Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

Community Bank Summary:

Proposed Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996

September 27, 2017

Introduction

This summary document discusses key aspects of the proposed rulemaking titled "Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996" (proposal or proposed rule). The full text of the proposed rule, which includes directions on how to comment on the proposal, is available on the federal banking agencies' websites. Most aspects of the proposed rule would apply only to banking organizations[1] that are not subject to the advanced approaches.[2]

This summary document is intended to provide community banks with a brief description of the most significant changes contained in the proposal, as applicable to community banks. It does not provide complete coverage of the notice of proposed rulemaking, and does not carry the force and effect of law or regulation. In addition to reading this summary document, community banks are encouraged to review the proposed changes in their entirety to understand what portions of the proposed rule are relevant to them.

The proposed rule would:

- Replace the complex definition of high volatility commercial real estate (HVCRE) exposures in the agencies' standardized approach capital framework with a more straightforward definition for higher-risk acquisition, development, or construction (ADC) loans called high volatility acquisition, development, or construction (HVADC).

- Simplify the threshold deduction treatment for mortgage servicing assets (MSAs), temporary difference deferred tax assets (DTAs) not realizable through carryback, and investments in the capital of unconsolidated financial institutions.

- Simplify the limitations on minority interest includable in regulatory capital.

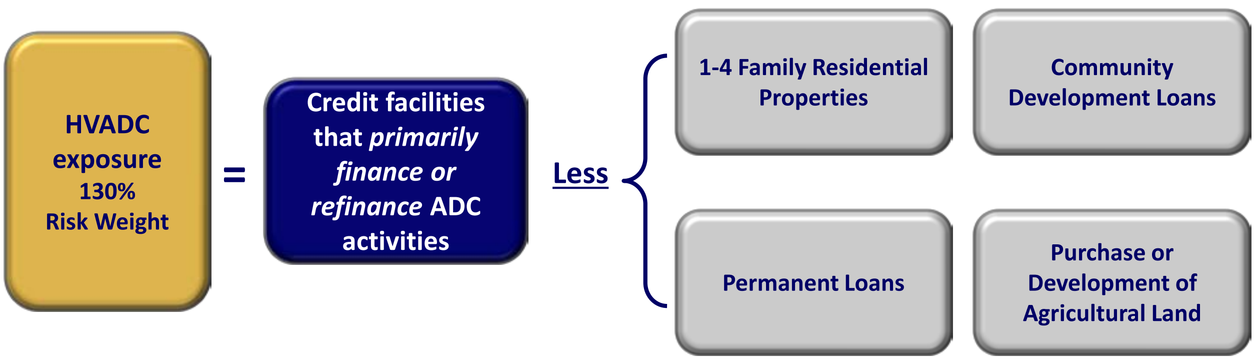
[1] Banking organizations subject to the agencies' capital rule include national banks, state member banks, state nonmember banks, savings associations, and top-tier bank holding companies and savings and loan holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement (12 CFR part 225, appendix C), but excluding certain savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities or that are estate trusts, and bank holding companies and savings and loan holding companies that are employee stock ownership plans.

[2] Banking organizations that are subject to the capital rule's advanced approaches would not be affected by the proposed changes to the treatment of mortgage servicing assets, deferred tax assets, investments in the capital of unconsolidated financial institutions, and minority interest. However, the standardized approach change in the treatment of ADC loans will apply to all banking organizations.

Key Changes Proposed to the Standardized Approach

- **Replace the complex HVCRE exposure definition with a simpler HVADC exposure definition**

On a going forward basis, the proposal would replace the complex HVCRE exposure definition in the standardized approach with a simpler definition, called HVADC, which would apply to credit facilities that *primarily* finance or refinance ADC activities. As proposed, an HVADC exposure would receive a 130 percent risk weight. The HVADC definition is generally expected to apply to a broader range of exposures than the HVCRE definition. For example, as compared to the HVCRE exposure definition, the proposed HVADC exposure definition would not include an exemption for loans that finance projects with substantial borrower contributed capital and consequently removes the restriction on the release of internally generated capital. In addition, the proposed rule simplifies and clarifies certain exemptions, and clarifies the scope of exposures captured by the HVADC exposure definition. Under the standardized approach, the proposal would grandfather the treatment of ADC loans originated prior to the effective date of a final rule. The proposed HVADC exposure definition would apply only to ADC exposures originated on or after the effective date of the final rule.



