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LEGAL UPDATES AND NEWS

Federal Agencies Adopt Final Rule Implementing BASEL III and Dodd-Frank Act

The Federal Reserve Board ("FRB"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC") have adopted final rules (collectively, the "Final Rule"), originally proposed in June 2012, which implement principles of the BASEL III Accords and certain requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). The Final Rule issued by the FRB applies to bank and savings and loan holding companies and state banks that are members of the Federal Reserve System, while the Final Rule issued by the OCC and FDIC apply to national banks/federal savings associations and state non-member banks/states savings associations, respectively. This update summarizes important aspects of the Final Rule from the perspective of community banks and savings institutions.

Highlights of the Final Rule include: a new 4.5% minimum common equity tier 1 capital to total assets ratio; an increase of the minimum tier 1 capital to risk-weighted assets ratio from 4% to 6%; and an increase from a 100% to a 150% risk-weighting for loans 90 days past due and nonaccrual loans. The Final Rule also includes a 2.5% common equity tier 1 capital to risk-weighted assets "capital conservation buffer" over and above the minimum regulatory requirements, which must be met to avoid restrictions on capital distributions and executive compensation. These provisions of the Final Rule were adopted essentially as proposed.

The Final Rule implements the Dodd-Frank Act's requirement that the capital requirements applicable to holding companies must be as stringent as those applicable to the institutions themselves; as the capital standards in the Final Rule generally apply equally to both institutions and their holding companies. The Dodd-Frank Act, however, contained certain grandfather provisions and transition rules. For example, the Dodd-Frank Act grandfathered holding companies and mutual holding companies with less than $15 billion in assets with respect to continued inclusion as tier 1 capital holding company capital of certain instruments, such as trust preferred securities, issued prior to May 19, 2010. The proposed rule disregarded the grandfathering requirements of the Dodd-Frank Act, and instead proposed a phase-out of such instruments over a ten-year period. Based on comments received, however, the Final Rule was revised to maintain the statutory grandfather.

The agencies decided not to adopt the proposed rule's scheme for risk-weighting residential mortgages between 35% to 200% based upon loan to value ratios and other factors. Instead, the Final Rule incorporates the existing 50% risk-weighting for most first-lien exposures and 100% for certain other residential mortgages. The Final Rule did retain the proposed rule's 150% risk-rating for certain "high volatility" commercial real estate exposures, compared to the

normal 100% risk-weight. The proposed requirement that the value of unrecognized gains and losses from "available for sale" securities must be recognized in regulatory capital was also generally retained. However, the Final Rule provides for a one-time opportunity to opt out of this requirement in the first regulatory reporting period after the effectiveness of the Final Rule.

The Dodd-Frank Act required the FRB to apply consolidated regulatory capital requirements to savings and loan holding companies ("SLHCs") which, unlike bank holding companies, have not been subject to such requirements. The Final Rule implements this requirement (except as to SLHCs primarily involved in insurance underwriting or commercial activities, which will be the subject of further study). The Dodd-Frank Act explicitly recognized the FRB's long standing exemption from its capital requirements of bank holding companies with less than $500 million in assets. It did not, however, specifically incorporate a similar exemption for SLHCs and the Final Rule contains no such exemption. Therefore, the consolidated capital requirements will apply to SLHCs with less than $500 million of assets, as well as larger SLHCs and, as a result, small SLHCs will be at a competitive disadvantage compared to similarly-sized bank holding companies.

Most of the key provisions of the Final Rule will not take effect until January 1, 2015 and other provisions will be phased in after that date. Generally, except for very large companies and institutions subject to the "advanced approaches procedures," the Final Rule makes the new regulatory capital requirements applicable on January 1, 2015. At that time, most bank holding companies of greater than $500 million in assets and FDIC-insured depository institutions will need to comply with the new capital requirements. SLHCs will also become subject to regulatory capital requirements for the first time on that date. The capital conservation buffer requirement will be phased in from January 1, 2016 through January 1, 2019, when it will be the full 2.5% common equity tier 1 capital to risk-weighted assets.

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Luse Gorman is one of the leading firms nationally in advising financial institutions on capital-raising, mergers and acquisitions, corporate and securities, regulatory and executive compensation/employee benefits matters. Please contact any of the attorneys listed below if you would like to discuss any information contained in this newsletter.

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