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Simplification of Basel III Capital Rules

- Regulatory Relief for Non-Advanced Approaches Banks
- Lower Risk Weighting but More Loans Classified as HVADC with Current Loans Grandfathered
- Increased Investment Permitted in MSAs, Temporary Difference DTAs, and Capital Securities Issued by Unconsolidated Financial Institutions (UFIs)
- Substantial Increase in Minority Interest Amount Includable in Regulatory Capital

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On September 27, 2017, the Board of Governors of the Federal Reserve Board (the Board), Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively referred to as the agencies) issued a notice of proposed rulemaking regarding several proposed simplifications (Simplification NPR) of the Basel III capital rules issued in 2013[1]. These changes were foreshadowed in the March 2017 EGRPRA Joint Report to Congress issued by the FFIEC[2] and the August 2017 Transitions NPR[3] which proposed to delay the phase-in of certain capital rules for non-advanced approaches banking organizations until January 1, 2019.

The Simplification NPR is subject to a 60-day comment period with implementation expected before January 1, 2019. Advanced approaches banks[4] must continue to comply with the Basel III capital rules and will generally not benefit from these changes and simplifications other than through certain technical corrections and clarifications to the capital rules. Overall, we think these rule changes acknowledge the current complexity of complying with the Basel III capital rules and provide substantial relief for non-advanced approaches banks.

[1] Notice of Proposed Rulemaking. Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. September 27, 2017. (See Appendix A for a glossary of key terms used in this report)
[2] Joint Report to Congress. Economic Growth and Regulatory Paperwork Reduction Act. Federal Financial Institutions Examination Council. March 2017.
[3] Notice of Proposed Rulemaking. Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations That Are Not Subject to the Advanced Approaches Capital Rules. Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. August 22, 2017.
[4] Advanced approaches banks have consolidated assets equal to $250 billion or more or foreign exposure of $10 billion or more or are subsidiaries of a bank holding company or savings and loan holding company that uses the advanced approaches methodology to calculate risk-weighted assets. There are currently 10 advanced approaches banks in the U.S.

At least five areas warrant further review and potential action by non-advanced approaches banks and certain non-bank investors:

1. Lower Risk Weighting but More Loans Classified as HVADC with Current Loans Grandfathered

Through the comment process for EGRPRA, community bankers expressed concern that the 150% risk weighting applied to HVCRE exposures was too high and the criteria for determining whether an ADC loan qualified for an exemption from HVCRE classification was confusing and did not track relevant or appropriate risk drivers. In particular, bankers expressed concern over the contributed capital exemption that allowed ADC projects that included a 15% borrower equity contribution and certain loan-to-value limits to avoid consideration as HVCRE. This 15% equity contribution was required to remain in the project for the life of the project. Conversion of the credit facility from HVCRE could only be accomplished by arranging permanent financing or paying it off.[5]

To address these concerns, the agencies developed the revised definition for HVADC to eliminate the 15% contributed capital exemption and restriction on the release of internally generated capital. The agencies also narrowed the definition of ADC exposures to only include exposures used primarily (more than 50%) for the financing or refinancing of the ADC of land, development of land or new structures, and the construction of buildings. Excluded from the HVADC definition are ADC exposures for residential properties, community development properties, and agricultural land.

Finally, the agencies changed the exit criteria for the life of a project to classify a credit facility as a permanent loan if it has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments without reliance on the sale of the property. The proposed HVADC exposure definition would only apply to exposures originated on or after the effective date of the final rule.

On balance, the agencies expect that more loans will be considered HVADC loans under the Simplification NPR than under the current HVCRE exposure definition. Based on Call Report data as of June 30, 2017, there were 2,338 FDIC-supervised small banks that reported approximately $14.4 billion of ADC loans (excluding residential 1-4 family projects). Of this group, 817 banks reported about $3.6 billion of non-residential ADC loans classified as HVCRE and risk weighted at 150%. The $10.8 billion balance of such loans was assumed to be risk-weighted at 100% as a result of meeting one or more of the currently available exemptions from the current definition of HVCRE related to either the amount of contributed capital or because the exposure would qualify as an agricultural or farm loan, community development loan, or permanent financing.[6] As shown below in Chart A, the proposed changes in classification from HVCRE to HVADC would likely increase

[5] Joint Report to Congress. Economic Growth and Regulatory Paperwork Reduction Act. Federal Financial Institutions Examination Council. March 2017. Page 20.

[6] Notice of Proposed Rulemaking. Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. September 27, 2017. Pages 33-34.

the amount of risk weighted assets by approximately $2.5 billion and increase the average risk weighting from approximately 113% to approximately 130%.

Chart A

Impact of Implementing HVADC Rules Under Simplification NPR

Risk Weighting Methodology	Number of Banks	Carrying Value of ADC Loans		Risk-Weighting	Loan Amount (000)	
Current Basel III Rules	817	$	3,600	150%	$	5,400
Current Basel III Rules	1,521	$	10,800	100%	$	10,800
	2,338	$	14,400	113%	$	16,200
Simplication NPR	2,338	$	14,400	130%	$	18,720
				Increase in Risk Weighting of Assets ($)	$	2,520
				Increase in Risk Weighting of Assets (%)		18%

Clearly, if this sample from the June 30, 2017 Call Reports is an accurate representation of the industry portfolio, an 18% increase in the risk weighting of ADC portfolios for these banks would be a substantial increase. The good news is that outstanding ADC loans will be grandfathered in their current risk weighting and the HVADC risk weighting will be 130% rather than 150% for HVCRE.

