Client Alert

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Proposed Capital Simplification Rule

The federal banking agencies have issued a joint notice of proposed rulemaking that would apply a simpler regulatory capital treatment for institutions that use the standardized approach for regulatory capital compliance. The proposed changes to the treatment of certain acquisition, development or construction ("ADC") loans would apply to both institutions that use the standardized approach as well as the advanced approaches capital requirements. The proposed new treatment covers (i) mortgage servicing assets, (ii) certain deferred tax assets arising from temporary differences that cannot be realized through net operating loss carrybacks, (iii) investments in the capital of unconsolidated financial institutions, and (iv) capital issued by a consolidated subsidiary of a banking organization and held by third parties. In addition, the proposal includes revisions to the treatment of certain ADC loans that are designed to address industry concerns regarding the current definition of high volatility commercial real estate ("HVCRE") loans under the capital rules standardized approach.

The proposal is a result of the agencies' joint report to Congress under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("EGPRA") which was submitted in March 2017. The report highlighted the agencies intent to meaningfully reduce regulatory burden, especially on community banking organizations, while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system. EGPRA requires that regulations prescribed by the agencies be reviewed at least once every ten years. The purpose of this review is to identify, with public input, outdated or unnecessary regulations and consider how to reduce regulatory burden on insured depository institutions while, at the same time, ensuring their safety and soundness and the safety and soundness of the financial system. The OCC estimates that the proposed rule would lead to an aggregate increase in reported capital of $4.7 billion for national banks and federal savings associations that use the standardized approach. Comments on the proposal are due within 60 days of publication in the *Federal Register*.

Replacement of the Complex HVCRE Exposure Definition

The proposed rule would replace the complex high volatility commercial real estate definition ("HVCRE") in the standardized approach with a simpler definition, called high volatility acquisition, development or construction loans ("HVADC"), which would apply to credit facilities that primarily finance or refinance ADC properties (i.e., more than 50% of the proceeds will be used for ADC activities). It is not necessary for the loan to be secured by the real property for it to be considered HVADC as the purpose of the loan is the controlling factor. The risk weighting would be reduced from 150% to 130% under the standardized approach.

The new definition would only apply to exposures originated on or after the rule's effective date. The new definition would exclude (i) one-to-four family residential properties, (ii) community development loans, (iii) permanent loans, and (iv) the purchase or development of agricultural land. In addition, the "contributed capital" exemption under the current rule is eliminated under the proposed rule. The agencies noted that since the simpler definition would likely capture more ADC loans than are currently captured under the HVCRE definition the agencies have proposed a lower risk weighting.

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The life of a project concludes only when the loan is converted to permanent financing or is sold or paid in full. Permanent financing is subject to the bank's underwriting criteria for long-term mortgage loans for long-term mortgage loans.

Residential Properties. Lot development loans and loans to finance the ADC of townhomes or row homes would not be considered HVADC loans. Raw land loans and loans to finance the ADC of apartments and condominiums, however, would generally be considered HVADC unless there are less than five units. Included within the scope of one-to-four family properties are (i) the acquisition of vacant or developed land, (ii) the development of land to erect new structures, including infrastructure and removal of existing structures and (iii) the construction of buildings or improvements and additions to existing structures.

Permanent Loans. A permanent loan means a "prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments aside from the sale of the property." Bridge loans would not be considered permanent loans. Owner occupied ADC projects that have sufficient capacity at origination to repay the loan from ongoing operations can qualify as a permanent loan. In addition, interest only loans can qualify as a permanent loan if there is a source of repayment identified that is sufficient to service an amortizing payment. If a loan does not qualify as a permanent loan at origination, it may be reclassified as such if the property later generates additional revenue sufficient to service amortizing principal and interest payments.

Community Development. The HVADC definition will continue to exempt community development projects. Under the proposed rule all credit facilities financing the ADC of real property projects for which the primary purpose is community development, as defined by the agencies' CRA rules, would be exempt from the HVADC category. In addition, loans that finance businesses or farms that meet the size eligibility standards of the SBA's Development Company or Small Business Investment Company programs or have gross annual revenues of $1 million or less would not be considered HVADC loans.

Agriculture. The agricultural exposure definition exclusion would not substantively modify the current exemption for agricultural land development. This category includes loans for the purchase or development of agricultural land used or usable for such purposes, provided the valuation of the land is based on its value for agricultural purposes only. Agriculture is broadly defined and would include timberland and fish farms. It would not include manufacturing or processing plants related to agricultural products as such as a dairy processing plant.

Treatment of mortgage servicing assets ("MSA"), temporary difference deferred tax assets ("DTA") not realizable through carryback and investments in the capital of unconsolidated financial institutions.

Under the current rules the inclusion of MSAs and DTAs is limited to 10% of common equity Tier 1 capital ("CET1") with a combined limit of 15%. Under the proposal the limit would be raised to 25% for each and there would not be a combined limit. In addition, the proposal removes the distinction between significant and non-significant investments in the capital of unconsolidated financial institutions ("CUFI") and establishes a limit of 25% of CET1.

MSAs. Any amount of MSAs (including PMSAs) that exceed the noted level would be deducted from regulatory capital and MSAs not deducted would be assigned a 250% risk weight. According to the agencies the proposal would continue to protect banking organizations from sudden fluctuations in the value of MSAs and from the potential inability of banking organizations to quickly divest of MSAs at their full estimated value during periods of financial stress.

Investments in Capital of Unconsolidated Institutions. The investment in the capital of unconsolidated financial institutions ("CUFI") that exceed 25% of CET1 will be deducted from regulatory

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capital. The amount that is not deducted is subject to various risk weights reflecting the exposure category of the investment. Equity exposure that does not exceed 10% of total capital is risk weighted at 100%. For investments in equities that exceed 10% of capital the risk-weight is either 300% or 400% depending upon whether the equity is publicly traded. The agencies are not proposing a specific methodology dictating which specific investments the institution must deduct and which it must risk weight in cases where the firm is exceeding the 25% threshold.

The proposed rule would eliminate the distinctions among (i) non-significant investments in the capital of unconsolidated financial institutions, (ii) significant investments in the capital of unconsolidated financial institutions that are in the form of common stock and (iii) significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock. The agencies believe that they can address any safety and soundness concerns that arise from this flexible treatment through the supervisory process. The agencies believe the proposed treatment would reduce complexity while maintaining appropriate incentives to reduce interconnectedness among banking organizations.

Temporary Difference DTAs. These assets are those from which the banking organizations may not be able to fully realize value, especially under adverse financial conditions. The ability to use DTAs is dependent upon future taxable income. Thus the proposed limitation would continue to protect against the possibility that the banking organization would need to establish or increase valuation allowances for DTAs during periods of financial stress

Minority Interests

Under current regulations the amount of capital issued by consolidated subsidiaries and not owned by the parent organization (a minority interest) is subject to certain limitations. An example of a Tier 1 minority interest is when a subsidiary of the banking organization issues Tier 1 capital to third parties (e.g., trust preferred securities). Instead of basing the limitation on the minimum required capital of its subsidiaries, a parent banking organization would be allowed to include a CET1 minority interest, Tier 1 minority interest and total capital minority interest up to 10% for each of the parent banking organization's CET1, Tier 1 and total capital elements (before the inclusion of any minority interests and after certain deductions and adjustments required under the capital rules) required under the capital rule, respectively. The agencies do not expect a significant impact on the capital ratios for most non-advanced approaches banking organizations as a result of these simplifications.

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