

Federal Reserve Adopts Final Capital Rules

Implementing Basel III and the Capital Requirements of the Dodd-Frank Act

On July 2, 2013, the Board of Governors of the Federal Reserve adopted final rules implementing the Basel III regulatory capital reforms and certain other capital reforms required by the Dodd-Frank Act.¹ With a few notable modifications highlighted below, the final rules essentially implement the proposed capital rules initially published by the Federal Reserve, OCC and FDIC on June 12, 2012 (comprised of three joint notices of proposed rulemaking, referred to as the NPRs). The modifications to the NPR are primarily intended to minimize the regulatory burden on community banks and were made in direct response to thousands of comment letters and an intense lobbying effort.

Significant provisions in the final rules include, among others:

- **Treatment of Accumulated Other Comprehensive Income (AOCI):** allowing banking organizations not subject to the advanced approaches rule to make a one-time election to opt out of including most elements of AOCI in regulatory capital in favor of following the existing treatment that excludes most AOCI elements from regulatory capital. This change was a direct response to comments that including AOCI (which includes unrealized gains and losses on securities designated as available-for-sale) could introduce significant volatility in capital ratios due to fluctuations in benchmark interest rates, complicating capital planning and asset-liability management for smaller, less complex institutions that may have less robust hedging portfolios and activities; and
- **Revised Risk Weighting for Residential Mortgages:** retaining the current treatment for residential mortgage exposures, generally assigning a 50% or 100% risk weight to exposures secured by one-to-four family residential properties, as opposed to the proposed rules which divide residential mortgage exposures into two categories, with risk weighting ranging from 35% to 200% based upon the mortgage exposure's LTV ratio and product features associated with higher credit risk, which many commentators asserted would inhibit lending to creditworthy borrowers and jeopardize the recovery of the residential real estate market.
- **Grandfathering Trust Preferred Securities:** permanently grandfathering non-qualifying capital instruments (including trust preferred securities and cumulative perpetual preferred stock issued before May 19, 2010) in the tier 1 capital of institutions with total consolidated assets of less than \$15 billion as of December 31, 2009.

Banking organizations that are subject to the advanced approaches rules (generally, all banking organizations with \$250 billion or more in assets) must begin to comply with the final rules on January 1, 2014, while banking organizations not covered by the advanced approaches rules must begin to comply with the final rules on January 1, 2015, in each case, subject to applicable phase-in periods. The final rules do not apply to savings and loan holding companies with significant commercial or insurance underwriting activities. Capital requirements for such entities are subject to further review and evaluation by regulators. The final rules maintain an exemption for those bank holding companies subject to the Federal Reserve's Small Bank Holding Company Policy Statement (i.e., bank holding companies with \$500 million or less in assets that also satisfy certain other criteria).

¹ The Federal Reserve has coordinated the final rules with the FDIC and the OCC, with the FDIC providing notice that it will consider the matter as an interim final rule on July 9, 2013. The OCC expects to review and consider the matter as a final rule by July 9, 2013.

As expected, the final rules increase both the quantity and quality of capital that must be held by banking organizations by imposing a new minimum common equity tier 1 capital ratio of 4.5%, along with a common equity tier 1 capital conservation buffer of 2.5%. The minimum tier 1 capital ratio was increased from 4% to 6%, along with a minimum leverage ratio of 4%. Advanced approaches institutions will be subject to a minimum supplementary leverage ratio of 3%. Also as expected, the final rules implement numerous changes to the methodology for calculating risk-weighted assets to enhance risk sensitivity, which has the effect of increasing the denominator in risk-based capital ratios, thereby increasing the amount of capital a banking organization must have in order to meet its minimum risk-based capital requirements.

Most of the capital enhancement provisions in the new rules apply equally to community banks, which will need to prepare to comply with the final rules. This may be accomplished, in part, by carefully managing the denominator, or risk-weighted asset portion of risk-based capital ratios, to reduce exposure to higher-risk assets. This may result in many institutions employing a variety of asset optimization strategies, such as selling off higher risk-weighted assets or business units (e.g., mortgage servicing and certain commercial real estate lending). For those community banks that have access to the capital markets, compliance with the final rules may also require raising capital by issuing, for example, common stock, convertible preferred stock or qualifying subordinated debt. Enhanced capital requirements may also serve as a catalyst to merger and acquisition activity.

A link to the final rules is below. The Federal Reserve has also published a one-page summary designed to assist community banks, a copy of which is also linked below.

- [Federal Register notice \(PDF\)](#)
- [Community Bank Guide \(PDF\)](#)

For further information regarding the impact of the final capital rules, or financial reform generally, please contact your principal Squire Sanders lawyer or one of the individuals listed on the following page.

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