Nonetheless, all non-advanced approaches banks should review their ADC exposures to make sure they understand how their loan exposures may be impacted by this change in rules. Non-advanced approaches banks should also consider restructuring the terms and conditions of ADC exposures when the loans are renewed or refinanced to avoid inadvertent classification as HVADC with the higher associated risk weighting and capital charges.

2. Increased Investment in Mortgage Servicing Assets (MSAs) and Mortgage Banking Activity

The federal banking regulators have historically used two primary approaches to address the risk of MSAs: (i) a deduction from regulatory capital of amounts above threshold levels and (ii) higher risk weighting to MSAs not deducted from capital.

The fair value method of accounting for MSAs limits the amount that a banking institution could include in regulatory capital to the lesser of 90% of the MSA's fair value or 100% of the MSA's carrying value. Amounts not deducted received a 100% risk weighting while the deducted amounts had the equivalent of 1250% risk weighting. As highlighted below in Chart B, this methodology resulted in MSAs having an effective risk weighting of 215%.

Chart B

<u>MSA Risk Weighting Under 90% Fair Value Requirement</u>

Federal Banking Agencies MSA Framework	
$ 1,000.0	CET1 Amount
8.00%	regulatory capital level
$ 100.0	MSA carrying value
90%	Fair value
10%	Fair value haircut
100%	RW for MSA fair value
1250%	RW for MSA hair cut
Results:	
$ 90.0	RWA for value of MSA
$ 125.0	RWA for 10% haircut of MSA
$ 215.0	Total RWA for investment in MSA
215%	RWA % for carrying value of MSA

In the report to Congress on the Effect of Capital Rules on Mortgage Servicing Assets[7], the agencies acknowledged that they evaluated a range of appropriate treatments in the rulemaking process before deciding on the current Basel III two-step approach shown below in Chart C.

Chart C

<u>10% Step 1 Cap and 15% Step 2 Cap</u>

Current Basel III Capital Rules	
$ 1,000.0	CET1 Amount
8.00%	Regulatory capital level
$ 100.0	MSA carrying value
100%	Fair value
10%	CET1 step 1 Cap for investment in MSA
15%	CET1 step 2 Cap for investment in MSA, DTA and significant investment in capital of unconsolidated financial institutions
250%	RW for MSA < =10% of CET1
1250%	RW for deduction against CET1 for inv. amount greater than 10% step 1 cap or greater than 15% step 2 cap
Results:	
$ 250.0	RWA for value of MSA < =10% CET1
$ -	RWA for amount > 10% or more of CET1
$ 250.0	Total RWA for investment in MSA
250%	RWA % for carrying value of MSA

[7] Report to the Congress on the Effect of Capital Rules on Mortgage Servicing Assets. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and National Credit Union Administration. June 2016. Pages 17-18.

Through the comment process for EGRPRA, a number of bankers commented that the two-step calculation process was unduly complex and burdensome and very restrictive for community banks. Unfortunately, FDICIA limits the amount of readily marketable purchase mortgage servicing assets (PMSA) that an insured depository institution can include in regulatory capital to no more than 90% of the PMSA's fair value. Any change to this limitation can only be made if the agencies jointly determine that such change would not "have an adverse effect on the deposit insurance fund or the safety and soundness of insured depository institutions."[8] Ultimately, the agencies agreed that raising the step one cap to 25% and retaining the risk weighting of 250% of the non-deducted MSAs under the proposed simplified Basel III rule would be consistent with FDICIA requirements.

This increase in the step one cap contemplated by the Simplification NPR to 25% of CET1 capital will provide a tremendous savings in risk weighting assets to non-advanced approaches banks. Chart D below highlights the savings of 600% from the current Basel III framework.

Chart D

Comparison of MSA Risk Weighting Under Various Capital Regimes

MSA % CET1 (1)	Regulatory Framework	Current Basel III	Basel III Simplified	RWA Savings
35%	215%	964%	536%	-429%
30%	215%	917%	417%	-500%
25%	215%	850%	250%	-600%
20%	215%	750%	250%	-500%
15%	215%	583%	250%	-333%
10%	215%	250%	250%	0%
5%	215%	250%	250%	0%

A reduction in RWA of 600% would likely attract substantial additional investment by non-advanced approaches banks. The Mortgage Bankers Association estimates that if all 64 banks with MSA concentrations greater than 10% were to re-enter to the maximum level of 25% of CET1, approximately $910 million of CET1 would be freed up and available to purchase MSAs, which would imply an unpaid mortgage balance of approximately $91 billion. Assuming that the entire mortgage debt market is roughly $10 trillion with $5 trillion in agency MBS (for which MSRs would be created), this $91 billion migration back to banks would

[8] Notice of Proposed Rulemaking. Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. September 27, 2017. Pages 19 and 20.

