



ACCOUNTING AND AUDITING UPDATE

NJBankers CFO Conference

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Barry is a partner in our financial services practice with more than 19 years of experience.

Specifically, his responsibilities include financial statement review, consultation on complex accounting and reporting matters, including mergers and acquisitions, capital market transactions and SEC reporting requirements.

Barry has developed programs that advised clients on improving overall operating efficiency and reporting practices with regard to Section 404 of the Sarbanes-Oxley Act, Internal Controls Over Financial Reporting and Basel III.

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Agenda

- ▶ Credit Losses
- ▶ Leasing Update
- ▶ Basel III



Credit Losses



Accounting for Credit Losses

Issues with current GAAP:

- ▶ Complex (e.g., multiple impairment models)
- ▶ “Too little, too late” (e.g., probability threshold)

Recent history of the project:

- ▶ Separate Exposure Documents: IASB Nov 2009; FASB May 2010
- ▶ Joint deliberations begin late 2010
- ▶ Joint deliberations developed a “three-bucket” approach
- ▶ In mid-2012, FASB decided to explore an alternative model; IASB proceeds with modified three-bucket approach
- ▶ Resulted in two separate Exposure Documents:
- ▶ FASB Current Expected Loss Estimate (“CECL”) **ASU 825-15 ED** issued Dec 2012 (comments were due July 5, 2013); Q&A supplement issued March 2013
- ▶ FASB met on July 23, 2013, no formal decisions have been reached through the current date



A bit of “history” - the “three-bucket” approach

On January 31, 2011, the FASB published for public comment a joint proposal with the IASB for accounting for impairment of financial assets, “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Impairment,” which included loans evaluated on an open pool basis (commonly referred to as the “FAS 5 pool”).

The more forward-looking approach to how credit impairment is recognized was thought to be more closely aligned with the economics of credit decision making.

Both the original proposal and the supplementary document received mixed reviews, so the boards decided to explore alternative models.

Board thinking for impairment was to follow a “three-bucket” approach in which an allowance balance is established capturing three different phases of deterioration in credit quality.



A bit of “history” - the “three-bucket” approach

Generally, the “three-bucket” approach was described as follows:

- ▶ **Bucket 1.** In the context of portfolios, financial assets evaluated collectively for impairment that do not meet the criteria for Bucket 2 or 3 (this would include loans that have suffered changes in credit loss expectations as a result of macroeconomic events that are not specific to either a group of loans or a specific loan);
- ▶ **Bucket 2.** Debt instruments affected by the occurrence of events that indicate a direct relationship to possible future defaults, however the specific debt instruments in danger of default have not yet been identified; and
- ▶ **Bucket 3.** Debt instruments for which information is available that specifically identifies that credit losses are expected to, or have, occurred on individual debt instruments.

We will **NOT** focus heavily on the recently issued IASB model



ASU 825-15 Credit Losses: FASB “CECL” Model - Current Expected Credit Loss

- ▶ Carries forward several key concepts jointly deliberated with the IASB
- ▶ Replaces the multiple existing impairment models in current U.S. GAAP
- ▶ Simplifies the accounting for purchased credit impaired financial assets
- ▶ Uses a single measurement objective for measuring expected credit loss



ASU 825-15 Credit Losses: FASB “CECL” Model - Current Expected Credit Loss

- ▶ The CECL would apply to the following financial assets (measured at AC or FV-OCI, but not those measured at FV-NI):
 - All debt instruments (e.g. debt securities and loans)
 - Receivables that result from revenue transactions
 - Reinsurance receivables
 - Lease receivables recognized by a lessor
 - Loan commitments
- ▶ The CECL would **NOT** apply to equity instruments

Matters for discussion

- ▶ Why is this change needed?
- ▶ What is changing?
 - Comparison to current guidance
 - Key elements of new exposure draft
- ▶ Where will the changes be disclosed?
- ▶ When will changes be effective?





Why is the Change Needed?

Global financial crisis raised concerns surrounding perceived flaws in the current impairment model:

- ▶ Accounting principles related to loan loss provisioning should be improved to permit consideration of a “broader range of credit information.”
- ▶ The financial crisis exposed weaknesses in financial reporting that included “delayed recognition of losses associated with loans...”, and recommendations were made to explore an approach using more forward-looking information.
- ▶ New standards should “reflect the need for earlier recognition of loan losses to ensure robust provisions.” (Basel Committee on Banking Supervision)



What is Changing?

Comparison to Current Guidance

INCURRED LOSS APPROACH

Current guidance

Various impairment models

CURRENT EXPECTED CREDIT LOSS "CECL" MODEL

Proposed new guidance

Recognition of the full expected credit loss

What is Changing?

