

July 12, 2019

## Bank Capital Requirements

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### Federal Banking Agencies Finalize Capital Rule Simplifications for Non-Advanced Approaches Banking Organizations

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On July 9, 2019, the Federal Reserve, the OCC, and the FDIC jointly issued a final rule<sup>1</sup> designed to simplify compliance with certain aspects of the agencies' capital rules for non-advanced approaches banking organizations<sup>2</sup> relating to the threshold deductions for mortgage servicing assets ("MSAs"), deferred tax assets arising from temporary differences that a banking organization could not realize through net operating loss carry backs ("*temporary difference DTAs*"), and investments in the capital of unconsolidated financial institutions, as well as the inclusion of minority interest in regulatory capital. The final rule also includes a significant change to the prior approval requirement in the Federal Reserve's capital rules for common stock repurchases, as described in our recent [Memorandum to Clients](#). Except in connection with this change, the agencies adopted the proposal, as described in our prior [Memorandum to Clients](#), without substantial modification.

The provisions of the final rule relating to the threshold deductions and minority interest are effective April 1, 2020. Various technical amendments in the final rule, as well as the elimination of the standalone prior approval requirement for common stock repurchases in the Federal Reserve's capital rules, are effective October 1, 2019, but banking organizations may elect to adopt these amendments prior to the effective date.

#### Background

In their March 2017 Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act ("*EGRPRA*"),<sup>3</sup> the agencies communicated their intent to reduce regulatory burden, in particular for community banking organizations.<sup>4</sup> The agencies also outlined their plans to issue a proposal simplifying the capital treatment of MSAs, certain DTAs, and investments in the capital of unconsolidated financial institutions and the calculation of minority interest that could be included in regulatory capital.<sup>5</sup> Later that

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year, the agencies issued a proposal to simplify certain aspects of their capital rule (the “*simplifications proposal*”).<sup>6</sup> The agencies issued the simplifications proposal “[w]ith the goal of meaningfully reducing regulatory burden 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.”<sup>7</sup> The final rule adopts most of the changes proposed in the simplifications proposal without substantial change. Shortly after issuing the simplifications proposal, as described in our prior [Memorandum to Clients](#), the agencies published a final rule in November 2017 that extended transitional regulatory capital treatment for certain capital deductions, risk weightings, and minority interest requirements for non-advanced approaches banking organizations.<sup>8</sup> The extended transition periods were to remain in effect until the simplifications proposal was finalized or the agencies “determine[d] otherwise.”<sup>9</sup> Under the final rule, the transition rule will remain in effect until April 1, 2020, when the provisions of the final rule related to the threshold deductions and minority interest take effect.

### Key Elements of the Final Rule

- ***Simplification of the threshold deductions for MSAs and temporary difference DTAs.*** The agencies adopted the proposed amendments without modification.<sup>10</sup> Accordingly, under the final rule, non-advanced approaches banking organizations must:
  - deduct from common equity tier 1 (“*CET1*”) capital the amount of MSAs and temporary difference DTAs that individually exceed 25% of the non-advanced approaches banking organization’s CET1 capital; and
  - assign a 250% risk weight to the amount of MSAs or temporary difference DTAs not deducted from CET1 capital.<sup>11</sup>
- ***Simplification of the threshold deductions for investments in the capital of unconsolidated financial institutions.*** The agencies adopted the proposed amendments without modification.<sup>12</sup> Under the final rule applicable to non-advanced approaches banking organizations, the agencies’ capital rules no longer provide for different treatment for different kinds of investments in the capital of unconsolidated financial institutions (*i.e.*, non-significant investments in the capital of unconsolidated financial institutions, significant investments in the capital of unconsolidated financial institutions in the form of common stock, and significant investments in the capital of unconsolidated financial institutions not in the form of common stock).<sup>13</sup> Instead, under the final rule, non-advanced approaches banking organizations must:
  - deduct from the applicable component of capital, in accordance with the corresponding deduction approach, the amount of investments in the capital of unconsolidated financial institutions that exceed 25% of the non-advanced approaches banking organization’s CET1 capital;<sup>14</sup> and
  - risk weight investments in the capital of unconsolidated financial institutions that are not deducted from CET1 capital according to the relevant treatment for the exposure category for the investment.<sup>15</sup>
- ***Simplification of the calculation limiting the inclusion of minority interest in regulatory capital.*** The agencies adopted the proposed amendments without modification.<sup>16</sup> Under the final rule, the limitation on the inclusion of minority interest in regulatory capital is based on the capital levels of the parent banking organization, not on the capital levels of consolidated subsidiaries.<sup>17</sup> Non-advanced approaches banking organizations may include CET1 minority interest, tier 1 minority interest, and total capital minority interest up to 10% of the parent banking organization’s CET1 capital, tier 1 capital, and total capital, respectively, with the parent banking organization’s regulatory capital measured before the inclusion of minority interest and after certain deductions and adjustments.<sup>18</sup>

