Banking Agencies Finalize Simplification of Capital Rules for Non-Advanced Approaches Firms

July 15, 2019

The U.S. banking agencies have released a **final rule** amending the U.S. Basel III capital rules[1] to simplify the capital treatment of capital deductions and recognition of minority interests for non-advanced approaches banking organizations, as well as implementing certain technical amendments applicable to both advanced approaches and non-advanced approaches banking organizations.

The final rule will:

- simplify for non-advanced approaches banking organizations the framework of regulatory capital deductions and heightened risk weights for mortgage servicing assets (**MSAs**), deferred tax assets (**DTAs**) arising from temporary differences that an institution could not realize through net operating loss carrybacks (**temporary difference DTAs**), and investments in the capital of unconsolidated financial institutions (**UFI investments**), resulting in potentially fewer deductions for these items (collectively, the **deduction framework simplifications**);
- simplify for non-advanced approaches banking organizations the recognition and calculation of minority interests that are includable in regulatory capital (the **minority interest simplification**), resulting in potentially greater recognition of minority interests; and
- make certain technical amendments to the capital rules for both non-advanced approaches and advanced approaches banking organizations, including, for banking organizations regulated by the Federal Reserve, the removal of the prior approval requirement for redemptions or repurchases of Common Equity Tier 1 (**CET1**) capital unless approval is required by other provisions of the capital rules or other applicable laws or regulations.

The technical amendments will be effective on October 1, 2019, and the deduction framework simplifications and minority interest simplifications will be effective on April 1, 2020. The final rule also supersedes the transition rule the agencies adopted in 2017 to allow non-advanced approaches banking organizations to continue to apply the transition treatment in effect in 2017 while the agencies considered the capital simplification proposals.

The final rule primarily applies to non-advanced approaches banks as they are currently defined, i.e., banking organizations with less than $250 billion in total consolidated assets or less than $10 billion in foreign on-balance sheet exposure. The deduction framework simplifications and minority interest simplification do not apply to advanced approaches banks, not even in their calculation of regulatory capital ratios under the standardized approach.

The tailoring proposals released by the banking agencies in October 2018 for **domestic banking organizations** and April 2019 for **foreign banking organizations** would, however, revise the scope of banking organizations that meet the definition of advanced approaches banking organizations. If the tailoring proposals are implemented as proposed, the only banking organizations that will be considered

[1] 12 CFR Part 3, 12 CFR Part 217 and 12 CFR 324 (collectively, **the capital rules**).

advanced approaches banking organizations will be those in Category I and II, i.e., U.S. G-SIBs and banking organizations that have $700 billion or more in total consolidated assets or $100 billion or more in total consolidated assets and $75 billion or more in cross-jurisdictional activity. Thus, if the tailoring proposals are finalized as proposed, many more banking organizations would be permitted to apply the deduction framework simplifications and minority interest simplification in this final rule.

MSAs, Temporary Difference DTAs, and UFI Investments

Under the existing capital rules, MSAs, temporary difference DTAs and *significant* UFI investments *in the form of common stock* are subject to a framework of regulatory capital deductions and heightened risk weights known as the **10% / 15% threshold deduction approach**, while *significant* UFI investments *not in the form of common stock* and *non-significant* UFI investments are each subject to an additional, separate framework of regulatory capital deductions. The final rule eliminates, for non-advanced approaches banking organizations, the distinctions between UFI investments and reduces both the complexity of the deduction framework and the amounts subject to deduction for MSAs, temporary difference DTAs and UFI investments by applying a single **25% threshold deduction approach** to each of these three exposure categories.

Under the existing 10% / 15% threshold deduction approach, a banking organization's MSAs, temporary difference DTAs and significant UFI investments in the form of common stock are subject to the following framework of regulatory capital deductions and heightened risk weights:

1. The amount (if any) by which each of these exposure categories individually exceeds 10 percent of the banking organization's CET1 capital must be deducted from the organization's CET1 capital;
2. The amounts of these exposure categories that were not deducted as a result of the first step are aggregated, and the amount (if any) by which the resulting sum for all three categories exceeds 15 percent of the banking organization's CET1 capital must be deducted from the organization's CET1 capital; and
3. The remaining amount of these exposure categories that was not deducted as a result of the first and second steps must be included in the banking organization's risk-weighted assets and assigned a 250 percent risk weight.