Key Elements of CECL

Key elements of Current Expected Credit Loss “CECL” model

- ▶ Objective
- ▶ Scope
- ▶ Measurement
- ▶ Subsequent measurement
- ▶ Information set to consider
- ▶ Interest income
- ▶ Modifications





CECL - Objective

- ▶ The objective of recording an allowance for credit losses is to reflect the estimate of the amount of contractual cash flows not expected to be collected
- ▶ CECL provides guidance on how to recognize and measure expected credit losses
- ▶ CECL is intended to simplify current practice by eliminating today's multiple impairment models
 - Ex: Current GAAP Impairment models for debt instruments
 - ASC 310-30 Receivables - Loans and Securities Acquired with Deteriorated Credit Quality
 - ASC 310-40 Receivables - Troubled Debt Restructurings by Creditors
 - ASC 320-10-35 Investments - Debt and Equity Securities - Recognition of an OTTI
 - ASC 325-40 Investments - Beneficial Instruments in Securitized Financial Assets
 - ASC 450 Contingencies



Recognizing Expected Credit Losses

- ▶ Expected credit losses would reflect an estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit
- ▶ At each reporting date, an entity would recognize an allowance for expected credit losses (i.e., a contra asset)
- ▶ There would be no recognition threshold (e.g., probable)



Recognizing Expected Credit Losses

- ▶ A provision for credit losses would be recognized in earnings for the amount required to adjust the allowance in the current period
- ▶ Recording an impairment as an allowance would represent a change from current U.S. GAAP for debt securities which currently requires an adjustment to the amortized cost basis when there is an other-than-temporary impairment. The new, CECL, model will require financial statement preparers to create models, similar to those used today for corporate loans, in order to apply the new impairment guidance



CECL - Scope

Applies to financial assets that are subject to losses related to credit risk and are not measured at fair value with changes in fair value recognized in net income

- ▶ Rather, financial assets that are carried at amortized cost or fair value with changes in fair value recorded in comprehensive income



FV-OCI Practical Expedient

- ▶ Entities would not need to estimate expected credit losses for financial assets classified at FV-OCI if both of the following conditions are met:
 - $FV \geq AC$, and
 - Expected credit losses on the financial assets are insignificant
- ▶ Is a cost-benefit consideration for the FASB



FV > AC Criteria

- ▶ If today FV > AC for a FV-OCI instrument, it would be eligible for the practical expedient
- ▶ A future change in fair value such that FV now < AC might be due solely due to fluctuations in interest rates or liquidity, not credit
- ▶ The need to measure and recognize credit impairment is triggered, due in no part to credit considerations
- ▶ The expedient should be dependent only on fair value changes due to credit issues
- ▶ Two units of the same instrument, purchased at different times, may have different outcomes when considering if FV > AC because they were purchased at different prices, even though they have the same credit exposure



Implementation Issue

Insignificant credit loss criteria:

- ▶ How are financial statement preparers to interpret “insignificant”?

Applicability to FV-OCI only:

- ▶ Two units of the same instrument, classified differently (AC and FV-OCI) because of the business model under which they are held, may have different impairment measurements, even though they have the same credit exposure
- ▶ I.e., Securities of AAA/AA issuers that are AC classified are provided no expedient, even though the likelihood of loss is the same as the same security classified in FV-OCI





CECL - Scope

- ▶ Includes: loans, debt securities, trade receivables, lease receivables, reinsurance receivables, and loan commitments
- ▶ Financial guarantees
 - Accounted for as loan commitments or insurance contracts?
 - FASB has made tentative decision that proposed insurance contracts standard should apply to guarantees, versus the CECL



CECL - Measurement

- ▶ Requires recognizing allowance for all expected credit losses on debt instruments
 - Credit losses: “an estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit.”
- ▶ No threshold to meet prior to recognizing a credit loss
 - Sample thresholds used currently: probability of loss within next 12 months, or significant deterioration of in credit.
 - Loans: All loans have some risk of loss. CECL will require day one loss recognition for credit risk associated with newly originated loans.



CECL - Measurement

- ▶ Entities must consider a minimum of two possible outcomes:
 - Credit loss results
 - No credit loss results
- ▶ Entities are prohibited from estimating expected credit losses on basis of most likely outcome for an individual financial asset
- ▶ Because one possible outcome must be that credit losses result, there will be some amount of allowance for every financial asset
 - *See practical expedient on next slide



CECL - Measurement

- ▶ Practical expedient
 - For financial assets measured at fair value (“FV”)
 - Allows for no recognition of credit losses when both of the following are present:
 1. FV of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset; and
 2. Expected credit losses on individual financial asset are insignificant, which may be determined by considering the general expectation of the range of expected credit losses given the credit-quality indicator(s) for the asset as of the reporting date
 - Consistent with current practice, CECL model provides practical expedient when estimating credit losses on collateral-dependent financial assets
See next slide for new definition of collateral dependent financial assets
 - Allowance = FV of collateral vs. amortized cost basis



CECL - Measurement

- ▶ Collateral-dependent financial asset, definition change
 - **Current guidance:**
 - A loan (only applies to loans) for which repayment is expected to be provided solely by the underlying collateral
 - **Exposure draft:**
 - A financial asset for which repayment is expected to be provided primarily or substantially through the operation (by the lender) or sale of the collateral, based on an entity's assessment as of the reporting date

Reasonable and Supportable Forecasts

How far into the future can banks reasonably forecast?

How to 'justify' longer-term forecasts that deviate from the long-term mean?





