AMERICA'S MUTUAL BANKS
7018 th Street NW Suite 700. Washington, D.C. 20001

FEDERAL RESERVE ISSUES FINAL RULE ON BASEL III CAPITAL REQUIREMENTS

Today the Board of Governors of the Federal Reserve System adopted a final rule regarding the Basel III capital requirements. The Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation are expected to take similar action early next week. Set forth below at the end of this alert is a brief description of the aspects of the final rule (all 972 pages) most relevant to mutuals and community banks and how they differ from the proposal.

While leaving many of the provisions unchanged from the proposal issued a year ago, the FRB made several modifications to the proposed rule which are important to AMB's members, mutual banks and community banks in general. As a result of its extensive comment letter, meetings with FRB Governor Duke and staff members and its legislative efforts, AMB has had a substantive role in reshaping some of the more consequential sections of the proposed rule, including the risk weighting of residential mortgages, the application of unrealized gains and losses on available-for-sale securities in accumulated other comprehensive income and the phase out of trust preferred securities for mutual holding companies. We are pleased with these important revisions, but much work still needs to be done. The final rule stated plainly that the FRB does not have the authority under Dodd-Frank to extend the exemption for bank holding companies subject to the FRB's small bank holding company policy statement to savings and loan holding companies of a similar size (and, therefore, with limited exceptions, all SLHC's are subject to the capital standards of the final rule). The final rule does not adopt the use of mutual investment certificates as a form of capital for mutual banks which was extensively discussed in AMB's comment letter and which the staff noted in its commentary. This comes as no surprise and was expected. However, the final rule specifically states that mutual banks may establish capital instruments provided the instrument meets certain criteria; at least the FRB recognizes that the need exists and mutual banks may yet propose acceptable capital instruments. Both the application of the small bank holding company policy statement and the concept of mutual investment certificates will be won or lost in the halls of congress. That is why it is especially important for AMB, its members and all mutual form banks to express their support for H.R. 1603, the Community Mutual Bank Competitive Equality Act (or the Grimm/Meeks Bill).

Set forth below is a brief summary of the more relevant sections of the final rule as excerpted from the staff memo to the FRB.

1. The final rule would apply to banking organizations of all sizes and types regulated by the Board and the OCC, except for bank holding companies that are subject to the Board's Small Bank Holding Company Policy Statement and SLHCs substantially engaged in insurance underwriting or commercial activities. These SLHC's are temporarily exempt pending further staff review.

2. Under the final rule, consistent with the proposals, all banking organizations would be subject to the following minimum regulatory capital requirements: a common equity tier 1 capital ratio of 4.5 percent (newly introduced requirement), a tier 1 capital ratio of 6 percent (increased from the current requirement of 4 percent), a total capital ratio of 8 percent of risk-weighted assets (unchanged from the current requirement), and a leverage ratio of 4 percent. Tier 1 capital will be equal to the sum of common equity tier 1 capital and additional tier 1 capital. Total capital will be the sum of common equity tier 1, additional tier 1, and tier 2 capital.

3. In order to avoid restrictions on capital distributions and discretionary bonus payments to executive officers, the draft final rule would require a banking organization to hold a buffer of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5 percent of its total risk-weighted assets (capital conservation buffer).

4. The final rule does not require a phase out of non-qualifying tier 1 capital instruments, including trust preferred, issued prior to May 19, 2010, for banking organizations with less than $15 billion in assets as of December 31, 2009, or that were organized in mutual form as of May 19, 2010.

5. Certain deferred tax assets, mortgage servicing assets, and "significant" investments in the capital instruments of unconsolidated financial institutions are subject to deduction if they surpass an individual limit of 10 percent of common equity tier 1 capital or an aggregate limit of 15 percent.

6. The final rule provides banks, other than the largest banks, a one-time election to opt-out of the requirement to include most AOCI components in the calculation of common equity tier 1 capital and, in effect, retain the AOCI treatment under the current capital rules.

7. Beginning on January 1, 2015, all banking organizations would be required to calculate risk-weighted assets under the newly adopted standardized approach. Under the final rule, exposures to the U.S. government generally would receive a zero percent risk weight and exposures to U.S. public-sector entities (PSEs), U.S. government-sponsored entities (GSEs), and U.S. depository institutions generally receive a 20 percent risk weight,

unchanged from the general risk-based capital rules. The final rule does not include the risk weights as proposed for residential mortgages and instead incorporates the risk weights for residential mortgages under the general risk-based capital rules, with a risk weight of either 50% (for most first-liens) or 100% for other residential mortgages. The final rule assigns a 150% risk weight to high-volatility commercial real estate loans, but the definition of acquisition, development and construction loans has been revised to exclude loans to facilitate certain community development projects as well as loans secured by agricultural land. The final rule generally increases to 150% the risk weight for loans that are more than 90 days past due or on nonaccrual.

With the issuance of the final rules, AMB must now focus its attention on legislative efforts while continuing the meaningful dialogue it has established and fostered with the senior staff of each of the agencies in an effort to assure that mutual form banks are permitted to continue their mission of serving their communities.