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- **Rescission of the transition rule.** The final rule rescinds the transition rule, including the application of the transitional 100% risk weight for MSAs, temporary difference DTAs, and significant investments in the capital of unconsolidated financial institutions in the form of common stock that are not deducted.
- **Prior Federal Reserve approval before repurchasing common stock.** As described in our recent [Memorandum to Clients](#), the final rule provides that banking organizations subject to the Federal Reserve's capital rules – bank holding companies, savings and loan holding companies, U.S. intermediate holding companies of foreign banking organizations, and state member banks – will be required to obtain Federal Reserve approval before repurchasing CET1 capital instruments only to the extent otherwise required by law or regulation: the standalone prior approval requirement currently in Section 20(b)(1)(iii) of the Federal Reserve's capital rules and the proposed additional standalone prior approval requirement for common stock repurchases in the simplifications proposal were eliminated in the final rule.<sup>19</sup> As under the current capital rules and the simplifications proposal, Federal Reserve-regulated institutions will continue to be required to obtain prior Federal Reserve approval before redeeming or repurchasing additional tier 1 capital instruments or tier 2 capital instruments such as non-cumulative perpetual preferred stock and subordinated debt.<sup>20</sup>
- **Technical amendments.** The agencies have adopted a number of technical changes to the capital rules for advanced and non-advanced approaches banking organizations with minor modifications.<sup>21</sup>

### Effective Dates

- **Threshold deductions and minority interest.** The provisions related to the threshold deductions and the treatment of minority interest will be effective April 1, 2020.<sup>22</sup>
- **Rescission of transition rule.** The rescission of the transition rule will take effect April 1, 2020.<sup>23</sup>
- **Prior approval for common stock repurchases, technical amendments, and optional early adoption.** The amendments to the prior approval requirements for common stock repurchases in the Federal Reserve's capital rules, along with the technical amendments, will take effect October 1, 2019, but banking organizations may elect to adopt these amendments prior to that date.<sup>24</sup>

### Notable Agency Commentary

- **Basel IV.** As described in our prior [Memorandum to Clients](#), the Basel Committee on Banking Supervision released standards to finalize its Basel III capital framework (commonly referred to as "Basel IV") in December 2017. The agencies note that they "are considering how to most appropriately implement these standards in the United States, including potentially replacing the advanced approaches with the risk-based capital requirements based on the Basel standardized approaches for credit and operational risk. Any such changes to applicable risk-based capital requirements would be subject to notice and comment through a future rulemaking."<sup>25</sup>
- **HVCRE.** Although the agencies originally included proposed changes to the high volatility commercial real estate exposure category in the simplifications proposal, the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA") became law after the agencies issued the simplifications proposal and Section 214 of EGRRCPA superseded those proposed changes.<sup>26</sup> As described in our prior [Memorandum to Clients](#), the agencies have published a separate proposal to conform their capital rules to the statutory definition of "high volatility commercial real estate acquisition, development, or construction loan" contained in EGRRCPA.<sup>27</sup>

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- ***Expected impact on non-advanced approaches banking organizations' capital ratios.*** The agencies state that they do not expect the final rule will have a “significant impact” on most non-advanced approaches banking organizations' capital ratios.<sup>28</sup> They also note, however, that “[s]ome non-advanced approaches banking organizations with substantial holdings of MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions may experience a capital benefit.”<sup>29</sup>

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ENDNOTES

- 1 Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, *Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996* (July 9, 2019), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190709a1.pdf> (hereafter, the “Final rule”).
- 2 Currently, advanced approaches banking organizations are those with total assets of at least \$250 billion or consolidated on-balance sheet foreign exposures of at least \$10 billion, and depository institution subsidiaries of a company that meets one of those thresholds.  
  
