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Basel III—Heightened Requirements May Create New Capital Pressures

At its meeting on September 12, 2010, the oversight body of the Basel Committee on Banking Supervision (Basel Committee) announced an agreement on higher capital standards for banking institutions located in member countries. These higher capital standards are part of what the Basel Committee called the "core of the global financial reform agenda." This agenda, commonly referred to as "Basel III," was introduced in December 2009, when the Basel Committee published its consultative proposals for global capital and liquidity standards. On July 26, 2010, the Basel Committee reached general agreement on the proposed capital and liquidity reforms. The Basel Committee's September 2010 actions finalized the capital ratio requirements and the phase-in arrangements. The agreed-upon reform measures will be presented to the summit of the Group of Twenty (G-20) Finance Ministers and Central Bank Governors to be held in Seoul, South Korea in November 2010. The leverage capital and liquidity standards are yet to be finalized and released.

It is widely expected that the G-20 summit will adopt Basel III. But even then, Basel III will not be legally binding in itself. The Basel III standards will need to be implemented by the regulatory authorities of member countries by statute or regulation. Member countries are expected to issue laws or regulations to implement Basel III by January 1, 2013, when the first benchmark in the phase-in period is scheduled to be implemented.

It is almost certain that the US federal banking agencies will implement Basel III. The question remains, however, as to how these standards will be harmonized with those imposed under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act), particularly under the so-called "Collins Amendment."

A summary of these matters is set forth in this advisory.

Enhanced Prudential Standards Under Basel III

Basel III requires more capital and a higher quality of capital. It does so by increasing the regulatory capital ratios, narrowing the definition of capital, and requiring capital

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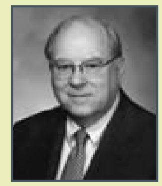

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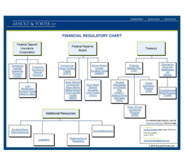

Financial Regulatory Chart

buffers. Basel III will also impose a leverage ratio and liquidity standards, although, as noted above, the specific quantitative requirements have yet to be finalized.

Increased Regulatory Capital Requirements

Basel III reflects a strong emphasis on common equity, and it also requires a corresponding increase in Tier 1 capital.

- Minimum Common Equity Requirement: The minimum common equity requirement is set at 4.5 percent under Basel III, which is up from the current minimum of 2 percent. This requirement will be phased in by January 1, 2015. It will start at 3.5 percent on January 1, 2013, rising to 4 percent on January 1, 2014, and reaching 4.5 percent on January 1, 2015.
- Minimum Tier 1 Capital Requirement: The minimum Tier 1 capital requirement will increase from 4 percent to 6 percent under Basel III. This new requirement will also be phased in by January 1, 2015. It will start at 4.5 percent on January 1, 2013, rising to 5.5 percent on January 1, 2014, and reaching 6 percent on January 1, 2015.
- The minimum total capital requirement remains at 8 percent.
- These ratios are based on risk-weighted assets.

The Basel Committee's September 12, 2010 Press Release contains charts that provide a visual presentation of the new capital requirements and phase-in schedule, *available at:* http://www.bis.org/press/p100912.pdf?noframes=1.

Capital Buffer

Basel III requires a capital conservation buffer in addition to the regulatory capital ratios discussed above. It also envisions a countercyclical buffer requirement that member countries could consider.

Capital Conservation Buffer. Under Basel III, a banking institution will be required to maintain a capital conservation buffer of 2.5 percent, which must be in the form of common equity. A banking institution may reduce this buffer during periods of financial and economic stress, but as the buffer diminishes, the institution will operate under greater constraints on earnings distributions, including not only dividends but also discretionary bonuses. It is not clear whether an institution would be permitted to reduce its 2.5 percent capital conservation buffer only when there is a formal determination that the financial system as a whole is stressed. Specifically, if an institution fails to maintain the full 2.5 percent capital conservation buffer when there is no system-wide financial or economic stress, will the adverse consequences to the institution be limited to restraints on earnings distributions alone, or will they also include those imposed on institutions failing to meet the minimum regulatory capital requirements? This issue is not addressed in the accord and so will need to be considered by member countries as the accord is implemented.

The capital conservation buffer will be phased in after the higher minimum regulatory capital requirements are already in effect. Specifically, it will start at 0.625 percent on January 1, 2016 and increase to 1.25 percent on January 1, 2017, to 1.875 percent on January 1, 2018, and finally to 2.5 percent by January 1, 2019.

Countercyclical Buffer. Basel III also recommends a countercyclical buffer. Each member country may choose to require this buffer "according to national circumstances." If implemented, the buffer would be in the range of 0 percent to 2.5 percent of common equity or "other fully loss absorbing capital." It would be an extension of the capital conservation buffer, and therefore, it would not directly increase the minimum regulatory capital requirements. Unlike the capital conservation buffer, the countercyclical buffer could be made up of "fully loss absorbing capital" other than common equity, and it would appear that each member country would be defining that term according to its own circumstances. In addition, the countercyclical buffer would be in effect only when there is excess credit growth that is resulting in a system-wide build-up of risk. The Basel Committee did not specify a phase-in period for the countercyclical buffer, presumably because it is a discretionary measure.