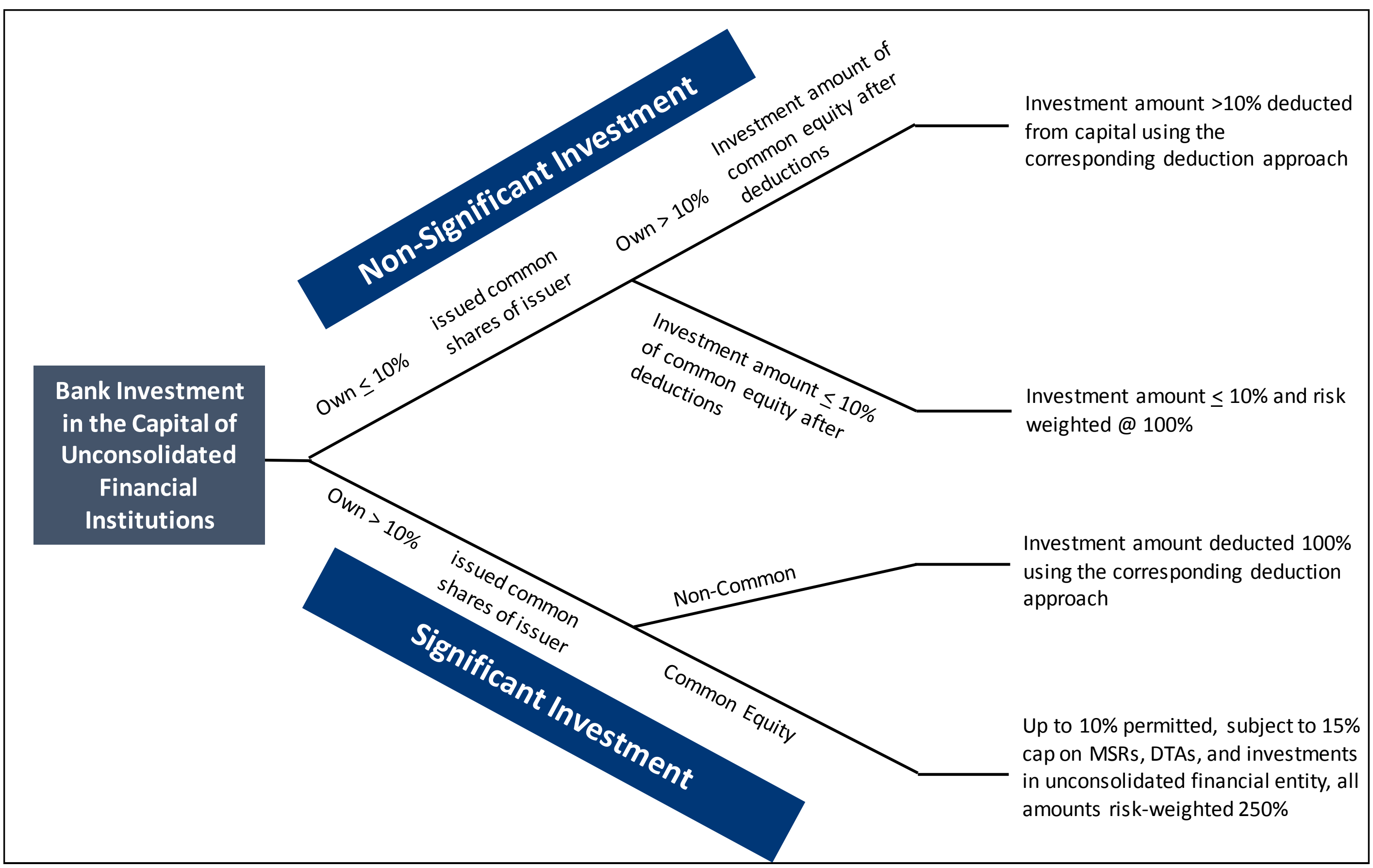
increase banks share of the mortgage servicing market by approximately 2%, from approximately 68% to a little less than 70%. That in and of itself is not a big move. However, this calculation does not include those banks that are currently under 10% MSA CET1 ratio, but were reluctant to take on more servicing to avoid bumping up against the 10% cap. Having more buyers among the non-advanced approaches banks would also create more demand for the servicing asset (adds a "bid"), and thus supports a higher value, which in turn will result in lower interest rates for consumers.

3. Increased Investment in Capital Securities and Covered Debt Issued by UFIs

Current Basel III capital rules require that all banking organizations deduct non-significant and significant investments in the capital securities issued by UFIs (such as subordinated debt, trust preferred, preferred stock and common stock) for amounts above the step 1 cap of 10% of CET1 and the step 2 cap of 15% using the corresponding deduction approach. As highlighted below in Chart E, the current Basel III rules require banking organizations to determine if: (i) the UFI investment was significant or non-significant, (ii) the investment amount was greater than 10% of CET1, and (iii) apply the corresponding deduction approach to deduct any amounts greater than 10% of CET1 from the banking organziations regulatory capital.

