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U.S. BASEL III:
Guide for Community Banks

WHITE PAPER

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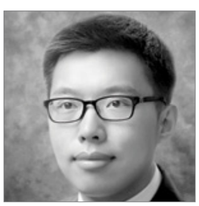

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Executive Summary

U.S. Basel III is the most complete overhaul of U.S. bank capital standards in nearly a quarter of a century. It comprehensively revises the regulatory capital framework for the entire U.S. banking sector and will have significant implications for community banks from a business, operations, M&A and regulatory compliance perspective. This article provides an overview of the key aspects of U.S. Basel III for community banks.

Introduction to U.S. Basel III

U.S. Basel III is a highly complex, 1,000-page regulation published by the U.S. banking agencies, the Federal Reserve, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corp. (FDIC), to implement the international Basel III capital standards in the United States. Developed originally in 2010, Basel III is an internationally agreed-upon set of reform measures to increase the quality and quantity of regulatory capital at banks. In addition to implementing Basel III, U.S. Basel III also gives effect to key provisions in the Dodd-Frank Act, including the Collins Amendment and the prohibition on references to credit rating agency ratings in federal regulations. The U.S. Basel III final rule makes a number of important changes to the U.S. Basel III proposal that was issued by the U.S. banking agencies in June 2012.

U.S. Basel III Will Affect All Community Banks

U.S. Basel III will apply to all national banks, state member and non-member banks, state and federal savings associations and covered savings and loan holding companies (SLHCs) regardless of size. The regulation will also apply to all bank holding companies (BHCs) other than certain small BHCs with less than $500 million in total assets. However, the bank and thrift subsidiaries of these small BHCs will still be subject to U.S. Basel III.

U.S. Basel III: Key Takeaways for Community Banks

• The compliance date for community banks is January 1, 2015. The new capital conservation buffer and deductions will be phased in over several years.

• U.S. Basel III introduces a new tier of capital—Common Equity Tier 1—and a new minimum Common Equity Tier 1 risk-based capital ratio of 4.5 percent.

• On top of the tougher new minimum capital ratios, community banks must maintain a common equity capital conservation buffer of greater than 2.5 percent of risk-weighted assets (RWAs) to avoid restrictions on dividends, redemptions and executive bonus payments.

• Compared with existing capital rules, U.S. Basel III will require community banks to deduct much more mortgage servicing assets (MSAs) and deferred tax assets (DTAs) from their common equity capital, shrinking their capital base.

• Community banks can opt out of a rule requiring banks to include accumulated other comprehensive income (AOCI) in their common equity capital. Opting out could help reduce volatility in a community bank's regulatory capital levels.

• U.S. Basel III retains the existing capital treatment of residential mortgages and certain other types of exposures.

• BHCs with less than $15 billion in total consolidated assets as of year-end 2009 can continue to treat existing trust preferred securities (TruPS) as Tier 1 capital, subject to certain conditions. M&A activity may affect the grandfathering of TruPS in Tier 1 capital.

How Will U.S. Basel III Increase Capital Requirements for Community Banks?

U.S. Basel III contains two types of capital ratio requirements: the risk-based capital ratio and the leverage ratio.

A bank's risk-based capital ratio is the ratio of its regulatory capital to its risk-weighted assets (RWAs). The risk-based capital ratio is not a new concept, but U.S. Basel III introduces a new tier of capital: Common Equity Tier 1. Thus, under U.S. Basel III, regulatory capital is divided into three different tiers: Common Equity Tier 1 (e.g., common stock, related surplus and retained earnings), Additional Tier 1 (e.g., certain preferred stock) and Tier 2 capital (e.g., certain subordinated debt and other capital instruments). U.S. Basel III subjects banks to three different risk-based capital ratio requirements: Common Equity Tier 1 risk-based capital ratio; Tier 1 risk-based capital ratio (Tier 1 capital is sum of Common Equity Tier 1 and Additional Tier 1 capital); and total risk-based capital ratio (total capital is the sum of Tier 1 and Tier 2 capital).