In October 2018 and April 2019, the agencies proposed to revise the framework for determining which banking organizations would be considered “advanced approaches” banking organizations. For additional information about these proposals, see our Memoranda to Clients: *Regulatory Tailoring for Large U.S. Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Enhanced Prudential Standards and Capital and Liquidity Requirements for Large U.S. Banking Organizations* (Nov. 5, 2018), available at <https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Large-US-Banking-Organizations.pdf> and *Regulatory Tailoring for Foreign Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Prudential Standards to Foreign Banking Organizations and Seek Comment on Whether to Impose Standardized Liquidity Requirements on their U.S. Branches and Agencies* (Apr. 23, 2019), available at <https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Foreign-Banking-Organizations.pdf>.
- 3 Final rule, at 6; Federal Financial Institutions Examination Council, *Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act*, 82 Fed. Reg. 15900 (Mar. 30, 2017) (hereafter, the “EGRPRA report”).
- 4 Final rule, at 6-7; EGRPRA report, at 15902.
- 5 Final rule, at 7; EGRPRA report, at 15902.
- 6 Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, *Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996*, 82 Fed. Reg. 49984 (Oct. 27, 2017) (hereafter, the “Simplifications proposal”).
- 7 EGRPRA report, at 15902.
- 8 Final rule, at 7-8; Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations that Are Not Subject to the Advanced Approaches Capital Rules*, 82 Fed. Reg. 55309 (Nov. 21, 2017) (hereafter, the “Transition rule”).
- 9 Transition rule, at 55313.
- 10 Final rule, at 18.
- 11 Final rule, at 12-13.
- 12 Final rule, at 18.
- 13 Final rule, at 22.
- 14 Final rule, at 70-71 (revised 12 C.F.R. § 3.22(c)(4)), 114 (revised 12 C.F.R. § 217.22(c)(4)), and 159 (revised 12 C.F.R. § 324.22(c)(4)).
- 15 Final rule, at 12-13.
- 16 Final rule, at 27.

ENDNOTES (CONTINUED)

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- 17 Final rule, at 13.
- 18 Final rule, at 13-14.
- 19 Final rule, at 33-34.
- 20 Final rule, at 33-34.
- 21 Final rule, at 2, 29-30.
- 22 Final rule, at 36.
- 23 Final rule, at 36.
- 24 Final rule, at 36-37.
- 25 Final rule, at 29.
- 26 Final rule, at 14.
- 27 Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, *Regulatory Capital Treatment for High Volatility Commercial Real Estate (HVCRE) Exposures*, 83 Fed. Reg. 48990 (Sept. 28, 2018). On June 7, 2019, the FDIC approved a [proposal](#) seeking comment on the treatment of land development loans for purposes of the exclusion for one- to four-family residential properties in the statutory definition.
- 28 Final rule, at 18, 27.
- 29 Final rule, at 18.