Stronger Definition of Capital

Basel III not only requires higher capital ratios, but also applies stricter definitions and adjustments to the components of capital.

Deductions From Common Equity. As discussed above, Basel III requires a banking institution to hold more common equity. Basel III also requires a banking institution to take certain deductions from its common equity. For example, under Basel III, the amount of each of the following types of assets must be deducted from the common equity of a banking institution to the extent that it exceeds 10 percent of the institution's common equity: significant investments (i.e., more than 10 percent of the issued shares) in the common shares of unconsolidated financial institutions, mortgage servicing rights, and deferred tax assets that arise from the different timing of financial and tax reporting. Moreover, if the aggregate amount of these three types of assets exceeds 15 percent of the institution's common equity, the institution must also deduct the excess from its common equity. Under the current capital regulations of the US federal banking agencies, certain deductions must be made from either the Tier 1 capital or total capital of a banking institution for these types of assets, but the implementation of Basel III will result in more deductions, and from the common equity component of Tier 1 capital.

The required deductions from common equity will be phased in starting on January 1, 2014. At that time, a banking institution will be required to make 20 percent of the full deductions that would be required but for the phase-in schedule. It will be required to make 40 percent of the full deductions on January 1, 2015, 60 percent on January 1, 2016, 80 percent on January 1, 2017, and 100 percent on January 1, 2018. Before full deductions are made, the amount that would be deducted under Basel III but for the phase-in schedule will need to be deducted to the extent required under the existing capital regulations of the applicable member country.

Stricter Definitions of Tier 1Capital and Tier 2 Capital. Under Basel III, a capital instrument must be perpetual (i.e., with no maturity date and no incentive to redeem) to qualify for inclusion in Tier 1 capital. As a result, trust preferred securities and preferred stock issued to the US Department of the Treasury under the Troubled Asset Relief Program (TARP) likely would not qualify for inclusion in Tier 1 capital under the Basel III definition. However, there is also a phase-in schedule for the new definition of Tier 1 capital. Existing public sector capital injections such as the TARP preferred stock will be grandfathered until January 1, 2018. For other capital instruments that will no longer qualify as non-common equity Tier 1 capital, 10% of their nominal amount must be excluded on January 1, 2013, another 10 percent must be excluded on the following January 1, and so forth, until the entire amount is excluded on January 1, 2022. The same phase-in schedule applies to capital instruments that would no longer qualify for inclusion in Tier 2 capital under Basel III, although it is less apparent which instruments would fall into this category, at least with respect to instruments widely used in the United States.

Leverage Ratio

Historically, the Basel capital standards have not included a minimum leverage ratio. This will change with Basel III. The supervisory monitoring period will commence on January 1, 2011. The parallel run period, during which banking institutions will calculate their leverage ratios for review by the regulators but will not be subject to a formal leverage ratio requirement, will run from January 1, 2013 to January 1, 2017, and it is currently proposed that a 3 percent Tier 1 leverage ratio be tested during that period. A banking institution will be expected to disclose its leverage ratio (including the components of the ratio) starting on January 1, 2015. The Basel Committee proposes to finalize a leverage ratio requirement in the first half of 2017, with the goal of making it a formal regulatory capital requirement on January 1, 2018.

Liquidity Standards

The Basel Committee is also working toward certain liquidity standards. It proposes to introduce the minimum liquidity coverage ratio on January 1, 2015. It also proposes to introduce the minimum net stable funding ratio by January 1, 2018.

Systemically Important Banking Institutions

The Basel Committee stated in the September 12, 2010, press release that systemically important banks should have greater loss absorbing capacity than the standards already agreed upon, and that it was working to develop measures for such institutions. However, the particulars of that greater capacity were not detailed, and could end up putting larger institutions at a disadvantage versus their smaller competitors who may not be subject to these additional standards.

Implications of Basel III for US Banking Institutions

Basel III has the potential to significantly impact US banking institutions. The magnitude of that impact will largely depend on how Basel III is implemented in the United States through regulations prescribed by the federal banking agencies and how these regulations interact with those adopted pursuant to the Dodd-Frank Act.

Application to Banking Organizations Irrespective of Size

The US federal banking agencies are expected to apply the Basel III standards generally to domestic banks, thrifts, and their holding companies irrespective of size. Despite their statement that Basel III "sets the stage for key regulatory changes to strengthen the capital and liquidity of internationally active banking organizations," it is generally expected that the US federal banking agencies will not limit the implementation of Basel III to those organizations. It is possible, however, that smaller institutions might benefit from extended phase-in periods or some grandfathering of existing requirements.