Chart E

Current Basel III Decision Tree for Investment in UFIs



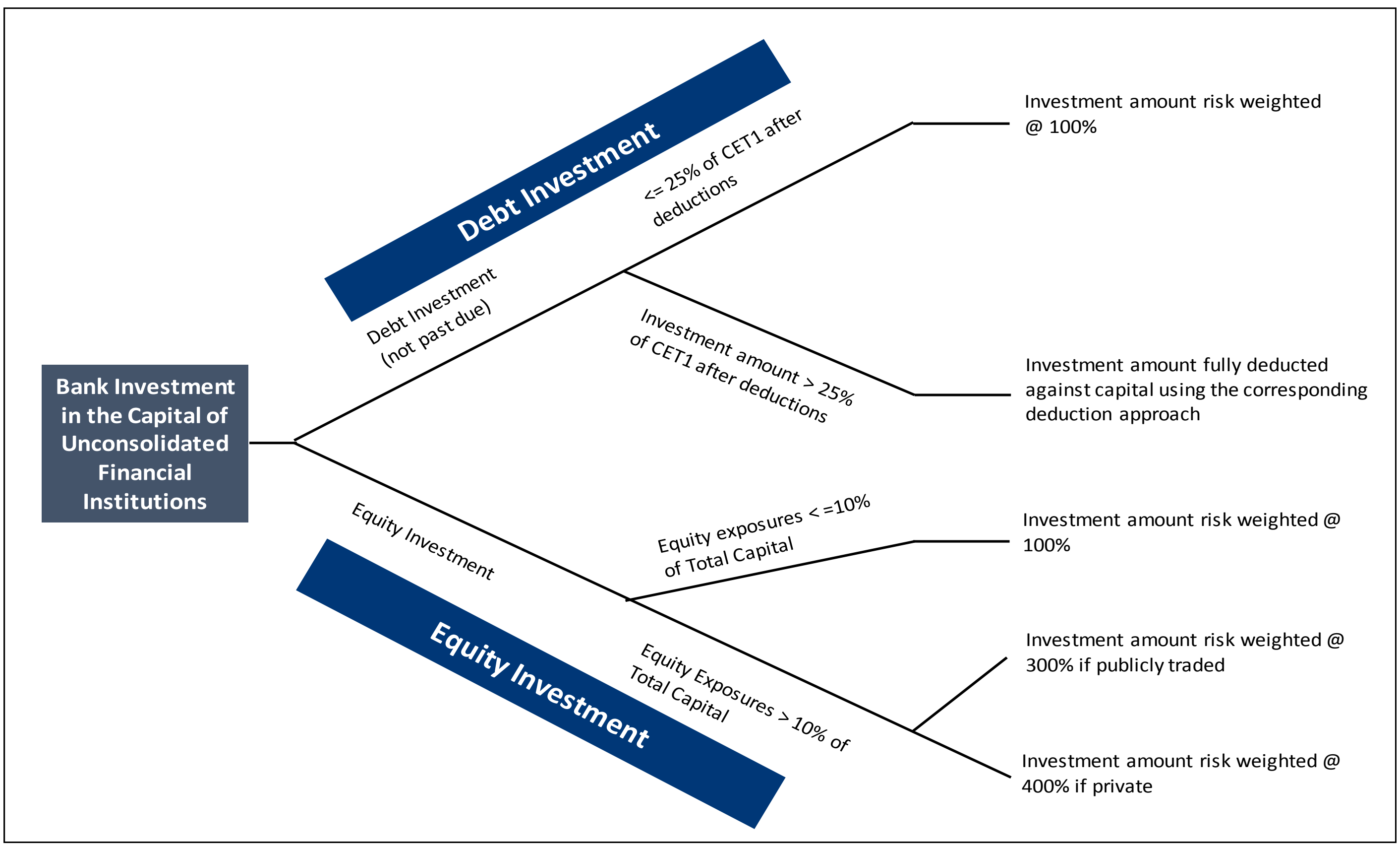
Note that for non-significant investments where the investment amount was 10% or less of the bank's CET1, the risk weighting would be 100%. For significant investments, non-common investments were deducted 100% using the corresponding deduction approach while equity investments of up to 10% of CET1 were permitted with a risk-weighting of 250%.

In December 2016, the Total Loss Absorbing Capacity (TLAC) final rules added senior BHC debt issued by GSIBs (Covered Debt) to the list of securities that will be considered capital securities and potentially deducted from bank capital effective January 1, 2019.[9] While the Board has remanded final action on this TLAC deduction to the FDIC and OCC for their further deliberation, the addition of TLAC debt to the list of capital securities subject to capital deduction has further complicated Basel III capital calculations.

The complexity of these calculations was noted through the EGRPRA process and through comments letters submitted under the TLAC rulemaking process to Chairman Yellen[10] and to the Federal Reserve Staff.[11] In response to these and other comment letters received, the Simplification NPR will dramatically simplify the decision tree for investment in UFIs as shown below in Chart F.

Chart F

<u>Simplification NPR Basel III Decision Tree for Investment in UFIs</u>



[9] Board of Governors of the Federal Reserve System. 12 CFR 252. Regulations YY; docket No. R-1523. Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations. December 15, 2016.

[10] https://www.federalreserve.gov/SECRS/2016/July/20160707/R-1523/R-1523_070616_130344_517019070434_1.pdf

[11] http://www.sandleroneill.com/Collateral/Documents/English-US/Fed%20Comment%20Letter%20on%20TLAC_1-20-16_FINAL-TWK-Website.pdf

UFIs will be divided into debt and equity investments. Debt and equity UFI amounts that are less than or equal to 25% of a banking organization's CET1 will be risk weighted at 100%. Debt UFI amounts greater than 25% of CET1 would be deducted against bank capital using the corresponding deduction approach. Equity UFI amounts greater than 25% of CET1 would be risk weighted at either 300% for public company stocks or 400% for private company stocks.

To show the benefit of increasing the step 1 cap (assuming the inclusion of Covered Debt to the securities to be deducted from capital), we have provided two case studies. In Chart G below, we highlight the impact of adding Covered Debt to the UFIs subject to the current 10% Basel III cap.