In addition, under the existing capital rules, significant UFI investments that are *not* in the form of common stock must be deducted from capital in their entirety, and non-significant UFI investments must be deducted from capital to the extent that the aggregate amount of such investments exceeds 10 percent of an organization's CET1 capital. Each of these deductions is subject to a like-for-like deduction approach known as the corresponding deduction approach, under which the deduction is made from the tier of capital corresponding to the tier for which the investment would qualify. Any non-significant UFI investments that are not deducted must be included in the banking organization's risk-weighted assets and assigned a risk weight pursuant to the otherwise applicable capital rules, which could result in risk weights ranging from 100 percent to 400 percent for equity investments.

The final rule simplifies these deduction approaches for MSAs, temporary difference DTAs and all UFI investments for non-advanced approaches banking organizations by eliminating the distinction between UFI investments and replacing the 10% / 15% threshold deduction approach with a single 25% threshold deduction approach. Under the final rule, non-advanced approaches banking organizations will be required to deduct from regulatory capital any amount of MSAs, temporary difference DTAs and UFI investments that individually exceed 25 percent of the banking organization's CET1 capital.

For MSAs and temporary difference DTAs, any deductions resulting from this 25% threshold deduction approach must be made from the banking organization's CET1 capital. The amounts of MSAs

and temporary difference DTAs that are not deducted under this approach must be assigned a risk weight of 250 percent.

For UFI investments, any deductions resulting from this 25% threshold deduction approach must be made from the tier of capital (CET1, Additional Tier 1, or Tier 2 capital) corresponding to the tier of the UFI investment, pursuant to the corresponding deduction approach. The amounts of UFI investments that are not deducted under this approach must be assigned a risk weight in accordance with the otherwise applicable capital rules, which could result in risk weights ranging from 100 percent to 400 percent for equity investments.[2]

The result of the deduction framework simplifications is to recognize potentially greater amounts of MSAs, temporary difference DTAs and UFI investments in non-advanced approaches banks' regulatory capital, subject to a 250 percent risk weight for any such non-deducted items.

The table below summarizes the deduction framework simplifications for non-advanced approaches banking organizations:

[2] The banking agencies noted in the preamble to the final rule that they deliberately did not specify a methodology by which non-advanced approaches banking organizations should allocate UFI investments either for the purpose of applying the corresponding deduction approach or for the purpose of determining which particular investments must be deducted and which investments must be risk weighted, leaving it to the banks to make those allocations.