At the same time, it should be expected that systemically important banks in the United States would be required to have loss absorbing capacity beyond the generally applicable Basel III standards as a result of Dodd-Frank Act requirements.

Interaction with the Capital Categories Under Prompt Corrective Action Regulations

Before Basel III, a banking institution generally meets the Basel capital adequacy standards if it has a Tier 1 capital ratio of 4percent and a total capital ratio of 8 percent. Under the Prompt Corrective Action Regulations in effect in the United States, an insured depository institution with these capital adequacy ratios is considered adequately capitalized (provided that it also attains a leverage ratio of 3 percent or 4 percent, depending on its regulatory rating). However, in certain cases, a US insured depository institution needs to be well capitalized, which requires higher capital ratios. Therefore, many US banking institutions may already maintain capital ratios higher than the Basel capital adequacy standards, ratios which may be increased even further as a result of the Dodd-Frank Act.

Interaction with the Collins Amendment

There seems to be uncertainty as to how Basel III will interact with section 171 of the Dodd-Frank Act, commonly known as the Collins Amendment.[1] The Collins Amendment requires that the federal banking agencies prescribe minimum leverage capital requirements and minimum risk-based capital requirements on a consolidated basis for insured depository institutions, bank holding companies, savings and loan holding companies, and nonbank financial companies supervised by the Federal Reserve. It may be that the requirements established under the Collins Amendment exceed the Basel III standards. (It is highly unlikely they would be less stringent.) For example, regulations to implement the Collins Amendment may assign higher risk-weightings to certain assets than Basel III requires, and thus increase capital requirements for banking institutions.

Furthermore, while both Basel III and the Collins Amendment eliminate Tier 1 capital treatment for trust preferred securities, the two regimes have different transition periods. Under the Collins Amendment, for depository institution holding companies with total consolidated assets of US$15 billion or more, the requirement to exclude trust preferred securities issued before May 19, 2010 from Tier 1 capital will be phased in over a period of three years, beginning on January 1, 2013. Under Basel III, the requirement to exclude trust preferred securities from Tier 1 capital will be phased in over a 10-year period beginning on the same date. On the other hand, under the Collins Amendment, trust preferred securities issued before May 19, 2010 by bank holding companies with consolidated assets of less

1 See Arnold & Porter Advisory, "Congress Finalizes Landmark Financial Regulatory Reform Legislation," July 2010, available at: http://www.arnoldporter.com/public_document.cfm?id=16134&key=2E2.

than US$15 billion in consolidate assets as of December 31, 2009 are grandfathered as Tier 1 capital, while Basel III has no such exception. Given the divergent measures, it is possible then that the shorter transition period in the Collins Amendment may prevail. As a result, US institutions could find themselves in the worst of both worlds, with the substantially shorter transition phase of the Dodd-Frank Act but without the benefit of the statute's grandfathering.

In addition, under the Collins Amendment, savings and loan holding companies in the United States will not be subject to consolidated capital requirements until July 21, 2015. It is unclear how the Federal Reserve, which is set to assume supervisory authority over such companies, will apply Basel III to them before that date. Arguably, savings and loan holding companies should enjoy the benefit of the statutory transition period. The Dodd-Frank Act appears to give the Federal Reserve the authority to impose capital measures on savings and loan holding companies prior to the five-year phase-in period set by the Collins Amendment.

International Consistency

Basel III seeks to promote international consistency of capital requirements, which should be considered a benefit to the US banking industry. As noted above, Basel III requires the deduction of significant investments in the common shares of unconsolidated financial institutions, mortgage servicing rights, and deferred tax assets above a certain threshold from common equity. Currently, US capital regulations require certain deductions of these items from Tier 1 capital or total capital, but other countries may not require such deductions. As another example, US insured depository institutions (but not holding companies) are currently subject to a leverage ratio, which does not apply in all other member countries of the Basel Committee. In this regard, even though Basel III sets a higher bar, it levels the international playing fields for US banking institutions.

Conclusion

US banking institutions would be well advised to carefully analyze and evaluate the possible aggregate effect of the implementation of the Basel III standards and the post-Dodd-Frank Act requirements on their operations and business models, with a view toward determining any need to raise capital to become capital compliant. It is likely that the new capital standards would increase the cost of capital for the US banking sector and affect its profitability and growth.

As with the earlier Basel capital adequacy frameworks, Basel III is expected to be implemented in the United States through regulation rather than legislation. Accordingly, banking institutions should consider participating in the regulatory process to explain their business needs in relation to the policy goal of ensuring financial stability, and contribute to a balanced and reasoned regulatory approach to the implementation of Basel III.

Arnold & Porter is pleased to assist banking institutions with new capital requirements imposed by the Dodd-Frank Act and Basel III. For further information, please contact your Arnold & Porter attorney or:

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