RECENT BANKING RELIEF: SIMPLIFICATIONS TO THE CAPITAL RULE AND UPDATES TO THE VOLCKER RULE

BY GINA OMOLON & ALEIDY DIAZ-WELLS

Simplifications to the Capital Rule

A final rule in the Federal Register has simplified certain aspects of the capital rule. Back in 2013, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System, and the FDIC (or the "agencies") adopted a rule which increased required regulatory capital, primarily to absorb losses in terms of market and economic stress. The recent simplifications apply solely to banking organizations that have less $250 billion in total consolidated assets or less than $10 billion in total consolidated foreign financial exposure. This rule simplifies the current regulatory treatment and is explained in OCC Bulletin 2019-34 (excerpted below).

With regard to the treatment of [mortgage servicing assets] ("MSAs"), [temporary difference deferred tax assets] ("DTAs"), and holdings of regulatory capital instruments issued by other financial institutions:

- For non-advanced approach banks, the rule replaces the existing individual 10 percent and cumulative 15 percent common equity tier 1 capital deduction thresholds for MSAs and temporary difference DTAs that cannot be realized through net operating loss carrybacks with individual thresholds of 25 percent of common equity tier 1. Non-advanced approaches banks will be required to deduct from common equity tier 1 capital any amount of these assets that individually exceeds the 25 percent threshold.
- To reduce complexity for non-advanced approaches banks, the final rule replaces the current capital rule's different deduction treatments for (i) significant investments in the regulatory capital of other financial institutions in the form of common stock, (ii) significant investments in the regulatory capital of other financial institutions that are not in the form of common stock, and (iii) non-significant investments in the regulatory capital of other financial institutions with one treatment for all investments in the regulatory capital of other financial institutions. Non-advanced approaches banks will be required to deduct from common equity tier 1 capital any amount of its total investments in the regulatory capital of other financial institutions that exceeds 25 percent of common equity tier 1 capital.

With regard to the inclusion of minority interest in regulatory capital:

- For non-advanced approaches banks, the agencies have simplified the calculation for limiting minority interest in regulatory capital. Specifically, the final rule limits the inclusion of minority interest in regulatory capital as follows: of common equity tier 1 minority interest up to 10 percent of the bank's common equity tier 1 capital; tier 1 minority interest up to 10 percent of the bank's tier 1 capital; and total capital minority interest up to 10 percent of the bank's total capital.

Updates to the Volcker Rule

The U.S. regulators also recently adopted a final rule that modified the Volcker Rule, a federal regulation referring to section 619 of the Dodd-Frank Wall Street Reform Act of 2010, which became effective in 2015.

This rule prohibits banks from conducting certain investment activities and limits their dealings with hedge funds and private equity funds. It prevents banks from taking advantage of customer opportunities or using customer accounts for their own benefit and eliminates material conflicts of interest.

The final rule adopted on July 9, 2019, allows small, government-insured banks to make investments for their own profit, essentially making Volcker non-existent for small community banks. This exemption applies to community banks with (i) equal to or less than $10 billion in total consolidated assets and (ii) total trading assets and liabilities equal to or less than 5% of the consolidated assets. Both conditions must be met to fall under the exemption. The final rule also permits a hedge fund or private equity fund, under certain circumstances, to share the same name or a variation of the same name with an investment adviser if the adviser is not an insured depository institution, a company that controls an insured depository institution, or a bank holding company.

The federal banking agencies in July 2017 granted opt-in relief for qualifying foreign excluded funds, related to activity that occurs solely outside the United States (or "SOTUS"). Under the relief, the agencies would not take action against either a non-U.S. banking entity or a foreign excluded fund that is an affiliate of the non-U.S. banking entity based on the activities of that foreign fund. The fund may engage in trading and other activities that do not comply with the Volcker Rule's prohibitions.

To qualify for this relief, the fund must meet the requirements to be a "qualifying foreign excluded fund," and the non-U.S. banking entity's investment in, or sponsorship of, the foreign excluded fund must meet the requirements of the "solely outside the United States" exemption. On July 17, 2019, the federal banking agencies announced that they would extend "no-action" relief with respect to certain foreign excluded funds until July 21, 2021

Gina is a Senior Manager in our New York Practice. She can be reached at 212.375.6867 or at Gina.Omolon@MazarsUSA.com

Aleidy is a Senior Manager in our New York Practice. She can be reached at 644.225.5935 or at Aleidy.Diaz-Wells@MazarsUSA.com