Capital Is King--Issues in Regulatory Capital Requirements

University of North Carolina School of Law
Center for Banking and Finance
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I. Dodd-Frank Act Regulatory Changes

A. Capital Requirements – Sections 171, 606, 616

1. A financial holding company ("FHC") must be well capitalized and well managed as a condition of engaging in expanded financial activities.

2. The FRB is authorized to issue regulations imposing capital requirements on bank holding companies. The FRB is required to "seek" to make such requirements countercyclical allowing for decreases in requirements during times of economic contraction.

3. Collins Amendment. The banking agencies are required to set capital requirements for insured institutions and holding companies with the existing minimum capital ratios applicable to depository institutions serving as a floor.

   a. Debt and equity instruments issued by a holding company that would not qualify as capital for a bank but issued prior to May 19, 2010 will be phased out for institutions that have $15 billion or more of assets. The phase out will commence on January 1, 2013 and run for three years.

   b. A holding company that had total consolidated assets of less than $15 billion as of December 31, 2009 may continue to include trust preferred securities ("TRUPS") issued before May 19, 2010 in Tier 1 capital. Preferred stock issued under TARP continues status as Tier 1 capital.

   c. Bank holding company subsidiaries of foreign banking organizations that have relied on SR 01-1 have a five-year deferred effective date before the requirements apply.
d. The holding company capital requirements will not apply to bank holding companies subject to the FRB Small Bank Holding Company Policy Statement ($500 million or less of assets).

e. Subject to recommendations of the Council, the banking agencies are required to develop capital requirements that address the risks that the activities of a banking organization pose to the institution as well as public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity. The rules should address the risks arising from (i) significant volumes of activity in derivatives, securitized products purchased and sold, financial guarantees purchased and sold, securities borrowing and lending, and repurchase agreements and reverse repurchase agreements; (ii) concentrations in assets for which values are based on models rather than cost or prices derived from liquid markets; and (iii) concentrations in market share for any activity that would substantially disrupt financial markets if the institution was forced to cease the activity unexpectedly.

4. The banking agencies are also required to “seek” to make capital requirements countercyclical allowing for decreases in requirements during times of economic contraction.

5. Source of Financial Strength. A holding company is required to serve as a source of financial strength, i.e., the ability to provide financial assistance in the event of the financial distress of the insured institution, to an insured institution subsidiary.\(^1\) Effective date: transfer date, with regulations to be issued within one year from the transfer date.

B. Authority of Financial Stability Oversight Council

1. Voting Members—Treasury Secretary (Chairperson), FRB Chairman, Comptroller, Bureau of Consumer Financial Protection Director, SEC Chairman, FDIC Chairman, CFTC Chairman, FHFA Director, and an independent member with insurance expertise (§ 111). Nonvoting advisory members representing state regulators among others are also designated.

2. The Council is authorized to identify systemically important nonbank financial companies and activities, financial market utilities, and payment, clearance, and settlement activities.

3. Purposes and Responsibilities (§ 112)

\(^1\) The requirement also applies to a company that controls an insured institution that is not the subsidiary of a holding company. Because a company that has control of an insured institution would be a bank or thrift holding company, this requirement serves no purpose.
a. Identify risks to financial stability, promote market discipline, and respond to emerging threats to U.S. financial markets;

b. Monitor the financial services marketplace in order to identify potential threats to the financial stability of the United States;

c. Require the FRB to supervise nonbank financial companies that may pose risks to the financial stability of the United States;

d. Council may issue recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice conducted by bank holding companies or nonbank financial companies under their respective jurisdictions, if the Council determines that the conduct of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities (§ 120); and

d. For other enumerated purposes.

4. A bank holding company would not be regarded as systemically important and subject to enhanced standards (§§ 115 and 165) unless it had $50 billion or more of assets.

II. Current Regulatory Capital Developments

A. Risk-Based Capital Guidelines: Market Risk


2. Proposal would revise the market risk capital rules to better capture positions for which the market risk capital rules are appropriate, reduce procyclicality in market risk capital requirements, enhance sensitivity to risks not adequately captured under current methodologies, and increase transparency through enhanced disclosures.

B. Risk-Based Capital Framework: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor

2. The proposal would amend the advanced approaches capital adequacy framework known as Basel II to be consistent with certain provisions of the Dodd-Frank Act. More specifically, a banking organization operating under the advanced approaches standards would be required to meet, on an on-going basis, the higher of the generally applicable and the advanced approaches minimum risk-based capital standards.

C. Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines


2. First step in implementing section 939A of the Dodd-Frank Act to modify regulations to remove any reference to, or requirements of reliance on, credit ratings in such regulations and substitute in their place other standards of creditworthiness that the agencies determine to be appropriate for such regulations.

III. International Capital Standards—Basel Committee on Banking Supervision

A. Fundamental Requirements of Basel III

1. Stricter definition of capital—greater reliance on common equity
   a. Excludes noncumulative perpetual preferred from highest quality category of equity
   b. Exclusion of some form of “hybrid” instruments

2. Formal liquidity requirements
   a. Liquidity Coverage Ratio—Promote short-term resilience by ensuring that a bank has sufficient high quality liquid resources to offset cash outflows during acute stresses. One month horizon.
   b. Net Stable Funding Ratio—Promote longer term resilience by creating additional incentives for a bank to fund its ongoing activities with stable sources of funding. One-year horizon to provide a sustainable asset-liability maturity structure.

3. Higher levels of minimum capital requirements, including an international minimum leverage requirement.
   a. Moving to a minimum Tier 1 common equity ratio of 7 percent including capital buffers.
b. Minimum Tier 1 to total assets (not risk-weighted) leverage ratio would be 3 percent.

4. Long phase-in running through January 2019
   a. Minimum common equity and Tier 1 ratios—Starts in January 2013 through January 2015
   b. Capital conservation buffer—three years starting in January 2016
   c. Deductions from capital of excess items—January 2014 through January 2018
   d. Phase-out of non-qualifying capital instruments—10 years beginning in January 2013

B. Details of Minimum Capital Requirements

1. Common equity component of Tier 1 capital will increase to 4.5 percent of risk-weighted assets.

2. Capital conservation buffer of 2.5 percent increases effective minimum ratio to 7 percent.

3. Tier 1 capital requirement will increase to 6 percent of risk-weighted assets; 8.5 percent with capital conservation buffer.

4. The total capital ratio would remain at 8 percent but would be based on the tighter definitions of capital; 10.5 percent with the capital conservation buffer.

5. Capital Conservation Buffer
   a. Set at 2.5 percent of risk-weighted assets.
   b. In theory, banks would be able to draw on the buffer during times of stress.
   c. Use of the buffer would trigger limits on dividends and bonuses.

C. Narrower Definition of Capital

1. Mortgage servicing rights, certain deferred tax assets, and certain minority investments could be included in Tier 1 capital only up to 15 percent of common equity.

2. Trust preferred securities not included in Tier 1 capital.
D. Principal Implementation Issues

1. Scope of application in the United States—only internationally active banks or all banks (mega-banks, banks with assets of $50 billion or more, and community banks)?

2. Reconciling Basel III standards with new requirements under the Dodd-Frank Act (e.g., elimination of the use of external ratings) and prompt corrective action.

3. What changes are need in audit and risk management functions, management culture, and corporate governance?

4. Additional requirements for systemically important financial institutions.

5. Role of contingent capital

IV. Sample Capital Requirements in Recent Agency Enforcement Actions

A. Federal Reserve Board

1. Within 60 days of this Agreement, BHC shall submit to the Reserve Bank an acceptable written plan to maintain sufficient capital at BHC on a consolidated basis. The plan shall, at a minimum, address, consider, and include:

   (a) the consolidated organization’s and the Bank’s current and future capital requirements, including compliance with the Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure and Tier I Leverage Measure, Appendices A and D of Regulation Y of the Board of Governors (12 C.F.R. Part 225, App. A and D) and the applicable capital adequacy guidelines for the Bank issued by the Bank’s federal regulator;

   (b) the adequacy of the Bank’s capital, taking into account the volume of classified credits, its risk profile, the adequacy of the allowance for loan and lease losses, current and projected asset growth, and projected earnings;

   (c) the source and availability of additional funds necessary to fulfill the consolidated organization’s and the Bank’s future capital requirements on a timely basis;

   (d) supervisory requests for additional capital at the Bank or the requirements of any supervisory action imposed on the Bank by its federal or state regulator; and
(e) the requirements of section 225.4(a) of Regulation Y of the Board of Governors that BHC serve as a source of strength to the Bank.

5. BHC shall notify the Reserve Bank, in writing, no more than 45 days after the end of any quarter in which any of BHC capital ratios fall below the approved plan’s minimum ratios. Together with the notification, BHC shall submit an acceptable written plan that details the steps that will take to increase BHC’s capital ratios to or above the approved plan’s minimums.

