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Basel III: Implications for Bank Holding Companies

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In July 2013, the federal banking agencies approved revised regulatory capital rules to help ensure that banking organizations of all sizes and risk profiles maintain strong levels of high-quality capital. In addition to applying to banks and savings associations, the rules apply to bank holding companies that are not subject to the Federal Reserve's Small BHC policy statement (generally, bank holding companies with more than $500 million in consolidated assets, i.e., those that are required to file quarterly consolidated financial statements). This article focuses on changes from existing capital rules that could be of particular relevance to bank holding companies covered by the new rules. Minneapolis Federal Reserve Bank staff want to work with institutions to ensure full compliance with the new rules. We encourage companies with questions about how to new rules may affect them to contact us well in advance of the January 1, 2015, effective date.

New Ratio: The revised capital rule provides for a new minimum capital ratio — common equity
tier 1 capital to total risk weighted assets of 4.5 percent. Subpart C, section_.20(b) of the revised rule defines common equity tier 1 capital which is primarily comprised of common stock and retained earnings minus applicable regulatory capital deductions (e.g., goodwill and other intangible assets except mortgage servicing rights). Under the new rules common stock instruments must meet 13 criteria to qualify as common equity tier 1 capital. Holding companies whose capital structures include multiple classes of stock or that are comprised of "non-traditional" elements should review the instruments to ensure they satisfy these criteria. The rule also reaffirms the long standing Federal Reserve System position that voting common equity should be the dominant element within common equity tier 1 capital.

Tier 1 Capital Definition: The revised capital rule also raises the minimum tier 1 capital to risk based capital ratio from 6.0 percent to 8.0 percent. Tier 1 capital includes common equity tier 1 capital, noncumulative perpetual preferred stock, and grandfathered nonqualifying instruments. (Securities issued to the U.S. Treasury under the Troubled Asset Relief Program and the Small Business Lending Fund are included in tier 1 capital.) Subpart C, section_.20(c) defines additional tier 1 capital elements which must meet 15 criteria described in the revised rule to qualify. Holding companies planning to issue noncumulative perpetual preferred stock should ensure that the terms of the new instrument meet these criteria.

Unless grandfathered as described below, cumulative preferred stock will no longer count as tier 1 capital. For holding companies with less than $15 billion in total consolidated assets as of December 31, 2009, grandfathered instruments include capital instruments that were issued by these institutions prior to May 19, 2010, and that are currently included in tier 1 capital, such as trust preferred securities (TruPS) and cumulative perpetual preferred stock, subject to limits. One question that is not explicitly addressed in the rule concerns the status of TruPS issued by a holding company that is acquired by another bank holding company. If the TruPS were issued before May 19, 2010 and the buyer has less than $15 billion in assets after the acquisition, the TruPS will continue to be counted as tier 1 capital.

Tier 2 Capital Elements: As under the existing rules, the principal elements of tier 2 capital under the revised rule include cumulative perpetual preferred stock, subordinated debt and the allowance for loan and lease losses (subject to limits). However, there are changes in the criteria for these instruments to qualify for inclusion in capital. Unlike, the grandfathered elements of tier 1 capital, existing tier 2 capital instruments must meet the requirements of the revised rule once the new rule becomes effective. Federal Reserve staff believes that most existing subordinated debt qualifying for tier 2 status under the current rule will also meet the requirements of the new rule. However, there are some differences between the current and new rules worth noting. For instance, the instrument must have a minimum original maturity of at least five years rather than a minimum average maturity of five years. Additionally, a holding company's ability to redeem subordinated debt prior to maturity is more restricted. Subpart C, section_.20 (d) defines tier 2 capital elements which must meet 10 criteria described in the revised rule to qualify as tier 2 capital. Companies with outstanding subordinated debt instruments should review the terms closely to ensure they comply with the new rules.

Fed Notes is provided through a partnership the Bank Holding Company Association shares with the Federal Reserve Bank of Minneapolis.