	Key clarifications	Impact
Scope	***Primarily finance or refinance*** means credit facilities where more than 50 percent of loan proceeds will be used for ADC activities.	Multipurpose facilities where more than 50 percent of loan proceeds finance non-ADC activities, such as the purchase of equipment, would not be considered HVADC.
Exemptions	***One- to four-family residential properties***	Lot development loans and loans to finance the ADC of townhomes or row homes would not be considered HVADC. Raw land loans and loans to finance the ADC of apartments and condominiums generally would be considered HVADC.

Key clarifications		Impact
	Community development loans	Real property projects that have the primary purpose of "community development" would not be considered HVADC. Loans to finance activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs or have gross annual revenues of $1 million or less also would not be considered HVADC so long as they meet the applicable public purpose test.
	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 generally are not considered to be "permanent loans" and generally would be considered HVADC. Owner-occupied ADC projects may have sufficient capacity at origination to repay the loan from ongoing operations, in which case the loan would be considered a "permanent loan" and would not be considered HVADC. Interest-only loans could be "permanent loans." Although the bank must identify a source of repayment that is sufficient to service an amortizing payment, the proposed rule would not require that the current loan payments be amortizing for a loan to be considered a "permanent loan."

As a result of this proposal, certain new ADC exposures that would have been considered HVCRE may receive a lower risk weight going forward than they would have received under the current rule (130 percent, rather than 150 percent). However, other new ADC exposures that would not have been considered HVCRE may receive a higher risk weight (130 percent, rather than 100 percent). Banking organizations are advised to carefully analyze their underwriting criteria to appropriately assess the net effect that this proposal would have on their ADC lending activity and the resulting regulatory capital consequences.

- **Simplify the treatment of exposures subject to the common equity tier 1 threshold deductions**

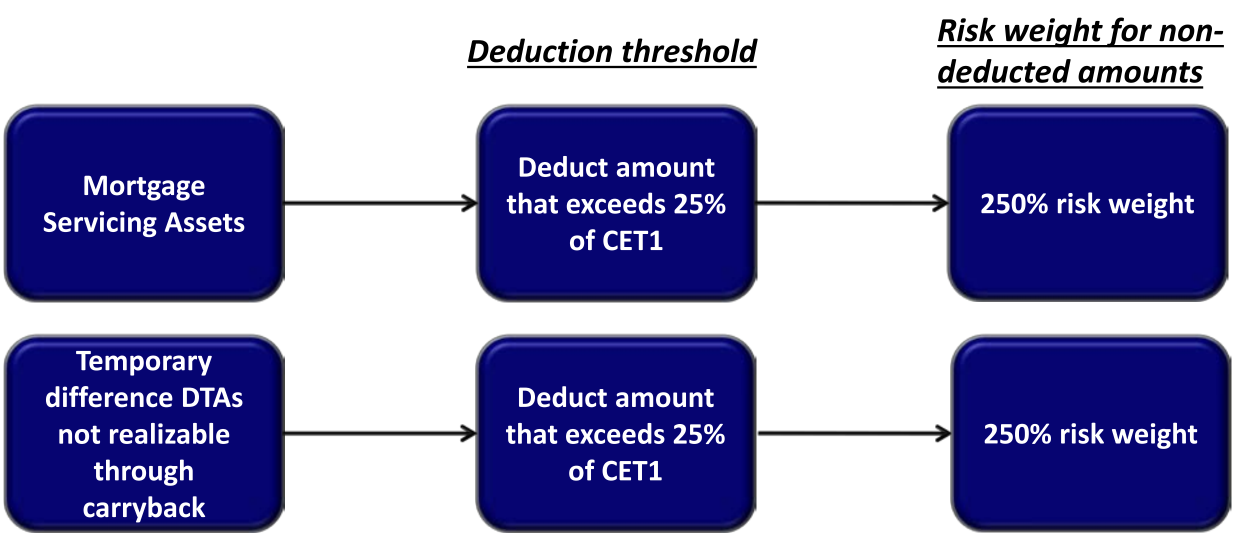
The proposal would revise the treatment of exposures subject to the common equity tier 1 capital threshold deductions under the capital rule, including MSAs, temporary difference DTAs not realizable through carryback, and significant investments in the capital of unconsolidated financial institutions.

In contrast to the existing capital rule, which limits the inclusion of each threshold deduction item to 10 percent of common equity tier 1 capital, with a combined 15 percent limitation, the proposal would raise the limit for MSAs and DTAs, individually, to 25 percent of common equity tier 1 capital **and would not include a combined limit**. Additionally, the proposal would remove the distinction between significant and non-significant investments in the capital of unconsolidated financial institutions and establish a combined limit on these investments of 25 percent of common equity tier 1 capital.