B. Federal Deposit Insurance Corporation

1. (a) Within one hundred twenty (120) days from the effective date of this ORDER, the Bank shall have Tier I capital in such amount as to equal or exceed eight and one-half percent (8.5%) of its total assets, and shall have total risk-based capital in such an amount as to equal or exceed twelve percent (12%) of the Bank’s total risk-weighted assets. During the life of this ORDER, the Bank shall maintain a Tier I leverage capital ratio of at least eight and one-half percent (8.5%) and total risk-based capital ratio of at least twelve percent (12%) as those capital ratios are defined in Part 325 of the FDIC Rules and Regulations, 12 C.F.R. Part 325. The level of Tier I capital to be maintained during the life of this ORDER pursuant to this paragraph shall in addition to a fully funded allowance for loan and lease losses (“ALLL”), the adequacy of which shall be satisfactory to the Supervisory Authorities as determined at subsequent examinations and/or visitations.

(b) Within sixty (60) days from the effective date of this ORDER, the Bank shall submit to the Supervisory Authorities a written capital plan. Such capital plan shall detail the steps that the Bank shall take to achieve and maintain the capital requirements set forth in this ORDER. In developing the capital plan, the Bank must take into consideration: (i) the volume of the Bank’s adversely classified assets; (ii) the nature and level of the Bank’s asset concentrations; (iii) the adequacy of the Bank’s ALLL; (iv) the anticipated level of retained earnings; (v) anticipated and contingent liquidity needs; and (vi) the source and timing of additional funds to fulfill future capital needs.

(c) In addition, the capital plan must include a contingency plan in the event that the Bank has: (i) failed to maintain the minimum capital ratios required by this paragraph; (ii) failed to submit an acceptable capital plan as required by this subparagraph; or (iii) failed to implement or adhere to a capital plan to which the Supervisory Authorities have taken no written objection pursuant to this paragraph. Said contingency plan shall include a plan to sell or merge the Bank. The Bank shall implement the contingency plan upon written notice from the Supervisory Authorities.

(d) Any increase in Tier I capital necessary to meet the requirements of this ORDER may be accomplished by the following: (i) sale of common stock; (ii) sale of non-cumulative perpetual preferred stock; (iii) direct contribution of cash by the Board, shareholders, and/or parent holding company; (iv) any
combination of the above; or (v) any other means acceptable to the Supervisory Authorities.

(e) Any increase in Tier 1 capital necessary to meet the requirements of paragraph 3 of this ORDER may not be accomplished through a deduction from the Bank's ALLL.

(f) If all or part of the increase in Tier 1 capital required by this ORDER is accomplished by the sale of new securities, the Board shall forthwith take all necessary steps to adopt and implement a plan for the sale of such additional securities, including the voting of any shares owned or proxies held or controlled by them in favor of the plan. Should the implementation of the plan involve a public distribution of the Bank's securities (including a distribution limited only to the Bank's existing shareholders), the Bank shall prepare offering materials fully describing the securities being offered, including an accurate description of the financial condition of the Bank and the circumstances giving rise to the offering, and any other material disclosures necessary to comply with the applicable securities laws. Prior to the implementation of the plan involving the public distribution of the Bank’s securities and, in any event, not less than fifteen (15) days prior to the dissemination of such materials, the plan and any materials used in the sale of the securities shall be submitted to the FDIC, Division of Supervision and Consumer Protection, Accounting and Securities Disclosure Section, 550 17th Street, N.W., Room F-6066, Washington, D.C. 20429 and to the Superintendent of the State Banking Department. Any changes requested to be made in the plan or materials shall be made prior to their dissemination. If the increase in Tier 1 capital is provided by the sale of noncumulative perpetual preferred stock, then all terms and conditions of the issue, including but not limited to those terms and conditions relative to interest rate and convertibility factor, shall be presented to the Supervisory Authorities for prior approval.

(g) In complying with the capital provisions paragraph of this ORDER, the Bank shall provide to any subscriber and/or purchaser of the Bank's securities, a written notice of any planned or existing development or other changes that are materially different from the information reflected in any offering materials used in connection with the sale of Bank securities. The written notice required by this paragraph shall be furnished within ten (10) days from the date such material development or change was planned or occurred, whichever is earlier, and shall be furnished to every subscriber and/or purchaser of the Bank's securities who received or was tendered the information contained in the Bank's original offering materials.

