHC, a foreign bank,	Claims conditionally guaranteed by the U.S. government receive a 20% risk weight.

Category	Current Risk Weight (in general)	Final Rules	Comments
	qualifying securities firms in OECD countries. Substitution approach that allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure.	or an entity other than a SPE that has investment grade debt, whose creditworthiness is not positively correlated with the credit risk of the exposures for which it provides guarantees and is not a monocline insurer or re-insurer. Substitution treatment allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure. Applies only to eligible guarantees and eligible credit derivatives, and adjusts for maturity mismatches, currency mismatches, and where restructuring is not treated as a credit event.	
Collateralized transactions	Recognize only cash on deposit, securities issued or guaranteed by OECD countries, securities issued or guaranteed by the U.S. government or a U.S. government agency, and securities issued by certain multilateral development banks.	Two approaches: 1. Simple approach: A banking organization may apply a risk weight to the portion of an exposure that is secured by the market value of collateral by using the risk weight of collateral—with a general risk weight floor of 20%.	Financial collateral: Cash on deposit at the banking organization (or third party custodian); gold; investment grade securities (excluding re-securitizations); publicly traded convertible bonds; money market mutual fund shares; and other mutual fund shares if a price is quoted daily. In all cases the banking organization must have a perfected, first priority interest.

Category	Current Risk Weight (in general)	Final Rules	Comments
	Substitute risk weight of collateral for risk weight of exposure, sometimes with a 20% risk weight floor.	2. Collateral haircut approach using standard supervisory haircuts or own estimates of haircuts for eligible margin loans, repo-style transactions, collateralized derivative contracts.	For the simple approach there must be a collateral agreement for at least the life of the exposure; collateral must be revalued at least every six months; collateral other than gold must be in the same currency.

Appendix E – Capital Treatment of Insurance Assets and Activities

Asset/Activity	Definition	Capital Treatment
Insurance underwriting subsidiaries	An insurance underwriting subsidiary of a BHC or SLHC.	BHCs and SLHCs are required to deduct an amount equal to the regulatory capital requirement for insurance underwriting risks established by the regulator of any insurance underwriting activities of the company (50% from tier 1 capital and 50% from tier 2 capital).
Policy Loans	A loan to policyholders under the provisions of an insurance contract that is secured by the cash surrender value or collateral assignment of the related policy or contract.	Risk weighted at 20%.
Separate Accounts	A legally segregated pool of assets owned and held by an insurance company and maintained separately from its general account assets for the benefit of individual contract holders. The account must meet the following additional conditions in order to be deemed a separate account: 1. The account must be legally recognized under applicable law; 2. The assets in the account must be insulated from the general liabilities of the insurance company and protected from the insurance company's general creditors in the event of the insurer's insolvency; 3. The insurance company must invest the funds within the account as directed by the contract holder in designated investment alternatives or in accordance with specific	

Asset/Activity	Definition	Capital Treatment
	investment objectives or policies; and 4. All investment performance, net of contract fees and assessments, must be passed through to the contract holder, *provided* that contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling.	
Non-guaranteed separate accounts	Any separate account that meets the above definition and the following additional conditions: 1. The insurance company does not guarantee a minimum return or account value to the contract holder; and 2. The insurance company is not required to hold reserves for these separate account assets pursuant to its contractual obligations on an associated policy.	The risk-weighted asset amount for an on-balance sheet asset that is held in a non-guaranteed separate account is 0% of the carrying value of the asset.
Guaranteed Separate Accounts	Any separate account that meets the above definition and is not a non-guaranteed separate account.	Assigned to risk-weight categories based on the risk weight of the underlying asset.
Deferred Acquisition Costs (DAC)	Costs incurred in the acquisition of a new contract or renewal insurance contract that are capitalized pursuant to GAAP.	Risk weighted at 100%.
Value of Business Acquired (VOBA)	Assets that reflect revenue streams from insurance policies purchased by an insurance company.	Risk weighted at 100%.

Asset/Activity	Definition	Capital Treatment
Surplus Notes	A financial instrument issued by an insurance company that is included in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations. A surplus note would generally have the following features: 1. The applicable state insurance regulator approves in advance the form and content of the note; 2. The instrument is subordinated to policyholders, to claimant and beneficiary claims, and to all other classes of creditors other than surplus note holders; and 3. The applicable state insurance regulator is required to approve in advance any interest payments and principal repayments on the instrument.	Surplus notes would be ineligible for treatment as tier 1 capital, but could be eligible for inclusion in tier 2 capital if the surplus note meets the generally applicable tier 2 capital eligibility criteria.