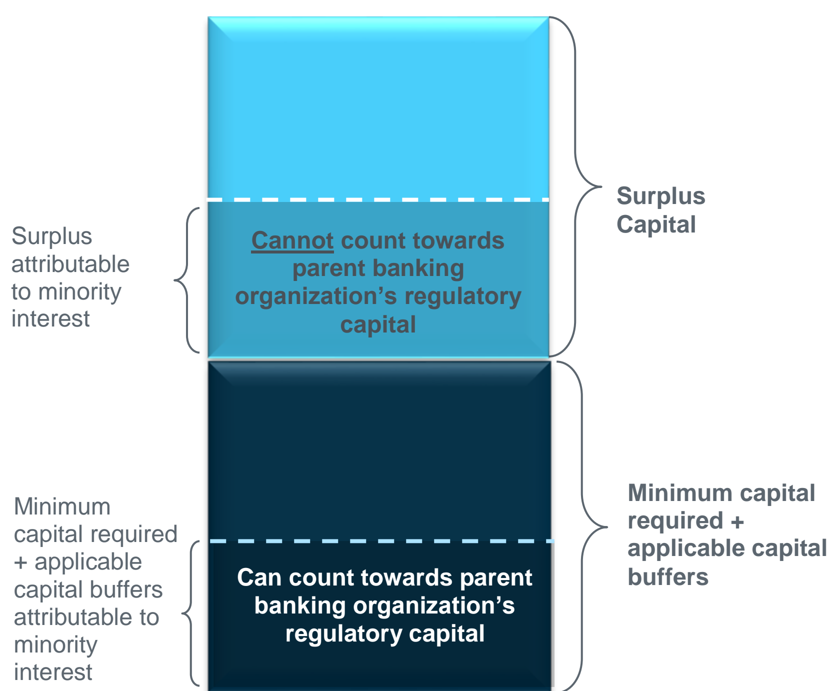
<table>
<tr><th colspan="5">Existing Capital Rules</th><th colspan="4">Capital Simplification Final Rule</th></tr>
<tr><th>Exposure Category</th><th colspan="2">Deduction Threshold</th><th>Tier of Capital from which Deducted</th><th>Risk Weight for Non-Deducted Amounts</th><th>Exposure Category</th><th>Deduction Threshold</th><th>Tier of Capital from which Deducted</th><th>Risk Weight for Non-Deducted Amounts</th></tr>
<tr><td>MSAs</td><td>10% individual</td><td rowspan="3">15% aggregate</td><td>CET1</td><td>250%</td><td>MSAs</td><td>25% individual</td><td>CET1</td><td>250%</td></tr>
<tr><td>Temporary Difference DTAs</td><td>10% individual</td><td>CET1</td><td>250%</td><td>Temporary Difference DTAs</td><td>25% individual</td><td>CET1</td><td>250%</td></tr>
<tr><td>Significant UFI in Common Stock</td><td>10% individual</td><td>CET1</td><td>250%</td><td rowspan="3">UFI</td><td rowspan="3">25% individual</td><td rowspan="3">Corresponding deduction approach (flexible allocation)</td><td rowspan="3">Otherwise applicable risk weight (generally, 100%, 300% or 400%)</td></tr>
<tr><td>Significant UFI Not in Common Stock</td><td colspan="2">N/A (complete deduction)</td><td>Corresponding deduction approach (proportionate allocation)</td><td>N/A</td></tr>
<tr><td>Non-significant UFI</td><td colspan="2">10% individual</td><td>Corresponding deduction approach (proportionate allocation)</td><td>Otherwise applicable risk weight (generally, 100%, 300% or 400%)</td></tr>
</table>

Minority Interests

The existing capital rules place quantitative and qualitative limits on the amount of capital issued by a consolidated subsidiary of a banking organization and not owned by the parent company—called minority interests—that the organization may include in regulatory capital. The final rules replace the existing calculations limiting the inclusion of minority interests with a much simpler 10% allowance framework for non-advanced approaches banking organizations.

Under the existing capital rules, the amount of minority interests of a subsidiary includable in the parent banking organization's consolidated regulatory capital is limited to the proportion of the subsidiary's **required capital** that is attributable to minority interests; the proportion of the subsidiary's **surplus capital** attributable to minority interests is not counted toward the parent banking organization's consolidated regulatory capital.

Recognition of Minority Interests under Existing Capital Rules: Consolidated Subsidiary's Actual Capital



For non-advanced approaches banking organizations, the final rule replaces the existing minority interest framework with a much simpler approach under which the organization may include in its regulatory capital:

- For purposes of the parent banking organization's CET1 capital, all CET1 minority interests up to 10 percent of the parent banking organization's CET1 capital;[3]

[3] The final rule does not amend the definition of "common equity tier 1 minority interest" in the existing capital rules and therefore only CET1 minority interests issued by a depository institution or foreign bank may be included in its parent's CET1 capital; CET1 minority interests issued by other subsidiaries would qualify for inclusion in the parent's Tier 1 capital.

- For purposes of the parent banking organization's Tier 1 capital, all Tier 1 minority interests up to 10 percent of the parent banking organization's Tier 1 capital; and
- For purposes of the parent banking organization's total capital, all total capital minority interests up to 10 percent of the parent banking organization's total capital.