Chart G

Case Study: 10% Cap -- Impact of Capital Deduction Including Covered Debt in UFIs

Non-significant Investment Type	A: Corresponding Deduction Approach 10% Step 1 Cap — Investment Amt. ($)	B: Corresponding Deduction Approach 10% Cap with Covered Debt — Investment Amt. ($)
Senior GSIB BHC Debt	$ 200.0	$ 200.0
Subordinated Debt	$ 300.0	$ 300.0
Trust Preferred Stock	$ 250.0	$ 250.0
Preferred Stock	$ -	$ -
Common Stock	$ -	$ -
Total Bank Investments	$ -	$ -
Subject to Basel III Deduction	$ 550.0	$ 750.0

	A	B
Common Equity Tier 1	$ 5,500.0	$ 5,500.0
> 10% CET1	$ 550.0	$ 550.0
Excess Bank Investments	$ -	$ 200.0

CET1 Deduction Amount:	A	B	% Total
Senior BHC Debt (GSIB)	$ -	$ 53.3	27%
Subordinated Debt	$ -	$ 80.0	40%
Trust Preferred	$ -	$ 66.7	33%
	$ -	$ 200.0	100%

Current Capital Structure	Before Deduction		After Deduction (1)
Subordinated Debt	$ 50.0	$ 50.0	$ -
Trust Preferred	$ 50.0	$ 50.0	$ -
Preferred Stock	$ -		$ -
Common Stock	$ 5,500.0	$ 100.0	$ 5,400.0
Total Regulatory Capital	$ 5,600.0	$ 200.0	$ 5,400.0

(1) Dedutions for UFIs>10% of CET1 are based on the percentage of each type of investment owned. As currently proposed, excess investments in covered GSIB BHC senior debt will be deducted against subordinated debt to the full extent available. If no subordinated debt is outstanding, then the deduction will be allocated against the next most junior form of capital.

Column A shows the impact of the 10% step 1 cap with Covered Debt not counted as capital. The investment total of $550 million equals 10% of CET1 so there would be no capital dedcution. With $250 million of Covered Debt included, the sample bank would have $200 million of excess investment amount that must be deducted from capital using the corresponding deduction approach. In Column B, the excess investment of $200 million would be deducted from Tier 2 capital. Since the combination of $50 million of subordinated debt and $50 million of trust preferred is less than the deduction amount of $200 million, the difference is deducted from the next highest form of capital which is common equity. This results in a $200 million reduction in total capital with $100 million being deducted from common equity. This 3.6% reduction in capital would not be required under current Basel III capital rules but would be triggered with Covered Debt included in UFIs.

Alternatively, as shown in Chart H, with the UFI cap raised to 25% of CET1, the sample bank would suffer no capital deduction even with Covered Debt included in UFIs.

Chart H

Case Study: 25% Cap -- Impact of Capital Deduction Including TLAC

	A		B	
	Corresponding Deduction Approach 25% Cap with Covered Debt		Corresponding Deduction Approach W/ 25% Cap With Covered Debt	
Non-significant Investment Type	Investment Amt. ($)		Investment Amt. ($)	
Senior GSIB BHC Debt	$	500.0	$	500.0
Subordinated Debt	$	500.0	$	500.0
Trust Preferred Stock	$	375.0	$	375.0
Preferred Stock	$	-	$	-
Common Stock	$	-	$	-
Total Bank Investments	$	-	$	-
Subject to Basel III Deduction	$	875.0	$	1,375.0
Common Equity Tier 1	$	5,500.0	$	5,500.0
> 25% CET1	$	1,375.0	$	1,375.0
Excess Bank Investments	$	-	$	-
CET1 Deduction Amount:				
Senior BHC Debt (GSIB)	$	-	$	-
Subordinated Debt	$	-	$	-
Trust Preferred	$	-	$	-
	$	-	$	-
Current Capital Structure	Before Deduction			
Subordinated Debt	$	50.0	$	-
Trust Preferred	$	50.0	$	-
Preferred Stock	$	-		
Common Stock	$	5,500.0	$	-
Total Regulatory Capital	$	5,600.0	$	-

With the deduction for investment in Covered Debt under TLAC approaching on January 1, 2019 and the agencies apparent unwillingness to exempt Covered Debt from deduction against capital for non-advanced approaches banks, the increase in the cap to 25% provides substantial capacity for non-advanced approaches banks to hold Covered Debt without risk of deduction against capital. These types of shorter duration, floating rate investments issued by investment grade-rated GSIB bank holding companies may be appealing to non-advanced approaches banks seeking higher yields with less interest rate risk in a potential rising rate environment.

4. Increased Investment in Temporary Difference Deferred Tax Assets (DTAs)

Because of the risk of utilization, current Basel III capital rules require that all banking organizations deduct investments in temporary difference DTAs above the step 1 cap of 10% of CET1 and the step 2 cap of 15% of CET1. Any amounts not deducted are risk weighted at 250%. Through the comment process for EGRPRA and ongoing discussions with the agencies, banking industry groups have expressed concerns about the impact of the Financial Accounting Standards Board's (FASB) implementation of the Current Expected Credit Loss (CECL) standard which could create substantial temporary difference DTAs upon implementation before 2020.

In October of 2016, the Basel Committee on Banking Supervision (BIS) recognized the potential disruptive impact on capital ratios from forward looking expected credit loss provisioning.[12] The BIS expressed concern that the adoption of expected credit loss methodology would trigger substantial temporary difference DTAs from non-deducted loss provisions. A potential sharp increase in DTAs could create a "capital shock" unless transitional arrangments were put in place. Some possible options may be excluding any CECL related temporary difference from deduction from CET1 and excluding any CECL related provision from inclusion in tier 2 capital. Recognizing the concerns about the implementation of CECL on capital and accounting considerations, the U.S. agencies released a Joint Statement on the New Accounting Standard on Financial Instruments - Credit Losses[13] followed by a Frequently Asked Questions bulletin on the adoption of CECL[14] in September 2017. This new accounting standard will take effecit in 2020 or 2021 depending on whether the financial institution is a public business entity (SEC filer or non-filer) or private business entity. The agencies have indicated that they are not planning to make revisions to the treatment of ALLL in regulatory capital calulations. By increasing the temporary difference DTA cap from 10% to 25% of CET1, the impact of an increase in temporary difference DTAs on regulatory capital will be muted for non-advanced approaches banks. This will, however, clearly have an impact on tax planning for CECL.

