Basel III's Framework for More Resilient Banks:

Challenges and Considerations for Banks in Implementing Basel-Related Regulations and Other Regulations Impacting CRE

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Disclaimer Statement

These discussion materials do not, and are not intended to, provide an official review or interpretation of the Basel III framework, or the U.S. banking agencies' implementation of the framework and related laws and regulations.

The excerpts and commentary presented are for discussion only and are not intended to reflect the official view or opinions of the presenter, or any individual or organization related to the presenter or the presentation sponsor.

What is Basel III (and Basel I and II)?

Basel III is the third in a series of banking standards and agreements among central bankers from around the world, who met in sessions held in **Basel**, Switzerland.

The series of standards, known as the Basel Accords, includes the 1988 Basel Accord (now referred to as Basel I), the subsequent Basel II accord from 2004, and the more recent Basel III framework from 2010-2011.

Basel I Overview

In 1988, the Basel Committee on Banking Supervision or BCBS published capital requirements for banks worldwide known as the"1988 Basel Accord", or Basel I. Basel I established standards for aligning the credit risk-weighting of assets, including the following examples:

- 0% - Cash, FED balances, Treasuries, GNMAs
- 20% - Agency fixed income and mortgage-backed securities, and balances between FDIC-insured banks
- 50% - First-lien residential mortgage loans; municipal revenue bonds
- 100% - Commercial loans not collateralized by bank deposits, <u>including commercial real estate loans</u>; commercial debt securities.

Basel II Overview

Basel II, which dates to June 2004, was intended to create an international standard for banking regulators to control how much capital banks should have as a buffer against the various types of risks that banks, and the overall economy and financial payments system, would face should a major financial institution or a series of banks collapse. Basel II was focused on the risks a bank exposes itself to through its lending and investment practices. **It was difficult to implement Basel II in the economic environment prior to the 2007-2008 financial crisis, which catalyzed the effort towards the more comprehensive Basel III standards.**

Basel III Overview

Basel III was originally agreed upon back in 2010-2011 by the Base Committee on banking Supervision (BCBS).

In addition to the United States FED and representation on behalf of the other U.S. federal banking agencies, BCSB members include central bankers from the European Union, United Kingdom, China, Russia, Canada, Australia, India, and several other countries.

Basel III Overview

Why the need for Basel III? Answers come from brief excerpts of the actual Basel III Framework document:

As witnessed during the financial crisis, losses incurred in the banking sector during a downturn preceded by a period of excess credit growth can be extremely large. Such losses can destabilize the banking sector, which can bring about or exacerbate a downturn in the real economy. *

The crisis demonstrated that credit losses and writedowns come out of retained earnings, which is part of banks' tangible common equity base. *

* Source: ***Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems,*** Published by the **© Bank for International Settlements** 2010. All rights reserved. Brief excerpts may be reproduced or translated provided the source is stated. http://www.bis.org/publ/bcbs189.pdf

Basel III Overview

What issues and perspective does Basel III intend to address?
Again, answers come from brief excerpts of the actual Basel III Framework document:

A strong and resilient banking system is the foundation for sustainable economic growth, as banks are at the center of the credit intermediation process between savers and investors. *

The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy. *

The reforms raise both the quality and quantity of the regulatory capital base *and enhance the risk coverage of the capital framework.* *

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Basel III Overview

What are the key Basel III capital quality/quantity reforms?

A capital conservation buffer of 2.5%, comprised of Common Equity Tier 1, is established above the regulatory minimum capital requirement. *Capital distribution constraints will be imposed on a bank when capital levels fall within this range. Banks will be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses. The constraints imposed only relate to distributions, not the operation of the bank.* *

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Basel III Overview

How did U.S. Banking Regulatory Agencies implement the Basel III recommendations?

*Community banking organizations become subject to the new rule on January 1, 2015. ***

*The new rule implements higher minimum capital requirements, includes a new common equity Tier I capital requirement, and establishes criteria that instruments must meet in order to be considered common equity Tier I capital, additional Tier I capital, or Tier 2 capital. ***

** Source: Excerpts from the document ***New Capital Rule, Community Bank Guide, July 2013*** jointly released by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency.
http://www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf

Basel III Overview

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*Under the new rule, in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common Tier I equity capital above its minimum risk-based capital requirements. This buffer will help to ensure the banking organizations conserve capital when it is most needed, allowing them to better weather periods of economic stress. ***

** Source: Excerpts from the document ***New Capital Rule, Community Bank Guide, July 2013*** jointly released by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency.
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Basel III Overview

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Banking organizations must hold a 2.5 percent capital conservation buffer, which is to be phased in over a four year period beginning January 1, 2016, with the full 2.5 percent required as of January 1, 2019.