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## CONTACTS

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### New York

Thomas C. Baxter Jr.	+1-212-558-4324	<a href="mailto:baxtert@sullcrom.com">baxtert@sullcrom.com</a>
Whitney A. Chatterjee	+1-212-558-4883	<a href="mailto:chatterjee@sullcrom.com">chatterjee@sullcrom.com</a>
H. Rodgin Cohen	+1-212-558-3534	<a href="mailto:cohenhr@sullcrom.com">cohenhr@sullcrom.com</a>
Elizabeth T. Davy	+1-212-558-7257	<a href="mailto:davye@sullcrom.com">davye@sullcrom.com</a>
Mitchell S. Eitel	+1-212-558-4960	<a href="mailto:eitelm@sullcrom.com">eitelm@sullcrom.com</a>
Michael T. Escue	+1-212-558-3721	<a href="mailto:escuem@sullcrom.com">escuem@sullcrom.com</a>
Jared M. Fishman	+1-212-558-1689	<a href="mailto:fishmanj@sullcrom.com">fishmanj@sullcrom.com</a>
C. Andrew Gerlach	+1-212-558-4789	<a href="mailto:gerlacha@sullcrom.com">gerlacha@sullcrom.com</a>
Wendy M. Goldberg	+1-212-558-7915	<a href="mailto:goldbergw@sullcrom.com">goldbergw@sullcrom.com</a>
Charles C. Gray	+1-212-558-4410	<a href="mailto:grayc@sullcrom.com">grayc@sullcrom.com</a>
Shari D. Leventhal	+1-212-558-4354	<a href="mailto:leventhals@sullcrom.com">leventhals@sullcrom.com</a>
Marion Leydier	+1-212-558-7925	<a href="mailto:leydiern@sullcrom.com">leydiern@sullcrom.com</a>
Erik D. Lindauer	+1-212-558-3548	<a href="mailto:lindauere@sullcrom.com">lindauere@sullcrom.com</a>
Mark J. Menting	+1-212-558-4859	<a href="mailto:mentingm@sullcrom.com">mentingm@sullcrom.com</a>
Camille L. Orme	+1-212-558-3373	<a href="mailto:ormec@sullcrom.com">ormec@sullcrom.com</a>
Stephen M. Salley	+1-212-558-4998	<a href="mailto:salleys@sullcrom.com">salleys@sullcrom.com</a>
Rebecca J. Simmons	+1-212-558-3175	<a href="mailto:simmonsr@sullcrom.com">simmonsr@sullcrom.com</a>
William D. Torchiana	+1-212-558-4056	<a href="mailto:torchianaw@sullcrom.com">torchianaw@sullcrom.com</a>
Donald J. Toumey	+1-212-558-4077	<a href="mailto:toumeyd@sullcrom.com">toumeyd@sullcrom.com</a>
Marc Trevino	+1-212-558-4239	<a href="mailto:trevinom@sullcrom.com">trevinom@sullcrom.com</a>
Benjamin H. Weiner	+1-212-558-7861	<a href="mailto:weinerb@sullcrom.com">weinerb@sullcrom.com</a>

## SULLIVAN & CROMWELL LLP

Mark J. Welshimer	+1-212-558-3669	<a href="mailto:welshimerm@sullcrom.com">welshimerm@sullcrom.com</a>
Michael M. Wiseman	+1-212-558-3846	<a href="mailto:wisemanm@sullcrom.com">wisemanm@sullcrom.com</a>

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### Washington, D.C.

Sarah C. Flowers	+1-202-956-7630	<a href="mailto:flowerss@sullcrom.com">flowerss@sullcrom.com</a>
Eric J. Kadel, Jr.	+1-202-956-7640	<a href="mailto:kadelej@sullcrom.com">kadelej@sullcrom.com</a>
William F. Kroener III	+1-202-956-7095	<a href="mailto:kroenerw@sullcrom.com">kroenerw@sullcrom.com</a>
Stephen H. Meyer	+1-202-956-7605	<a href="mailto:meyerst@sullcrom.com">meyerst@sullcrom.com</a>
Jennifer L. Sutton	+1-202-956-7060	<a href="mailto:suttonj@sullcrom.com">suttonj@sullcrom.com</a>
Andrea R. Tokheim	+1-202-956-7015	<a href="mailto:tokheima@sullcrom.com">tokheima@sullcrom.com</a>
Samuel R. Woodall III	+1-202-956-7584	<a href="mailto:woodalls@sullcrom.com">woodalls@sullcrom.com</a>

---

### Los Angeles

Patrick S. Brown	+1-310-712-6603	<a href="mailto:brownp@sullcrom.com">brownp@sullcrom.com</a>
William F. Kroener III	+1-310-712-6696	<a href="mailto:kroenerw@sullcrom.com">kroenerw@sullcrom.com</a>

---

### Paris

William D. Torchiana	+33-1-7304-5890	<a href="mailto:torchianaw@sullcrom.com">torchianaw@sullcrom.com</a>
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### Tokyo

Keiji Hatano	+81-3-3213-6171	<a href="mailto:hatanok@sullcrom.com">hatanok@sullcrom.com</a>
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