[12] Consultative Document. Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements. October 2016 - Issued for Comment by January 13, 2017. Bank for International Settlements.

[13] https://www.fdic.gov/news/news/press/2016/pr16051a.pdf

[14] https://www.fdic.gov/news/news/financial/2017/fil17041a.pdf

5. Substantial Increase in Minority Interest Amount Includable in Regulatory Capital

Minority interests are capital instruments issued by a consolidated subsidiary of a banking organization to third party investors. Capital instruments issued as minority interests must meet all of the eligibility requirements for the relevant tier of capital. Under current Basel III capital rules, the amount of a subsidiary's surplus capital contributed by third party investors cannot be counted towards the parent organization's consolidated capital. Under the Simplification NPR, the calculation of the amount of minority interest included in regulatory capital would be 10% of the parent banking organization's CET1, tier 1 or total capital. As shown below in Chart I, based on the assumptions outlined, the banking organization will be able to issue $40 million of tax deductible REIT preferred capital to third party investors, 100% of which would be included in the parent BHC's tier 1 capital.

Chart I

REIT Preferred Capital Efficiency for Minority Interest Under Simplification NPR

Parent BHC Total RWA ($)	$	3,500,000
Parent BHC Avg. RWA %		70%
Parent BHC Total Asset	$	5,000,000
Parent BHC CET1 ($)	$	400,000
Parent BHC CET1 / RWA ($)		11.43%
Parent Total Tier 1 Capital	$	400,000
Parent BHC Total Tier 1 / RWA ($)		11.43%
Pro Forma BHC Tier 1/RWA %		12.43%
REIT Subs Total Assets	$	500,000
REIT Subs. Avg. RWA %		50%
REIT Subsidiary Total RWA ($)	$	250,000
REIT Total Equity Capitalization ($)	$	100,000
REIT Subsidairy Common Equity ($)	$	60,000
REIT Preferred Issuance Amt ($)	$	40,000
REIT Total Equty Capitalization ($)	$	100,000
REIT Total Debt Capitalization ($)	$	400,000

- REIT subsidiary would have intercompany debt of $400 million or approximately 80% of total REIT capitalization that would be eliminated in consolidation with the bank parent
- BHC consolidated Tier 1/RWA would increase from 11.43% to 12.34% or roughly 8%
- 100% of the $40 million REIT preferred issued would count as BHC tier 1 capital

	(a) Capital Issued By Subsidiary ($)	(b) Capital Owned by Third Parties (%)	(c) Amount of Minority Interest ($) (a) * (b)	(d) Maximum Permitted Amount (%) 10%	(e) Surplus Minority Interest ($) (d) - (c)	(f) Minority Interest Included at Banking Organization Level ($) (c)- (e)
CET1	$ 60,000	0.00%	$ -	-	$ -	$ -
Additional Tier 1	$ 40,000	100.00%	$ 40,000	$ 40,000	$ -	$ 40,000
Total Tier 1 Capital	$ 100,000	40.00%	$ 40,000	$ 40,000	$ -	$ 40,000
Tier 2 Capital	$ -	$ -	$ -	-		
Total Capital	$ 100,000	40.00%	$ 40,000	$ 40,000	$ -	$ 40,000

As shown below in Chart J, the minority interest calculation under current Basel III capital rules consists of eight factors and is unnecessarily complex based on the minimum required capital levels of subsidiaries. Using the same assumptions as detailed in Chart I above but applying the current Basel III minority interest calculation methodology, only $8.5 million of the $40 million of REIT preferred would be includable in the parent BHC's tier 1 capital.

Chart J

REIT Preferred Capital Efficiency for Minority Interest Under Current Basel III Capital Rules

Parent BHC Total RWA ($)	$ 3,250,000
Parent BHC Avg. RWA %	65%
Parent BHC Total Asset	$ 5,000,000
Parent BHC CET1 ($)	$ 400,000
Parent BHC CET1 / RWA ($)	12.31%
Pro forma Parent BHC Total Tier 1 / RWA	12.57%
REIT Subs Total Assets	$ 500,000
REIT Subs. Avg. RWA %	50%
REIT Subsidiary Total RWA ($)	$ 250,000
REIT Total Equity Capitalization ($)	$ 100,000
REIT Subsidairy Common Equity ($)	$ 60,000
REIT Preferred Issuance Amt ($)	$ 40,000
REIT Total Equty Capitalization ($)	$ 100,000
REIT Total Debt Capitalization ($)	$ 400,000

- REIT subsidiary would have intercompany debt of $400 million or approximately 80% of total REIT capitalization that would be eliminated in consolidation with the bank parent
- BHC consolidated capital would increase from 12.31% to 12.57% or approximately 2%
- Only 21.2% or $8.5 million of the $40 million REIT preferred issued would count as BHC tier 1 capital

(a) Capital issued by subsidiary ($)	(e) Minimum capital requirement plus capital conservation buffer ($) (RWAs) x (d)
(b) Capital owned by third parties (%)	(f) Surplus capital of subsidiary ($) (a) - (e)
(c) Amount of minority interest ($) = (a) x (b)	(g) Surplus minority interest ($) (f) *(b)
(d) Minimum capital requirement plus capital conservation buffer (%)	(h) Minority interest included at banking organization level ($) (c) - (g)