Time Value of Money

- ▶ The ED implies that loss-rate and other approaches ‘implicitly’ consider TVM
- ▶ Calculating CECL using these, versus a true DCF approach, could yield significantly different impairment amounts
 - Because loss-rates do not consider timing of losses
- ▶ Better to characterize loss-rates et al as ‘acceptable alternatives’ than ‘equivalent’ to DCF



Contractual Term

- ▶ The ED calls for the use of an instrument's contractual life
- ▶ Why use this if weighted average expected life is shorter?
- ▶ No cash flows are expected after the instrument's expected (versus contractual) settlement



Purchased Credit Impaired Financial Assets

- ▶ May assess whether individual financial assets/groups of financial assets meet the definition of PCI- different from current U.S. GAAP
- ▶ Expected credit losses at acquisition date are recognized as an allowance through a gross up to the balance sheet and would not be recognized in interest income
- ▶ Subsequent increases or decreases in expected credit losses would be recognized immediately in earnings as a provision for credit losses
- ▶ Measurement of credit impairment would follow same approach as originated assets



Purchased Credit Impaired Financial Assets

Scope of PCI Accounting:

- ▶ ED definition: “Acquired individual financial assets that have experienced a significant deterioration in credit quality since origination, based on the assessment of the acquirer”
- ▶ SOP 03-3 scope did not require the impairment to be ‘significant’

Purchased assets with credit impairment that is not significant:

- ▶ If the credit impairment inherent in a purchased financial asset is not ‘significant’ per the definition: that impairment would not be recorded as LLR at acquisition, but will be recognized in the provision for loan losses at the next reporting date



Purchased Credit Impaired Financial Assets

Interest income:

- ▶ Not clear how interest income would be recognized

Securities:

- ▶ How is the PCI guidance to be applied to securities which, by definition, are purchased?

Initial adoption:

- ▶ How should financial statement preparers apply the transition method (cumulative-effect adjustment) to existing SOP 03-3 loans?
- ▶ Keep existing pools, or update?



CECL - Interest Income

PCI asset example:

- ▶ Assume an entity purchases an asset with a par value of \$100 for \$85. At the acquisition date, the entity estimates it will not collect \$10 of the contractual cash flows. The \$85 cost basis of the asset will be “grossed up” to \$95 to reflect the \$10 embedded allowance. The remaining \$5 of purchase discount attributed to factors other than credit is accreted in interest income over the remaining life of the asset.



CECL - Subsequent Measurement

- ▶ Provision: no change from current guidance
- ▶ Write-offs: significant change
 - Required to write off a financial asset (or portion thereof) in the period in which a determination is made that the entity has no reasonable expectation of future recovery



CECL - Subsequent Measurement

Write offs: Securities

- ▶ Current guidance
 - Able to write down cost basis to reflect OTTI
- ▶ CECL
 - Record allowance for credit losses, which could decrease in future

Write offs: Loans

- ▶ Current practice
 - Varies (i.e. write off loans > 180 days delinquent)
- ▶ CECL
 - Write off when there is no reasonable expectation of recovery (*room for interpretation*)

CECL - Interest Income

- ▶ Non-accrual status
 - Per CECL, an entity should cease accrual of interest income when:
 1. It is not probable that it will receive substantially all of the principal
 2. It is not probable that it will receive substantially all of the interest





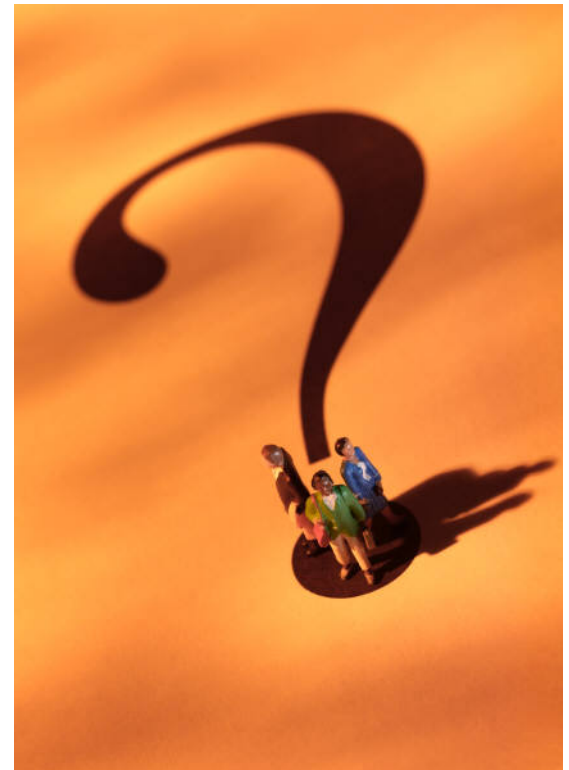
CECL - Interest Income

- ▶ **Non-accrual situation #1:** it is not probable that entity will receive substantially all of the principal
 - Recognize all future cash receipts as reduction in carrying amount of asset
 - When carrying value reduced to \$0, additional payments are recoveries of amounts previously written off (adjustment to allowance)
 - An excess is interest income

- ▶ **Non-accrual situation #2:** it is not probable that entity will receive substantially all of the interest, but will receive all principal
 - Recognize all future cash receipts as interest income
 - When receipts exceed interest income, apply to carrying amount of asset

Non-accrual

- ▶ How should financial statement preparers apply the non-accrual concept to FV-OCI securities?
- ▶ How does the nonaccrual principal match up with the concept that the allowance for credit losses represent the current estimate of contractual cash flows not expected to be collected on financial assets held at the reporting date?





