Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Extension of Transition Period for Certain Basel III Rules[*]

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September, 2017

On August 25, 2017, the Federal banking agencies published a notice of proposed rulemaking (NPR) that will extend the transition period for certain Basel III rules for banking organizations (banks, savings associations, and their holding companies) that are not required to use the Advanced Approach framework.[1] Comments on the proposal are due September 25.

I. Introduction

The Basel III capital rules adopted in 2013 required the deduction from capital of the value of certain assets that were deemed to be risky or unreliable, and raised the risk-weight to 250 percent for the portion of these assets that are not deducted. The capital rules contain transition provisions that phase-in these changes over several years in order to give banking organizations sufficient time to adjust to the new requirements. The transition periods end on December 31, 2017. The proposed regulation will extend these transition periods, but only for banking organizations that are not required to use the Advanced Approach framework, that is banking organizations with less than $250 billion in consolidated assets and less than $10 billion in foreign exposures.

The notice of proposed rulemaking noted that the agencies are developing a second proposal to simplify certain aspects of the capital rules with the goal of reducing regulatory burden on community banking organizations. The agencies will review the transition provisions contained in this rulemaking in connection with the yet to be issued "simplifications NPR." However, as of now, there is no specified end date for the extensions provided by this proposed rule.

II. Minority Interests in Consolidated Subsidiaries

Under accounting principles, the assets and liabilities of a consolidated subsidiary are combined with those of the parent banking company. A subsidiary is any company controlled by the parent banking organization.

[*] The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] 82 Fed. Reg. 40495 (Aug. 25, 2017).

Where the banking organization has a majority ownership in the subsidiary, and another company owns a minority of its shares, the accounting rules normally treat the minority equity interest in the subsidiary as a capital element of the parent company.

Under the 2013 Basel III rules, the minority equity interest in the subsidiary will not be allowed to be part of the banking organization's capital unless the subsidiary meets all regulatory capital standards necessary to avoid restrictions on distributions and bonuses.[2] If the subsidiary is not subject to capital adequacy standards similar to those of the parent banking organization, the parent company must assume that the capital adequacy standards applicable to the parent also apply to the subsidiary.[3] To effectuate this limitation, the 2013 rules prescribe various calculations that limit the amount of the common equity, tier 1 and total capital of the subsidiary that can be consolidated with the parent, so as to prevent the parent from benefiting for any capital component that is required for the subsidiary to meet its own actual or assumed capital requirements.

The 2013 rules provided a transition period gradually reducing the amount of non-qualifying minority equity interests in the subsidiary. In 2017, the phase-in is 80 percent, and on January 1, 2018, the rule is completely phased-in, thereby eliminating the use of any non-qualifying minority interest for regulatory capital purposes.[4] The NPR retains the 80 percent phase-in level for non-Advanced Approaches banking organizations. Thus, these institutions would be permitted to continue to count up to 20 percent of non-qualifying minority equity interests in a consolidated subsidiary toward the parent banking organization's capital requirements.

III. Investments in the Capital of Unconsolidated Financial Institutions

The Basel III rules require banking organizations to deduct a portion of their investment in an <u>unconsolidated financial institution</u>. Thus, if a bank owns equity shares in another financial company but does not have control of that company, a portion of the bank's investment must be deducted from the bank's capital accounts.

The rule defines "financial institution" broadly, to include not only banks and savings associations and their holding companies, but also such organizations as credit unions, foreign banks, industrial loan companies, insurance companies, registered broker-dealers, futures commission merchants, swap dealers, and other companies predominately engaged in financial activities.[5]

The required deductions are phased-in, and in 2017 the percentage of the deduction must equal at least 80 percent of the total amount required to be deducted. The deduction is completely phased-in as of January 1, 2018. Also, as of that date, the risk-weight for that portion of the investment that is not deducted from capital would increase from 100 percent to 250 percent. The NPR would extend the 80 percent level for banking organizations not subject to the Advanced Approach framework. The NPR would also continue the 100 percent risk-weight for that portion of the investment that is not deducted from capital.

[2] See, e.g., 12 CFR §3.21.
[3] Id.
[4] 12 CFR §3.300.
[5] See 12 CFR §3.2 for a more comprehensive list of "financial institutions."

IV. Mortgage Servicing Assets

Many banking organizations perform mortgage servicing activities for other institutions that hold the underlying mortgages. For example, a mortgage lender holding mortgages in portfolio may contract with a bank to perform the servicing related to the mortgage, such as collecting and accounting for the monthly payments, sending out late notices, collecting fees, and taking steps to cure a default. Banks performing these services receive a fee from the company actually holding the mortgage. These contractual rights are called "mortgage servicing assets."

Under the 2013 Basel III rules, a banking organization must deduct from common equity tier 1 capital mortgage servicing assets that exceed 10 percent of the banking organization's common equity tier 1 capital, after certain adjustments are made.[6] Further, the amount of mortgage-servicing assets and certain other specified assets cannot exceed, in the aggregate, more than 15 percent of a banking organization's common equity tier 1 capital, again after certain adjustments are made.[7] These deductions are phased-in and the amount of the deduction in 2017 is equal to 80 percent of the required amount. As of January 1, 2018, the deduction will be fully phased-in, and the risk-weight for mortgage servicing assets that are not deducted is increased to 250 percent.

The NPR would continue the 80 percent deduction level for non-Advanced Approaches banking organizations, and retain the risk-weight at 100 percent for the amount of mortgage servicing assets not required to be deducted.

V. Deferred Tax Assets

Deferred tax assets (DTA) may arise in two ways. A banking organization may have a net operating loss that can be carried forward to a future tax year in which the banking institution earns a net profit, thereby reducing a future tax liability. A deferred tax asset can also be created when there is a temporary difference in the timing of certain financial events between the bank's accounting rules and tax rules. For example, a banking organization may be required to book an expense before the actual payment is made, while the tax rules only recognize the expense when paid. When the bank books the expense, it also records a "deferred tax asset" to indicate that it will receive a future tax benefit when the expense is paid. This second type of deferred tax asset is referred to as a DTA resulting from timing differences.

Under Basel III, a banking organization must deduct from common equity tier 1 capital DTA resulting from timing differences to the extent that those assets exceed 10 percent of the organization's common equity. This asset is also combined with MSA and other specified assets so that in the aggregate these assets cannot exceed 15 percent of common equity tier 1. These deductions are subject to various adjustments.[8] As of January 1, 2018, the DTA due to timing differences that are not deducted are risk-weighted at 250 percent.

The NPR would extend the current phase-in level of 80 percent for banking organizations that are not required to use the Advanced Approach. The NPR would also retain the 100 percent risk-weight for assets that are not deducted from capital.

[6] The adjustments are described at 12 CFR §§3.22(d) and (e).
[7] Id.
[8] Id.

VI. Conclusion

The notice of proposed rulemaking would extend the current phase-in level of 80 percent for required deductions from capital for the following: (i) non-qualifying minority investments in consolidated subsidiaries; (ii) banking organizations' investments in unconsolidated financial companies; (iii) mortgage servicing assets; and (iv) deferred tax assets arising from temporary timing differences. To the extent that these assets are not deducted from capital, they would continue to be risk-weighted at 100 percent. The NPR does not provide any relief for banking organizations subject to the Advanced Approaches capital rules. The extensions in the NPR do not have a specified end date, but the agencies will be revisiting these extensions as part of a future rulemaking designed to ease regulatory burden for community banks.

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