	(a) Capital Issued By Subsidiary ($)	(b) Capital Owned by Third Parties (%)	(c) Amount of Minority Int ($) (a) * (b)	(d) Minimum Capital Requirement + Capital Conserv. Buffer (%)	(e) Minimum Capital Requirement + Capital Conserv Buffer ($) (RWAs) * (d)	(f) Surplus Capital of Subsidiary ($) (a) - (e)	(g) Surplus Minority Int ($) (f) * (b)	(h) Minority Interest Included at Banking Organization Level ($) (c)- (g)
CET1	$ 60,000	0.00%	$ -	7.00%	$ 17,500	$ 42,500	$ -	$ -
Additional Tier 1	$ 40,000	100.00%	$ 40,000		$ -			
Total Tier 1 Capital	$ 100,000	40.00%	$ 40,000	8.50%	$ 21,250	$ 78,750	$ 31,500	$ 8,500
Tier 2 Capital	$ -	$ -	$ -					
Total Capital	$ 100,000	40.00%	$ 40,000	10.50%	$ 26,250	$ 73,750	$ 29,500	$ 10,500

Clearly, the issuance of $40 million of REIT preferred with only $8.5 million included in the parent BHC's tier 1 capital is not efficient. This inefficiency was a key reason why the issuance of REIT preferred to raise tier 1 capital was significantly reduced after the implementation of the current Basel III rules.

Since REIT preferred is the <u>ONLY</u> form of tax deductible tier 1 capital allowed under Basel III capital rules, this simplification of the minority interest rules should spur significant interest among non-advanced approaches banks who want to bolster their tier 1 capital -- particularly among those banks with existing REIT subsidiaries of their banks.

Summary and Implications

Overall, we think the Simplification NPR provides regulatory relief to non-advanced approaches banks from the current complexity of complying with the Basel III capital rules. The agencies have indicated that they believe any potential safety and soundness concerns arising from the more flexible treatment offered by the Simplification NPR can be addressed through the supervisory process at each non-advanced approaches bank. The revisions to the definition and risk weighing of HVCRE provide clarification and reduced risk weighting for this important type of lending but some lenders may find more loans classified as HVACP subject to the 130% risk weighting. The higher step 1 cap of 25% for investment in MSAs offers welcome relief that will likely attract more investment interest in MSAs and the mortgage banking industry in general from regional and community banks and will likely stimulate price appreciation in the value of MSAs. The higher step 1 cap of 25% for investment in UFIs will enable banks to own more capital securities issued by banks as well as Covered Debt issued by GSIB BHCs. The higher step 1 cap of 25% for investment in DTAs will help address potential concerns about substantial increases in DTAs arising from timing differences with the adoption of CECL beginning in 2019. Finally, the simplification of the calculation to determine the amount of minority interest includable in regulatory capital (assuming the instrument meets all other requirements) will substantially increase the amount includable in regulatory capital. We anticipate that this may rekindle interest by banks in issuing tax-deductible REIT preferred as a form of tier 1 capital.

In addition to proposing regulatory relief as described herein, the agencies have also invited comments (Questions 14 and 15)[15] on whether they should consider more comprehensive simplifications to the capital rules applicable to small and medium-sized, non-GSIB banks. Further changes could include simplifying the calculation of risk-weighted assets, reducing the number of capital ratios, and relying instead on a simple U.S. GAAP based equity ratio to average assets (leverage ratio). We are certainly encouraged by the agencies willingness to consider these fundamental changes to the regulatory capital regime and suggest that all regional and community bankers share their views during the 60-day comment period.

[15] Notice of Proposed Rulemaking. Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation. September 27, 2017. Page 27.

Appendix – A

Selected Glossary of Key Terms (*)

ADC – acquisition, development or construction loan

Advanced Approaches Banks – Banks with consolidated assets of $250 billion or more or consolidated on-balance sheet foreign exposures of $10 billion or more.

Corresponding Deduction Approach - As defined in the Basel III capital rules, this is the methodology used for the deductions from regulatory capital for non-significant investments in the capital of unconsolidated financial institutions and non-common stock significant investments in the capital of unconsolidated financial institutions. Under the corresponding deduction approach, banking organizations must make deductions from the component of capital for which the underlying instrument would qualify if it was issued by the banking institution itself. If the banking organization does not have a sufficient amount of a specific component of capital to effect the required deduction, the shortfall must be deducted against the next highest form of capital.

CET1 - Common equity tier 1 capital as defined in the Basel III final capital rules.

Covered BHCs – Currently consists of 8 top tier U.S GSIB BHCs.

Covered Debt – Senior eligible external BHC debt issued by 8 top tier U.S. BHCs of GSIBs.

EGRPRA – Report submitted by the Federal Financial Institutions Examination Council in March 2017 pursuant to the Economic Growth and Regulatory Paperwork Reduction Act.

Eligible LTD - Debt that is (i) paid-in, (ii) not secured or guaranteed by the GSIB BHC or any other subsidiaries and not subject to any other arrangement that enhances the seniority of the debt, (iii) has a maturity greater than 1 year from date of issuance, (iv) governed by U.S. state or federal law, and (v) "plain vanilla" with no contractual right of acceleration for payment of principal or interest except in the event of insolvency or upon payment default, no credit-sensitive feature, not a structured note, and no conversion or exchange for equity of the GSIB BHC.

Eligible TLAC – Debt and equity issued to third parties that counts as tier 1/tier 2 capital as well as debt that is (i) paid-in, (ii) unsecured, (iii) perpetual or has a remaining maturity of at least 1 year, and non-redeemable by the holder within one year, (iv) must absorb losses prior to "excluded liabilities" in insolvency, without giving rise to compensation claims or legal challenge, (v) subordinated to excluded liabilities, (vi) may be ranked as senior to capital instruments, including tier 2 subordinated debt, and (vii) cannot be hedged or netted in a way that would reduce ability to absorb losses.