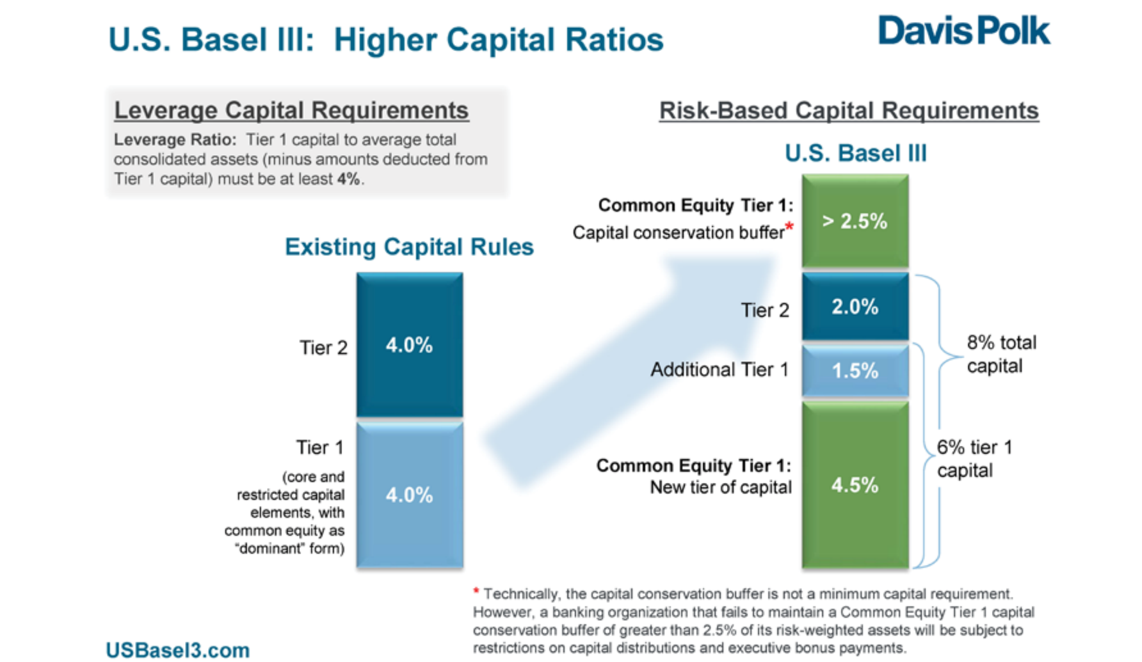
RWAs constitute the denominator of the risk-based capital ratio. In summary, a community bank must calculate RWAs by multiplying the amount of an asset or exposure by the standardized risk weight (percentage) associated with that type of asset or exposure. The standardized risk weights prescribed in U.S. Basel III reflect regulatory judgment regarding the degree of risk of a type of asset or exposure. RWAs must be calculated for both on- and off-balance sheet assets and exposures. All else being equal, a higher risk weight results in a higher RWA amount which, in turn, gives rise to a lower risk-based capital ratio.

A bank's leverage ratio is the ratio of its Tier 1 capital to its average total consolidated on-balance sheet assets (minus amounts deducted from Tier 1 capital). Calculation of the leverage ratio does not involve assigning risk weights to assets. Thus, the leverage ratio is commonly referred to as a non-risk-based capital ratio. U.S. banks have been subject to the leverage ratio requirement for many years.

Higher Capital Ratios under U.S. Basel III

U.S. Basel III increases the minimum risk-based capital ratios for all U.S. banking organizations, including community banks. It also requires all U.S. banking organizations, including community banks, to maintain a capital conservation buffer above the minimum requirements to avoid restrictions on capital distributions and executive bonus payments. These aspects of U.S. Basel III are illustrated on the following page.

FIG. 1



Capital Conservation Buffer

U.S. Basel III introduces a capital conservation buffer of Common Equity Tier 1 capital above the minimum risk-based capital requirements. The buffer must be maintained to avoid:

- Limitations on capital distributions (e.g., repurchases of capital instruments or dividend or interest payments on capital instruments); and

- Limitations on discretionary bonus payments to executive officers such as the CEO, president, CFO, CIO, CLO and heads of major business lines.

As a community bank dips further below its capital conservation buffer, it will be subject to increasingly stringent limitations on capital distributions and bonus payments. The capital conservation buffer will be phased in over three years, beginning on January 1, 2016.

New Well-Capitalized Standard under U.S. Basel III

U.S. Basel III revises the capital thresholds of the prompt corrective action categories for insured depository institutions (IDIs), including the well-capitalized standard, to reflect the new minimum capital ratios in Basel III. The revised prompt corrective action thresholds will become effective on January 1, 2015.