CECL - Information Set to Consider

- ▶ CECL requires estimates of expected credit losses based on internally and externally available information
 - Past events
 - Current conditions
 - Reasonable and supportable forecasts
 - Qualitative and quantitative factors specific to borrowers and the economy

- ▶ CECL does not mandate specific approaches or policy elections to determine expected credit losses
 - Various methodologies permitted
 - vs. current practice where discounted cash flow mandated in certain situations
 - Required to consider time value of money, either:
 - Implicitly - historical loss ratios & probability of default
 - Explicitly - discounted cash flow



CECL - Information Set to Consider

- ▶ CECL allows for consideration of credit enhancements that mitigate expected credit losses
 - Credit enhancements cannot be separate freestanding instruments
 - Example: purchased credit default swap



CECL - Interest Income

- ▶ Exposure draft addresses interest income for two areas only:
 1. Interest income recognition on purchased credit-impaired (“PCI”) financial assets
 2. When to cease the accrual of interest income on financial assets

- ▶ Purchased Credit Impaired (“PCI”) financial assets
 - PCI assets: “acquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination, based on the assessment of the acquirer.”



CECL - Interest Income

Current practice

- ▶ PCI assets are impaired if...
 - there is evidence of credit deterioration since origination
 - it's probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable
- ▶ PCI assets discount embedded in purchase price
 - Discount recognized as interest income

CECL

- ▶ PCI assets are impaired if...
 - there is evidence of credit deterioration since origination
 - *(second criteria eliminated)*
- ▶ PCI assets discount embedded in purchase price
 - Record allowance equal to the portion of discount that is attributable to expected credit losses, at the date of the acquisition
 - Remaining portion of discount accreted in interest income over life of asset



CECL - Modifications

- ▶ No change for modifications that are not TDRs
- ▶ TDRs
 - No change in definition from GAAP
 - Adjustment to cost basis required (w/ corresponding adjustment to expected credit losses) so that effective interest rate on modified asset continues to be the original effective interest rate, given the new series of cash flows



Where will the changes be disclosed?

- ▶ Various new disclosures (see full ASU for examples)
- ▶ Intended to enable users of financial statements to understand:
 - Credit risk inherent in portfolio and how management monitors the credit quality of the portfolio
 - Management's estimate of expected credit losses
 - Changes in the estimate of expected credit losses that have taken place during the period



When will the changes be effective?

- ▶ No effective date determined
 - Unlikely to have effective date earlier than 2015
- ▶ Comment period ended July 5, 2013
- ▶ FASB will consider multiple potential effective dates (public vs. non-public, regulated vs. non-regulated, etc.)
- ▶ Early adoption will not be permitted
- ▶ Entities will apply the guidance by recording a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective
 - Calendar YE example: if effective date is 1/1/15, cumulative effect adjustment will be recorded as of 1/1/15, with first reporting period that guidance will be effective is quarter ending 3/31/15

Leasing Update



Discussion Outline

Proposed ASU: Leases (Topic 842)

- ▶ Summary and Scope
- ▶ Lease Identification and Classification
- ▶ Lessee Accounting
- ▶ Lessor Accounting
- ▶ Other Provisions
- ▶ Disclosures
- ▶ Appendix: Changes from the 2010 Exposure Draft



Lease Exposure Draft Summary (TOPIC 842)

- ▶ Re-released on 5/13/2013; comments were due 9/13/2013. Board plans to consider all feedback during 4th quarter 2013
- ▶ Dual approach to recognition, measurement & presentation for both lessees and lessors
- ▶ Based on whether lessee is expected to consume more than an insignificant portion of economic benefits embedded in underlying asset
- ▶ For most property leases, lessee would report a single, straight-line lease expense for its use of underlying asset
- ▶ For most other leases (e.g., equipment or vehicles), lessee would report asset amortization separately from interest on the lease liability
 - Results in “front-loading” expense recognition in early years of the lease



Scope, Transition and Effective Date

- ▶ Applies to all leases, except leases of intangible assets, leases for exploration or use of certain natural resources and leases of biological assets
- ▶ Effective date will be determined after FASB/IASB consider feedback *but an effective date prior to 2017 is **NOT** expected*
- ▶ Would apply to all leases existing at “the beginning of the first comparative period” present upon adoption. Thus, ***no grandfathering*** of existing leases!
- ▶ Transition: modified retrospective approach or full retrospective approach



Identifying a Lease

Lease

A contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration

Determine at inception based upon:

- ▶ Whether contract fulfillment depends on use of an *identified asset**
- ▶ Whether contract conveys right to control use of identified asset for consideration for a time period