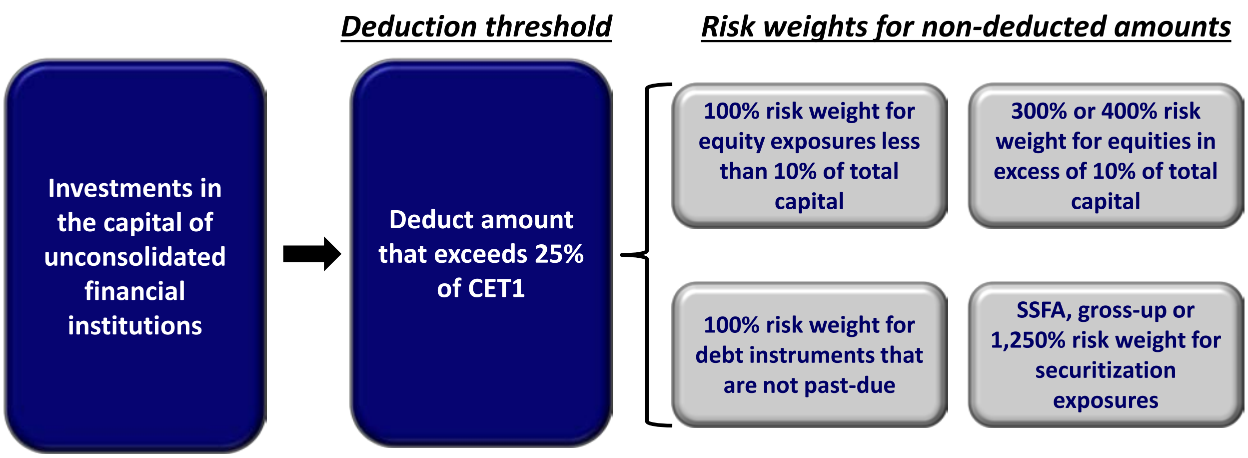
Specifically, the proposal would:

1) **Increase the limit on MSAs to 25 percent of common equity tier 1 capital:** Any amount of MSAs held by a banking organization that exceeds this limit would be deducted from regulatory capital. MSAs not deducted from regulatory capital would be assigned a 250 percent risk weight.

2) **Increase the limit on temporary difference DTAs not realizable through carryback to 25 percent of common equity tier 1 capital:** Any amount exceeding this limit would be deducted from regulatory capital and the amount not deducted from regulatory capital would be assigned a 250 percent risk weight.



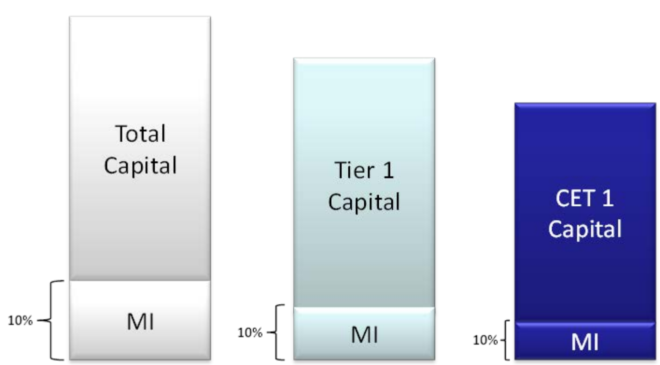
3) **Remove the distinction between significant and non-significant investments in the capital of unconsolidated financial institutions — the deduction limit on all investments in the capital of unconsolidated financial institutions would be 25 percent of common equity tier 1 capital:** Any amount of these investments exceeding the 25 percent limitation would be deducted from regulatory capital and the amount of these investments not deducted from regulatory capital would be risk weighted according to the relevant treatment for the exposure category of the investment.



- **Simplify the limitations on minority interest includable in regulatory capital**

The proposal would eliminate the existing complex calculation to determine the amount of minority interest (regulatory capital issued by a consolidated subsidiary and held by third parties) that could be included in the regulatory capital of a parent banking organization. Instead of basing the limitation on the minimum required capital of its subsidiaries, a parent banking organization would be allowed to include common equity tier 1 minority interest, tier 1 minority interest, and total capital minority interest up to 10 percent of the parent banking organization's common equity tier 1, tier 1, and total capital elements (before the inclusion of any minority interest and after certain deductions and adjustments), respectively.