As fully phased in, a banking organization with a buffer greater than 2.5% would not be subject to limits on dividend payments or discretionary bonus payments; however, a banking organization with a buffer less than 2.5% would be subject to increasingly stringent limitations as the buffer approaches zero. The new rule also prohibits a banking organization from paying dividends or discretionary bonuses if its eligible net income is negative in that quarter and its capital conservation buffer ratio was less than 2.5% as of the beginning of that quarter.

The transition schedule for new ratios, including the capital conservation buffer, is shown on the following slide.

Basel III Overview

How did U.S. Banking Regulatory Agencies implement the Basel III recommendations?

	As of January 1:				
	2015	2016	2017	2018	2019
Minimum common equity Tier 1 capital ratio	4.5%	4.5%	4.5%	4.5%	4.5%
Common equity Tier 1 capital conservation buffer	N/A	0.625%	1.25%	1.875%	2.5%
Minimum common equity Tier 1 capital ratio plus capital conservation buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of most deductions from common equity Tier 1 capital	40%	60%	80%	100%	100%
Minimum Tier 1 capital ratio	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Tier 1 capital ratio plus capital conservation buffer	N/A	6.625%	7.25%	7.875%	8.5%
Minimum total capital ratio	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital ratio plus capital conservation buffer	N/A	8.625%	9.25%	9.875%	10.5%

** Source: Excerpts from the document ***New Capital Rule, Community Bank Guide, July 2013*** jointly released by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency.
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Basel III Overview

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Capital Conservation Buffer (as a % of risk-weighted assets)	Maximum Payout (as a % of eligible net income)
Greater than 2.5%	No payout limitation applies
≤2.5% and >1.875%	60%
≤1.875% and >1.25%	40%
≤1.25% and >0.625%	20%
≤0.625%	0%

** Source: Excerpts from the document ***New Capital Rule, Community Bank Guide, July 2013*** jointly released by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency.
http://www.federalreserve.gov/bankinforeg/basel/files/capital_rule_community_bank_guide_20130709.pdf

Basel III Impact

How will Basel III impact a Bank's ability and willingness to make commercial real estate loans?

For banking organizations that are well-capitalized and hold a 2.5 percent or better capital conservation buffer, the impact of Basel III will not be significant, and would not specifically drive a Bank to change its operating profile, including its ability to do commercial real estate lending.

For banking organizations that are not as well-capitalized and hold less than the 2.5 percent or better capital conservation buffer, the impact of Basel III could change the Bank's lending and investing activities, driving more growth towards lower-risk-weighted residential mortgage loans, U.S. Agency investments, or municipal securities.

However, Basel III does not change other significant regulatory restrictions on commercial real estate lending that banks have already been dealing with.

Other Regulatory Restrictions on Commercial Real Estate Lending

Supervisory Review of CRE Concentrations and Risk Management ***

While guidance does not establish specific CRE lending limits, OCC Bulletin 2006-46, ***Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices: Interagency Guidance on CRE Concentration Risk Management***, describes criteria that, when approached or exceeded, may prompt further supervisory analysis of the level, nature, and management of a bank's CRE concentration risk:

(1) Total reported loans for construction, land development, and other land represent 100 percent or more of the bank's total capital; or

(2) Total non-owner-occupied CRE loans represent 300 percent or more of the bank's total capital, and the outstanding balance of the bank's CRE loan portfolio has increased by 50 percent.

The effectiveness of a bank's risk management practices is a key component of the supervisory evaluation of a bank's CRE concentrations. Banks that have experienced recent, significant growth in CRE lending will receive closer supervisory review.

*** Source: ***Commercial Real Estate Lending, August 2013***, Comptrollers Handbook A-CRE, Office of the Comptroller of the Currency

Questions/Comments

THANK YOU!