* Consider whether supplier has *substantive right of substitution*

Lease Classification

Both lessees and lessors must evaluate at commencement of lease:

TYPE A

- ▶ Most leases *other than property* (e.g., equipment, aircraft, cars, trucks)
- ▶ A non-property lease is considered Type A unless lease term is:
 - for an insignificant part of the total economic life of the underlying asset OR
 - Present value of the lease payments is insignificant relative to the FV of the underlying asset at commencement.
- ▶ If either of the above considerations are met, the lease is Type B

TYPE B

- ▶ Consist of *most property leases* (e.g., land and/or building or part of a building)
- ▶ A property lease is considered Type B unless:
 - lease term is for the major part of the remaining economic life of the underlying asset OR
 - present value of the lease payments accounts for substantially all of the FV of underlying asset at commencement
- ▶ If either of the above conditions is met, the lease is Type A



Lease Classification Examples

Facts:

- ▶ Asset: Tractor
- ▶ Term: 2 years
- ▶ Asset economic life: 12 years
- ▶ Lease payments (LP): \$9K per year
- ▶ PV of LP: \$16.7K (using rate lessor charges lessee)
- ▶ Fair value of tractor at commencement: \$60K

*Is this a
type A or
type B lease?*



Lease Classification Examples

Answer: Type A

Reasons

1. The underlying asset is not property.
2. The lease term is for more than an insignificant part of the total economic life of the equipment.
3. The present value of the lease payments is more than insignificant relative to the fair value of the equipment at the commencement date.



Lease Classification Examples

Facts:

- ▶ Asset: Office building
- ▶ Term: 15 years
- ▶ Asset economic life: 40 years (remaining at commencement)
- ▶ Lease payments (LP): \$30K per year
- ▶ PV of LP: \$300K (using incremental borrowing rate)
- ▶ Fair value of building at commencement: \$400K

*Is this a
type A or
type B lease?*



Lease Classification Examples

Answer: Type B

Reasons

1. The underlying asset is property.
2. The lease term is not for a major part of the remaining economic life of the property.
3. The present value of the lease payments does not account for substantially all of the fair value of the property.



Lessee Accounting

At commencement, lessee to record ALL leases as follows:

- ▶ Recognize right-of-use (ROU) asset
- ▶ Lease liability for future rental payments

Measure both at present value (PV) of lease payments

- ▶ Based on both lease term and rentals
- ▶ Discount at lessee's incremental borrowing rate or rate lessor charges, if known
- ▶ Include recoverable initial direct costs in the ROU asset



Lease term and rentals

Two elements form basis for PV of lease payments:

LEASE TERM

- ▶ Estimated as the non-cancellable period of the lease
- ▶ Include periods under option to extend IF lessee has *significant economic incentive to exercise* option
- ▶ Include periods under option to terminate IF lessee has *significant economic incentive NOT to exercise* option

RENTALS

Include:

- ▶ Fixed lease payments (less incentives to be paid by lessor)
- ▶ Contingent rentals tied to an index
- ▶ Contingent rentals which are in-substance fixed payments
- ▶ Residual value guarantees
- ▶ Exercise price of purchase option IF lessee has *significant economic incentive to exercise* option
- ▶ Termination penalties IF lease term reflects lessee exercising option



Lessee Accounting

Different accounting after commencement for **LESSEES**:

Type A

- ▶ Amortize ROU asset:
 - Method: straight-line basis, unless another basis is more representative
 - Period: shorter of the estimated lease term or underlying asset's useful life
 - If significant economic incentive to exercise a purchase option, amortize ROU asset to end of useful life of underlying asset

Type B

- ▶ Amortize ROU asset:
 - Difference b/t periodic lease cost and interest on lease liability (i.e., amount of asset amortization is a “residual”)



Lessee Accounting

Different accounting after commencement for LESSEES:

Type A

- ▶ Separately reflect in P&L:
 - Accretion of lease liability as interest
 - Amortization of ROU asset

Type B

- ▶ Reflect a single lease cost in P&L:
 - Combine effective interest on lease liability w/ amortization of ROU asset, so remaining cost of lease is allocated over remaining lease term on SL basis.
 - Note: Periodic lease cost cannot be less than effective interest charge associated w/ lease liability.



Lessee Accounting

Accounting after commencement for LESSEES:

For both Type A and Type B leases:

- ▶ Assess ROU asset for impairment in accordance with Topic 360
- ▶ Reassess lease liability each period for significant changes in lease payments, term or discount rate
- ▶ Recognize amount of remeasurement of lease liability as an adjustment to ROU asset*

* Exceptions: when related to a change in an index or a rate attributable to the current period or when the carrying amount of the right-of-use asset has been reduced to zero, the remeasurement should be reflected in P&L



Lessee Accounting

Presentation for LESSEES:

Balance Sheet

All leases:

Either present separately* or combine with appropriate class of assets and liabilities with proper disclosure

*No co-mingling of Type A and Type B leases

Income Statement

- ▶ Type A: Display interest on lease liability *separately from* amortization of ROU asset
- ▶ Type B: Display interest on lease liability *together with* amortization of ROU asset