The minority interest simplification has the potential to make minority interests a more important form of capital for non-advanced approaches banking organizations. Although some minority interests are includable in regulatory capital under the existing rules, the final rule would effectively eliminate, for non-advanced approaches banking organizations, the limitation based on the ratio of a subsidiary's required capital to its actual capital, thereby eliminating an effective "haircut" on minority interests for surplus capital. Although the overall 10 percent cap under the final rule limits the total amount of minority interests that a non-advanced approaches banking organization could include in its regulatory capital, by removing the haircut for surplus capital, the final rule improves the efficiency of minority interests as a mechanism for raising additional capital for such organizations.

Technical Amendments

In addition to the simplifications discussed above, the agencies also finalized a number of other revisions to the U.S. Basel III capital rules. The most significant of these changes in the Federal Reserve's capital rules are (1) a revision to one of the existing qualification criteria for CET1 capital and (2) the introduction of a standalone provision, separate and apart from the existing qualification criteria for CET1 capital, Additional Tier 1 capital and Tier 2 capital instruments, relating to the need for the Federal Reserve's prior approval for a redemption or repurchase of the capital instrument to the extent such approval is required under the qualification criteria. As proposed, the stand-alone prior approval requirement would have applied to all discretionary repurchases of CET1 capital because the qualification criteria for CET1 capital in the existing capital rules included a requirement that the instrument could only be redeemed via discretionary repurchases with the prior approval of the Federal Reserve. In the final rule, that qualification criterion for CET1 capital in the Federal Reserve's capital rules was revised to provide that the Federal Reserve's prior approval is required only "to the extent otherwise required by law or regulation." This means that, for example, a BHC would only be required to obtain the prior approval of the Federal Reserve for a repurchase of its common stock to the extent that it was either subject to limitations on its distributions pursuant to other provisions of the capital rules (e.g., for not having the full amount of its capital conservation buffer) or pursuant to the Federal Reserve's capital planning rule.

The other amendments to the capital rules consist of the following:

- Adding the European Stability Mechanism and the European Financial Stability Facility to the list of eligible guarantors in section 2 and the list of entities eligible for a zero percent risk weight in section 32(b) of the capital rules, and other similar revisions;
- Amending section 11(a) of the capital rules, on the capital conservation buffer, to clarify the calculation of a banking organization's maximum payout amount for a specific calendar quarter;
- Removing the requirement in section 20(c) of the capital rule that cash dividend payments on Additional Tier 1 capital instruments may not be subject to a "limit" imposed by the contractual terms governing the instrument;
- Removing specific references to certain assets in section 22(g) of the capital rules to exclude them from risk weighting if they are required to be deducted from regulatory capital, thus excluding from standardized total risk-weighted assets and, as applicable, advanced approaches total risk-weighted assets, any items deducted from capital, not only the items specifically enumerated;

- Clarifying that banking organizations are required to assign a 20 percent risk weight to an exposure that is a self-liquidating, trade-related contingent item that arises from the movement of goods and that has a maturity of three months or less to a foreign bank whose home country has a CRC of 0, 1, 2, or 3, or is an OECD member with no CRC, which requirement is currently embedded in section 32(d)(2)(iii) of the capital rules;
- Clarifying the requirement in section 61 of the capital rules that a non-advanced approaches banking organization with $50 billion or more in total consolidated assets must complete the disclosure requirements described in sections 62 and 63, unless it is a consolidated subsidiary of a bank holding company, savings and loan holding company, or depository institution that is subject to the disclosure requirements of section 62, or a subsidiary of a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction;
- Adding references in section 210(b)(2)(vii) of the capital rules to U.S. intermediate holding companies to clarify for these firms how to calculate capital requirements related to securitization positions under the Federal Reserve's market risk capital rule depending on whether they are using the advanced approaches to calculate risk-weighted assets;
- Clarifying in section 300(c)(2) that the mergers and acquisitions that can potentially affect the inclusion of certain non-qualifying capital instruments in a Federal Reserve-regulated banking organization's regulatory capital must have occurred after December 31, 2013; and
- Revising certain cross-references or correcting typographical errors.

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