FIG. 2

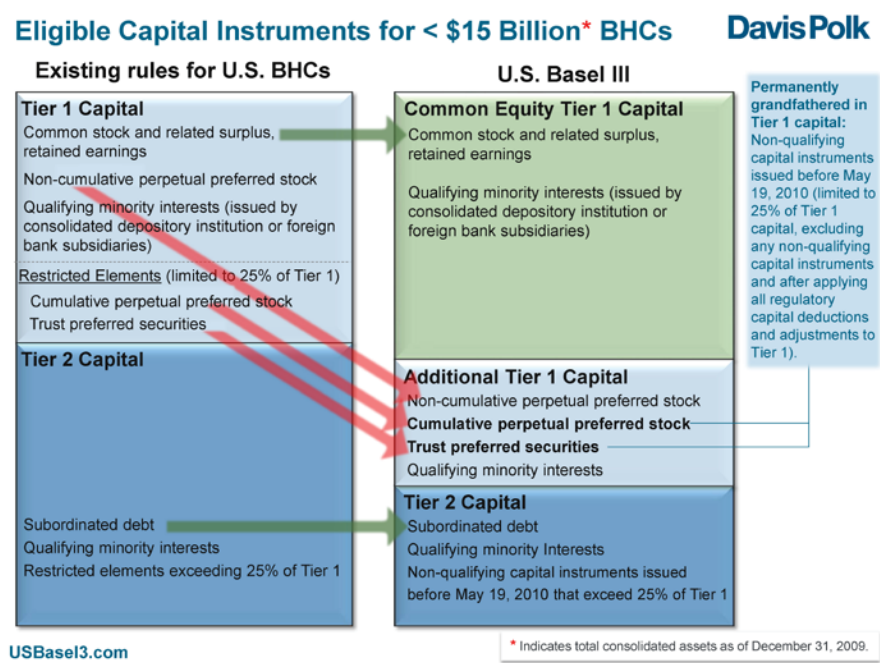
Prompt Corrective Action Threshold	Risk-Based Capital Ratios			Leverage Ratio
	Total capital (unchanged)	Tier 1 capital	Common Equity Tier 1 capital	
Well-capitalized	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%
Adequately capitalized	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%
Significantly undercapitalized	< 6%	< 4%	< 3%	< 3%
Critically undercapitalized	Tangible equity (defined as Tier 1 capital plus non-Tier 1 perpetual preferred stock) to total assets ≤ 2%			

New Eligibility Criteria for Capital Instruments

In addition to increasing minimum risk-based capital ratios and introducing the capital conservation buffer, U.S. Basel III also defines new eligibility criteria for capital instruments within each tier of regulatory capital. As a result of the new eligibility criteria, certain types of capital instruments that qualified as Tier 1 capital under existing capital rules will no longer qualify, subject to grandfathering or phase-out arrangements for certain existing instruments.

The following chart illustrates the impact of the new eligibility criteria for BHCs with less than $15 billion in total consolidated assets as of December 31, 2009.

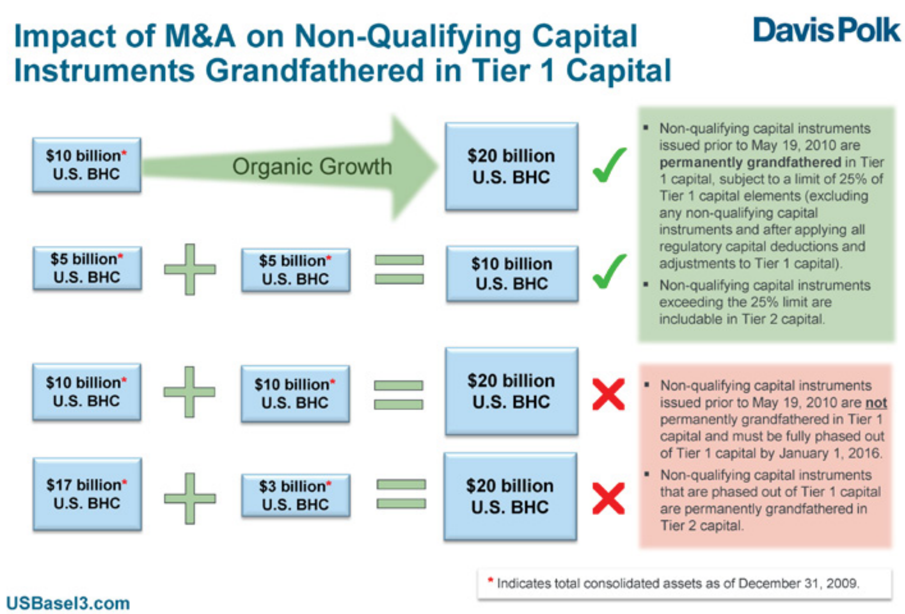
FIG. 3



Impact of M&A on Non-Qualifying Capital Instruments Grandfathered in Tier 1 Capital

As noted above, BHCs with less than $15 billion in total consolidated assets as of year-end 2009 can continue to treat existing non-qualifying capital instruments such as TruPS and cumulative perpetual preferred stock as Tier 1 capital, subject to certain conditions, including an aggregate limit for non-qualifying capital instruments of 25 percent of Tier 1 capital. U.S. Basel III contains specific rules addressing the impact of M&A activity on the ability of a BHC to continue to benefit from the permanent grandfathering of existing non-qualifying capital instruments in Tier 1 capital. These rules can create disincentives for community banks to expand through M&A transactions instead of organic growth.