Lessee Accounting

Presentation for LESSEES:

Statement of Cash Flows

- ▶ Operating activities
 - Interest on lease liability arising from Type A leases
 - Payments arising from Type B leases
 - Variable lease payments and S/T lease payments not included in lease liability
- ▶ Financing activities
 - Principal repayments on Type A leases





Lessee Accounting Example

Facts:

- ▶ 10-year lease, option to extend 5 years
- ▶ LP = \$50K/year (initial term); \$55K/year (optional period)
- ▶ No significant economic incentive to exercise option to extend, therefore, lease term = 10 years
- ▶ Payments due at beginning of each year
- ▶ Initial direct costs (IDC) = \$15K
- ▶ Lessee's incremental borrowing rate = 5.87%
- ▶ PV of remaining LP after payment of 1st year rental & IDC = \$342,017



Lessee Accounting Example (Continued)

Journal entry to record lease assets & liabilities at commencement:

Right-of-use asset	407,017	
Lease liability		342,017
Cash (lease payment for year 1)		50,000
Cash (initial direct costs)		15,000

Lessee Accounting Example (Continued)

Journal entry to recognize lease expense during 1st year, if **Type A**:

Interest expense	20,076 ¹	
Lease liability		20,076
Amortization expense	40,702 ²	
Right-of-use asset		40,702

1. Calculated as $(5.87\% \times 342,017)$

2. Calculated as $(407,017 \div 10)$



Lessee Accounting Example (Continued)

Journal entry to recognize lease expense during 1st year, if **Type B**:

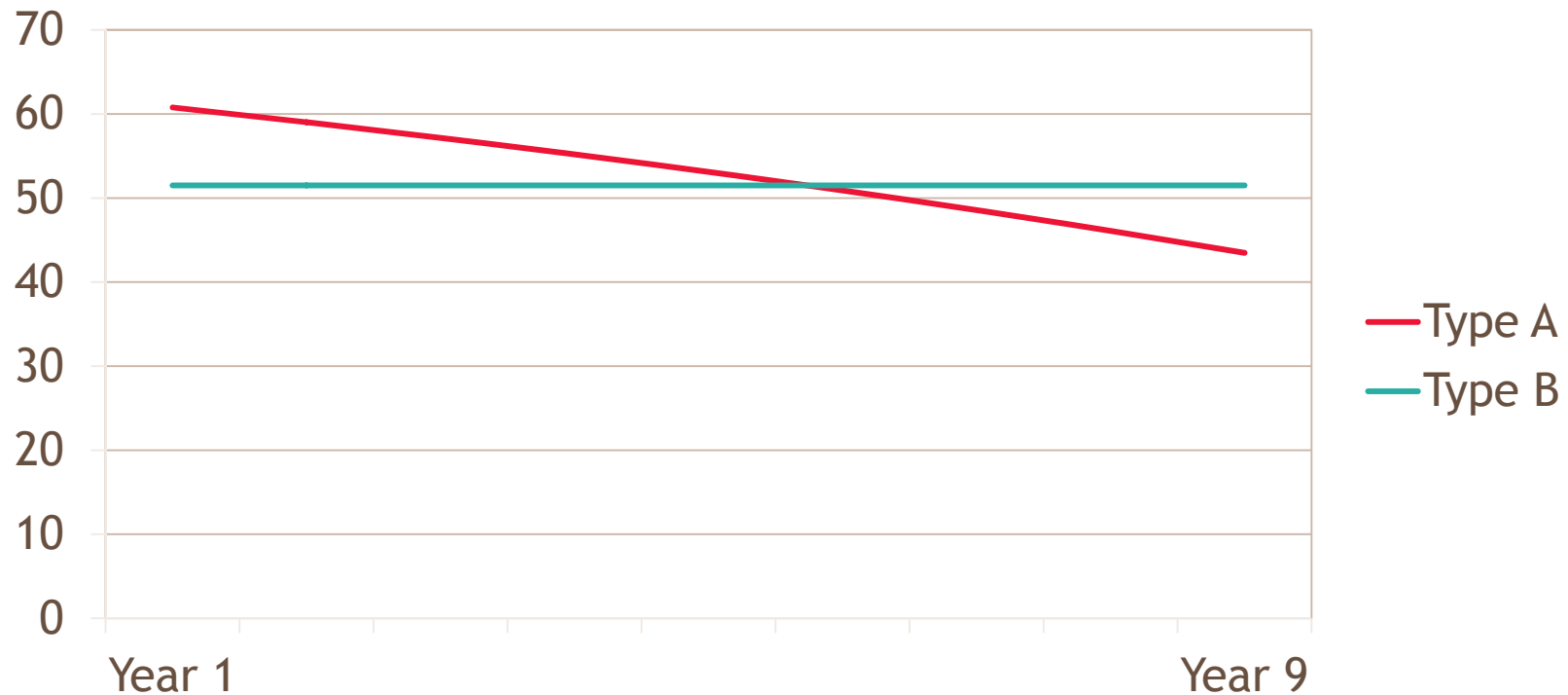
Lease expense	51,500 ¹	
Lease liability		20,076 ²
Right-of-use asset		31,424 ³