Regulatory Capital Stack with Includable Minority Interest (MI)



Appendix: Summary Table Comparing the Current Capital Rule with the Proposed Rule

	Current rule	Proposed changes applicable to banks that do not use the Advanced Approaches
Acquisition, development, or construction (ADC) exposures		
Term	High volatility commercial real estate (HVCRE) exposure	High volatility acquisition, development, or construction (HVADC) exposure* *The proposed HVADC exposure category would also be applicable to advanced approaches banking organizations only for the calculation of risk-weighted assets under the standardized approach.
Scope	A credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property.	A credit facility that *primarily* finances or refinances: i. the acquisition of vacant or developed land; ii. the development of land to prepare to erect new structures, including, but not limited to, the laying of sewers or water pipes and demolishing existing structures; or iii. the construction of buildings or dwellings, or other improvements including additions or alterations to existing structures. Primarily finances: If more than 50 percent of the funds (e.g., loan proceeds) are intended for ADC activities. The proposed HVADC exposure definition would exclude an exposure that is considered to be a permanent loan. Bridge loans generally would not qualify as permanent loans as the property is not generating sufficient revenue to make amortizing principal and interest payments.
Risk weight	150 percent risk weight	130 percent risk weight for new HVADC exposures with grandfathering of existing HVCRE exposures.
Residential properties exemption	One- to four-family residential properties	Maintains the one- to four-family residential properties exemption. The proposal clarifies for HVCRE and HVADC that this exemption includes loans to construct one- to four-family residential structures and loans that combine the land, acquisition, development, or construction of one- to four-family residential structures.

Appendix: Summary Table Comparing the Current Capital Rule with the Proposed Rule

	Current rule	Proposed changes applicable to banks that do not use the Advanced Approaches
Community development exemption	Many community development projects are exempt. Certain activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company of Small Business Investment Company programs, or have gross annual revenues of $1 million or less are ineligible for the community development exemption solely by virtue of size or annual revenue eligibility.	All real property projects that serve the primary purpose of community development under the agencies' Community Reinvestment Act rules would be exempt.
Agricultural exemption	Credit facilities that finance the purchase or development of agricultural land are exempt.	Largely unchanged with a minor clarification.
Contributed capital exemption	Exemption for projects with 15 percent contributed capital and also meet supervisory loan-to-value limits.	Removes the contributed capital exemption and explicit requirement about meeting supervisory loan-to-value limits and consequently removes the restriction on the release of internally generated capital.
Exit criteria	The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Permanent financing is subject to the banking organization's underwriting criteria for long-term mortgage loans.	An exposure is no longer considered HVADC, when the credit facility is classified as a "permanent loan," proposed to be defined as 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.
Mortgage servicing assets (MSAs), temporary difference deferred tax assets (DTAs), investments in the capital of unconsolidated financial institutions		
Individual threshold deduction	Individual 10 percent common equity tier 1 capital deduction threshold for MSAs, temporary difference DTAs, and significant investments in the capital of unconsolidated financial institutions in the form of common stock.	Increases the individual common equity tier 1 capital deduction thresholds for MSAs and temporary difference DTAs to 25 percent and imposes a 25 percent limit on all investments in the capital of unconsolidated financial institutions.
Aggregate threshold deduction	Aggregate 15 percent common equity tier 1 deduction threshold for the above items.	Eliminates the aggregate deduction threshold.

Appendix: Summary Table Comparing the Current Capital Rule with the Proposed Rule

	Current rule	Proposed changes applicable to banks that do not use the Advanced Approaches
Investment in unconsolidated financial institutions	Different deduction treatments for: • significant investments in the capital of other financial institutions in the form of common stock; • significant investments in the capital of other financial institutions that are not in the form of common stock; and • non-significant investments in the capital of other financial institutions.	The proposal would simplify and replace the current capital rule's different deduction treatments with one treatment for all investments in the capital of unconsolidated financial institutions.
Risk weight	If fully phased in,* MSAs, temporary differences DTAs, and significant investments in common stock that are not deducted receive a risk weight of 250 percent. * In August 2017, the agencies invited public comment on a proposed rule to extend the capital rule's transitional provisions for MSAs, temporary difference DTAs, and investments in the capital of consolidated financial institutions (82 FR 40495 (August 25, 2017), Transitions NPR). The Transitions NPR proposed to retain the transitional 100 percent risk weight for these items until this proposal is finalized.	MSAs and temporary differences DTAs not deducted would receive a risk weight of 250 percent. Investments in the capital of unconsolidated financial institutions that are not deducted would be subject to the relevant risk-weight treatment for the exposure category of the investment.
Minority interest		
Includable minority interest	Minority interest includable in common equity tier 1, tier 1, and total capital is based on capital requirements and ratios of each consolidated subsidiary that has issued capital instruments that are held by third parties.	Limits common equity tier 1 minority interest, tier 1 minority interest, and total capital minority interest up to 10 percent of the banking organization's common equity tier 1, tier 1, and total capital, respectively.