Excluded Liabilities – Excludes the following liabilities from external TLAC requirement: (i) insured deposits, sight deposits, and deposits with an original maturity of less than 1 year, (ii) liabilities arising from derivatives or debt instruments with derivative linked features such as structured notes, (iii) liabilities arising other than through a contract, (iv) liabilities which are preferred to normal senior unsecured creditors, and (v) liabilities that, under the laws governing the resolution entity, are excluded from bail-in or cannot be bailed in without external risk of a successful legal challenge compensation claim.

External Debt – Eligible LTD issued to third parties.

External TLAC – TLAC issued to third parties.

FDICIA – Federal Deposit Insurance Corporation Improvement Act of 1991.

GSIB - Global Systemically Important Bank as determined by the Financial Stability Board and updated yearly. The eight firms currently identified as U.S. GSIBs are Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup, Inc., Goldman Sachs Group, Inc., JP Morgan Chase & Co., Morgan Stanley, State Street Corporation, and Wells Fargo & Company. Source: http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf.

PMSAs - As defined in FIDICA, purchases mortgage servicing assets.

RWA – Risk weighted assets that comprise the denominator in the risk weighted assets ratio applicable to GSIB BHCs.

Step 1 Cap – the limit of no more than 10% of CET1 for investment in MSAs, temporary difference DTAs or unconsolidated financial institutions as defined in the October 11, 2013, Federal Register, Volume 78, No. 198, (pages 62055 to 62072), regulatory adjustments and deductions from common equity tier 1 capital included in the Basel III capital rules.

Step 2 Cap – The combined limit of 15% of CET1 for an investment in MSAs, temporary difference DTAS and unconsolidated financial institutions with investment in any one category not exceeding 10% of CET1. This cap was defined in the October 11, 2013, Federal Register, Volume 78, No. 198, (pages 62055 to 62072), regulatory adjustments and deductions from common equity tier 1 capital included in the Basel III capital rules.

TLAC – Total loss absorbing capacity rules and requirements applicable to 8 U.S. GSIBs and 22 foreign GSIBs.

Transitions NPR – On August 22, 2017, the agencies proposed the Transitions NPR applicable to non-advanced approaches national banks and federal savings associations (collectively, banks) that would maintain the capital rule's 2017 transition provisions for several regulatory capital deductions and certain other requirements that are subject to multi-year phase-in schedules (transitions notice of proposed rulemaking (NPR)) in the regulatory capital rules. Specifically, the agencies proposed to maintain the capital rule's 2017 transition provisions for the regulatory capital treatment of the following items: (i) mortgage servicing assets (MSAs), (ii) deferred tax assets (DTA) arising from temporary differences that could not be realized through net operating loss carrybacks (temporary difference DTA), (iii) investments in the capital of unconsolidated financial institutions (both significant and non-significant investments), and (iv) minority interest included in regulatory capital. This proposed rule would maintain the 2017 transition provisions for certain items for non-advanced approaches banks while the agencies work on the NPR to simplify certain aspects of the capital rules (simplifications NPR). The effective date of the final rule must be no later than December 31, 2017.

Simplified NPR – Simplified Notice of Proposed Rulemaking as more fully described in this report.

UFIs – Unconsolidated Financial Institution.

(*) This is intended to provide a brief summary of the key terms mentioned in this report. For a complete list of all key terms of the Board's Simplification NPR please refer to: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170927a1.pdf

Thomas W. Killian *is a Principal of Sandler O'Neill + Partners, L.P. His 38-year career in commercial and investment banking includes seven years of commercial banking experience with NationsBank, structuring and arranging leveraged finance transactions; two years with Salomon Brothers, transacting capital markets and advisory assignments for a variety of major corporations; five years with J.P. Morgan, managing financial advisory and capital raising activities for banks and thrifts in the Western region of the United States; and 24 years with Sandler O'Neill, advising banks, thrifts, and insurance companies on a variety of capital markets, strategic advisory and M&A assignments.*

At Sandler O'Neill, Mr. Killian has managed the successful execution of 13 M&A transactions representing over $2.4 billion in deal value and $8.7 billion of capital raising transactions. Most recently, he advised the FDIC on the successful least cost resolution of Doral Bank using a multiple acquirer strategy. He has co-managed the Sandler O'Neill team responsible for successfully completing 17 pooled trust preferred transactions that raised over $7 billion for approximately 650 financial institutions. Included in Mr. Killian's capital raising transactions are eight recapitalization and restructuring transactions that involved complex capital structures designed to preserve tax benefits for the issuing institutions. He functions as a primary resource in structuring and implementing complex capital markets transactions for financial institutions.

Mr. Killian holds a Bachelor of Science from the University of North Carolina at Chapel Hill, where he was a John Motley Morehead Merit Scholar, and a Masters in Business Administration from Northwestern University's J.L. Kellogg Graduate School of Management. He has represented Sandler O'Neill in conferences with the Federal Financial Institutions Examination Council, the Federal Reserve, the Federal Deposit Insurance Corporation, and SNL Financial to discuss capital structure, Dodd-Frank and Basel III related issues. His articles have appeared in Bank Accounting & Finance, U.S. Banker and Modern Bankers, a publication of the Peoples Bank of China.

Mr. Killian is also a founding board member of Students Bridging the Information Gap, a 501(c)(3) charity that provides computers, books and other support to African schools and orphanages.

General Information and Disclaimers