C. Office of the Comptroller of the Currency

**HIGHER CAPITAL MINIMUMS**

(1) By December 31, 2010, the Bank shall achieve and thereafter maintain the following minimum capital ratios (as defined in 12 C.F.R. Part 3):
(a) Total risk-based capital at least equal to eleven percent (11%) of risk-weighted assets;

(b) Tier 1 capital at least equal to nine percent (9%) of adjusted total assets.2

1 The requirement in this Capital Directive to meet and maintain a specific capital level means that the Bank may not be deemed to be "well capitalized" for purposes of 12 U.S.C. § 1831o and 12 C.F.R. Part 6, pursuant to 12 C.F.R. § 6.4(b)(1)(iv).

2 Adjusted total assets is defined in 12 C.F.R. § 3.2(a) as the average total asset figure used for call report purposes minus end-of-quarter intangible assets.

CAPITAL PLAN

(1) By November 30, 2010, the Bank shall submit to the Director of Special Supervision ("Director") an acceptable written Capital Plan, covering at least a three-year period. An acceptable Capital Plan must describe the means and the time schedule by which the Bank will achieve the capital ratios required in Article I.

(2) The Capital Plan shall:

(a) describe the detailed actions that the Bank intends to take in order to achieve and maintain adequate capital, which may in no event be less than the ratios contained in Article I;

(b) identify the primary sources and timing of additional capital to meet the Bank's current and future needs;

(c) provide projections for growth and capital requirements, based upon a detailed analysis of the Bank’s assets, liabilities, earnings, fixed assets, and off-balance sheet activities;

(d) restrict the payment of dividends unless such payment is consistent with the capital plan and only after capital ratios are achieved and the OCC has provided a written no-objection;

(e) detail how the Bank will comply with restrictions and requirements set forth in this Capital Directive;

(f) include contingency plans to identify alternative methods to strengthen capital, should the primary sources of capital not be available; and

(g) include a contingency plan requiring the Bank to sell, merge or liquidate itself upon the failure to comply with the capital plan and/or attain the required capital ratios if directed to do so by the OCC.

(3) An acceptable Capital Plan shall include an accurate analysis of the Bank’s current condition and a realistic analysis of the Bank’s future prospects. The Capital Plan should fully document the results of that analysis.
Elements of an accurate and realistic analysis of the Bank’s current condition and future prospects should include:

(a) current and pro forma balance sheets,

(b) current and long-term budgets,

(c) a strategic plan for the Bank,

(d) the market analysis used to derive the appropriate means to raise capital, and any other relevant information. The capital plan should also clearly detail the assumptions used in the analysis.

(4) Additionally, a Capital Plan will not be deemed acceptable unless the plan:

(a) is based on realistic assumptions and is likely to succeed in restoring the Bank’s capital;

(b) would not appreciably increase the risk to which the Bank is exposed; and

(c) meets the requirements for such a plan that are described in the most recent Report of Examination.

(5) The Bank may pay a dividend or make a capital distribution (as defined in 12 U.S.C. § 1831o(b)(2)(B)) only:

(a) when the Bank is in compliance with the requirements of this Capital Directive and its approved Capital Plan and would remain in compliance;

(b) when the Bank is in compliance with applicable laws and regulations, including 12 U.S.C. §§ 56, 59 and 60, and 12 C.F.R. Part 5; and

(c) following the prior written determination of no supervisory objection by the Director.

(6) The Capital Plan and analysis required by Paragraph (3) shall be submitted to the Director for a prior written determination of no supervisory objection. The Bank shall make any changes to the Capital Plan required by the Director.

(7) At the next Board meeting following receipt of the Director’s written determination of no supervisory objection to the Capital Plan, but within twenty (20) days of the Bank’s receipt of such determination, the Board shall adopt, approve and implement the Capital Plan. Thereafter, the Bank (subject to Board review and ongoing monitoring) shall implement and ensure adherence to the Capital Plan.
(8) The Board shall review and update the Bank's Capital Plan at least annually and more frequently if necessary or if requested by the Director. Revisions to the Bank's Capital Plan shall be submitted to the Director for a prior written determination of no supervisory objection.

Christina M. Gattuso  
Kilpatrick Townsend & Stockton LLP  
607 14th Street, NW  
Washington, DC 20005  
202-525-5884  
cgattuso@kilpatricktownsend.com

Paul S. Pilecki  
Kilpatrick Townsend & Stockton LLP  
607 14th Street, NW  
Washington, DC 20005  
202-824-1415  
ppilecki@kilpatricktownsend.com