1. Calculated as $[(500,000+15,000) \div 10]$
2. Calculated as $(5.87\% \times 342,017)$
3. Calculated as $(51,500-20,076)$

Lessee Accounting Example (Continued)

Total lease expense recognized over life of lease - Type A vs. Type B

(in \$000s, approximate)





Lessor Accounting

Accounting at commencement of lease for **LESSORS**:

Type A

- ▶ Recognize an asset for right to receive lease payments (plus any initial direct costs) and lease income
- ▶ Derecognize a portion of underlying leased asset and charge lease expense
- ▶ Reclassify retained portion of rights in leased property as a residual asset
- ▶ Initially measure lease receivable consistent w/ lessee measurement of lease liability (i.e., PV of lease payments)
- ▶ Recognize residual asset as PV of salvage amount expected at end of lease term, PLUS PV of expected variable lease payments, LESS unearned profit



Lessor Accounting

Accounting after commencement for **LESSORS**:

Type A

- ▶ Measure lease receivable by increasing carrying amount to reflect interest accretion and reducing it to reflect lease payments rec'd during period
- ▶ Subsequently measure residual asset at its initial carrying amount plus accretion, adjusted for any reassessment and impairment requirements and for variable lease payments
- ▶ Reassess lease receivable for changes to lease term, payments or discount rate
- ▶ Assess impairment: Lease receivable in accordance with Topic 310 (consider collateral); residual asset in accordance with Topic 360 (consider residual value guarantees)



Lessor Accounting

Presentation for **LESSORS - TYPE A:**

Balance Sheet

- ▶ Present lease assets (sum of receivables and residual assets) separately from other assets
 - Permitted to present lease receivables and residual assets separately or disclose separately in notes

Statement of Cash Flows

- ▶ Classify cash receipts from lease payments as operating activities

Income Statement

- ▶ Present interest income on receivables separately from other interest income or separately disclose which lines items include the income
- ▶ Profit or loss recognized at lease inception will be presented gross or net, depending on the lessor's business model



Lessor Accounting Example

Facts:

- ▶ Vehicle lease, initial term of 3 years
- ▶ LP = \$2,400/year payable at end of year
- ▶ Initial direct costs (IDC) = \$200
- ▶ Carrying amount & fair value at commencement = \$10,000
- ▶ Amount expected to derive from vehicle after 3 years = \$4,500
- ▶ Lessee has option to purchase vehicle or extend lease after 3 years, but no significant economic incentive to exercise options, thus, lease term = 3 years
- ▶ Lease = Type A
- ▶ Rate lessor charges lessee = 6.87%

Lessor Accounting Example (continued)

Computation of lease receivable:

- ▶ PV of 7,200 (3 payments of 2,400)
- ▶ Discounted at: 6.87%
- ▶ Plus: IDC of 200
- ▶ Equals: 6,513

Computation of gross residual asset:

- ▶ PV of 4,500 (amt lessor expects to derive from vehicle after lease term)
- ▶ Discounted at: 6.87%
- ▶ Equals: 3,687*

*Carrying amt = fair value at commencement thus no profit/loss or unearned profit recorded



Lessors Accounting Example (Continued)

Journal entry to derecognize vehicle and to recognize lease receivable and residual asset at commencement:

Lease receivable (LR)	6,513	
Residual asset	3,687	
Vehicle		10,000
Cash/payable for initial direct costs		200

Notes:

- ▶ Lessor determines imputed rate to reduce LR balance to \$0 at end of term = 5.18%
- ▶ Lessor may also present revenue and COGS of 6,313

Lesser Accounting Example (Continued)

Journal entry to recognize lease payment, interest on receivable, and interest on residual asset at end of Year 1:

Cash	2,400	
Lease receivable		2,400
Lease receivable	338 ¹	
Residual asset	253 ²	
Interest income		591 ³

1. Calculated as: (imputed rate of 5.18% × 6,513)
2. Calculated as: (6.87% × 3,687)
3. Calculated as: (338 + 253)

Lessors Accounting Example (Continued)

Presentation of assets, liabilities, and income/expense during lease term:

End of Year	Statement of Financial Position			Statement of Comprehensive Income		
	Lease Receivable	Gross Residual Asset	Carrying Amount of Residual Asset	Interest on Lease Receivable	Interest on Residual Asset	Interest Income
1	CU4,451	CU3,940	CU3,940	CU338	CU253	CU591
2	2,282	4,211	4,211	231	271	502
3	-	4,500	4,500	118	289	407



Lessor Accounting Example (Continued)

What if the carrying amount of the vehicle at the commencement date is \$7,500, while fair value is \$10,000 (ignore initial direct costs)?