FIG. 4



Regulatory Adjustments to and Deductions from Capital

On top of increasing minimum risk-based capital ratios, introducing the capital conservation buffer and defining new eligibility criteria for capital instruments, U.S. Basel III will also require banks to make several new deductions from and adjustments to regulatory capital. Most of these will apply to Common Equity Tier 1 capital and have the effect of focusing bank regulatory capital on tangible common equity. The new deductions for mortgage servicing assets (MSAs) and deferred tax assets (DTAs) are much more stringent than under existing capital rules and will reduce community banks' equity capital base.

U.S. Basel III's deductions from Common Equity Tier 1 capital include, among other items:

• Goodwill and other intangibles, other than MSAs, net of associated deferred tax liabilities (DTLs);

• DTAs that arise from operating loss and tax credit carryforwards, net of associated DTLs; and

• Defined benefit pension fund net assets, net of associated DTLs. IDIs are not required to make this deduction. However, non-IDIs such as BHCs and covered SLHCs generally must make this deduction.

U.S. Basel III provides for limited recognition of the following items, which are subject to a 10 percent individual threshold and a 15 percent aggregate threshold of Common Equity Tier 1 (after applying certain regulatory adjustments and deductions):

• DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of any related valuation allowances and net of DTLs;

• MSAs net of associated DTLs; and

• Significant investments in unconsolidated financial institutions in the form of common stock, net of associated DTLs.

AOCI Opt-out for Community Banks

AOCI includes unrealized gains and losses on available-for-sale (AFS) securities. Under existing capital rules, unrealized gains and losses on AFS debt securities are not included in regulatory capital, i.e., these unrealized gains and losses are filtered out of regulatory capital. This feature of the existing capital rules is referred to as the AOCI filter. One of the perceived benefits of the AOCI filter is that it reduces volatility in a bank's capital levels, especially during periods of interest rate movements. In the June 2012 U.S. Basel III proposal, the U.S. banking agencies proposed to remove the AOCI filter. This was one of the most contentious aspects of the proposal. In a significant change from the June 2012 proposal, the U.S. Basel III final rule permits community banks and many other U.S. banking organizations to make a one-time, permanent election to retain the AOCI filter. This feature of the final rule is referred to as the AOCI opt-out election because the banking organization would be electing to opt-out of the removal of the AOCI filter. An opt-out election must be made in the regulatory report filed for the first reporting period after the banking organization becomes subject to U.S. Basel III. If a top-tier banking organization makes an election, any consolidated banking organization subsidiary must make the same election as its parent. We expect that many community banks will opt out of the removal of the AOCI filter.

New Risk Weights under U.S. Basel III

In addition to making significant changes to the numerator of the risk-based capital ratio (regulatory capital), U.S. Basel III makes important changes to the calculation of RWAs, the denominator of the risk-based capital ratio. Among other things, U.S. Basel III:

• Retains existing risk weights for residential mortgages, i.e., assigns a 50 percent risk weight to prudently underwritten first-lien exposures that are performing according to their original terms and a 100 percent risk weight to other residential mortgage exposures;

• Assigns a 100 percent risk weight to most commercial real estate loans; and a 150 percent risk-weight for high volatility commercial real estate loans;

• Assigns a 150 percent risk weight to past due exposures (except sovereign exposures and residential mortgages);

• Retains the existing 100 percent risk weight for corporate and retail loans;

• Increases the risk weight for exposures to qualifying securities firms from 20 percent to 100 percent;

• Introduces new methods for calculating RWAs for over-the-counter and centrally cleared derivatives;

• Introduces new methods for calculating RWAs for securitizations;

• Establishes new methods for calculating RWAs for equity exposures;

• Introduces new rules for recognizing collateral and guarantees as credit risk mitigants; and

• Removes references to credit rating agency ratings in methods for calculating RWAs.

Effective Date and Transitional Arrangements

Community banking organizations will become subject to U.S. Basel III beginning on January 1, 2015. Certain aspects of U.S. Basel III will take effect immediately on that date, including new minimum risk-based capital ratios, revisions to the capital thresholds in the prompt corrective action framework and the new risk weights regime. Other aspects of U.S. Basel III will be phased in over several years, including new deductions from and adjustments to regulatory capital and the new capital conservation buffer.

If you are interested in learning more about U.S. Basel III and its impact on your bank, we invite you to visit Davis Polk's Basel III resources website, USBasel3.com, where you can access webcasts, visual memos, interactive web tools and other materials on U.S. Basel III and other related topics.