- ▶ Lease receivable = \$6,313
- ▶ Gross residual asset = \$3,687
- ▶ FV less carrying amount = \$2,500



Lessor Accounting Example (Continued)

Computation of recognized profit:

\$	2,500	FV less carrying amount
x	<u>(6,313/10,000)</u>	PV of LP as proportion of FV
	1,578	

Computation of unearned profit:

\$	2,500	FV less carrying amount
-	<u>1,578</u>	Recognized profit
	922	

Lesser Accounting Example (Continued)

Journal entry to derecognize vehicle and recognize lease receivable, gross residual asset, and unearned profit on residual asset, as well as profit on the lease:

Lease receivable	6,313	
Revenue		6,313
Gross residual asset	3,687	
Cost of goods sold	4,735 ¹	
Unearned profit on the residual asset		922
Vehicle		7,500

1. Calculated as: $(7,500 - 3,687 + 922)$



Lessor Accounting

Type B

- ▶ Lessor would continue to measure underlying asset, both at lease inception and over lease terms, in accordance with other applicable GAAP
- ▶ Approach would be similar to existing lessor accounting for operating leases
- ▶ Presentation in B/S and I/S would be consistent with this approach
- ▶ All cash receipts from lease payments would be classified as operating activities



Other Provisions

- ▶ **S/T Leases:** At inception, both lessees and lessors could elect **NOT** to recognize assets or liabilities, **NOR** to derecognize a portion of the leased asset and simply recognize lease activity in earnings over the lease term
- ▶ **Sale-Leasebacks:** A transferor would assess whether transferred asset has been sold using the “control principle” (outlined in 2011 Revenue Recognition ED) and account for transactions as either sales or financings



Other Provisions

- ▶ **Separate Components:** Lessees and lessors would both be required to separately account for lease and nonlease components
 - ED provides separation and allocation guidance for lessees; lessors would apply allocation guidance in the 2011 Revenue Recognition ED
- ▶ **Subleases:** Classify as Type A or Type B with reference to underlying asset (vs. right-of-use asset)



Disclosures

- ▶ Contractual details (lease term, contingent rentals, options, etc.) and related accounting judgments
- ▶ Maturity analyses of undiscounted lease payments
- ▶ Reconciliations of amounts recognized in the statement of financial position
 - Lessees: rollforwards of lease liabilities by class of underlying asset
 - Lessors: reconciliations of right to receive lease payments and residual assets
- ▶ Narrative disclosures about leases (including information about variable lease payments and options)



Appendix: Significant Changes From the 2010 ED

Classification of leases

2010 ED	2013 Revised ED
Lessor would assess whether significant risks and benefits associated with the underlying asset are transferred to the lessee	Lessee and lessor would classify leases on the basis of whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset (resulting in Type A or Type B classification)

Appendix: Significant Changes From the 2010 ED

Lessee accounting model

2010 ED	2013 Revised ED
<p>One accounting model for all leases (right-of-use approach) replaces current two model approach:</p> <ul style="list-style-type: none">• Asset = right to use item for lease term; recognized and carried at amortized cost• Liability = obligation to pay rentals; PV of payments• Subsequently recognize in P&L:<ul style="list-style-type: none">• Interest expense on the liability• Amortization expense of the ROU asset• Changes in the liability resulting from reassessment of contingent rentals, residual value guarantees, or term option penalties• Impairment losses on the ROU asset	<p>Type A model consistent with 2010 ED</p> <p>Type B model differs as follows:</p> <ul style="list-style-type: none">• A lessee would amortize the right-of-use asset so that the remaining cost of the lease is allocated over the lease term on a straight-line basis.• The lessee would present amortization of the right-of-use asset and the unwinding of the discount on the lease liability together as a single lease cost.• The lessee would classify cash flows arising from Type B leases within operating activities.

Appendix: Significant Changes From the 2010 ED

Lessor accounting model

2010 ED	2013 Revised ED
<p>Dual model approach; centers on whether significant risks or benefits of the leased asset are retained</p> <ol style="list-style-type: none"><li data-bbox="172 797 1029 898">1. If retained = performance obligation model<li data-bbox="172 971 882 1016">2. If transferred = derecognition	<p>Type A model similar to derecognition approach, with differences:</p> <ol style="list-style-type: none"><li data-bbox="1064 683 1921 841">1. Recognize unwinding of the discount on the residual asset as interest income over lease term<li data-bbox="1064 857 1902 1133">2. Present carrying amount of lease receivable and residual asset together as lease assets, with lease receivable and residual asset presented or disclosed separately <p>Type B model similar to existing operating lease accounting for lessors</p>

Appendix: Significant Changes From the 2010 ED

Measurement of lease assets and liabilities

2010 ED	2013 Revised ED
<i>Variable lease payments</i>	
Lease payments would include all contingent rentals, estimated using a probability-weighted approach.	Include only variable lease payments that either depend on an index or a rate or are in-substance fixed payments; reassess at the end of each reporting period.
<i>Options to extend or terminate a lease or to purchase the underlying asset</i>	
Include lease payments on the basis of an estimate of the lease term as the longest possible term that is more likely than not to occur.	Include lease payments to be made in optional periods, or the exercise price of a purchase option, only when a lessee has a significant economic incentive to exercise an option (or significant economic incentive not to terminate).

Appendix: Significant Changes From the 2010 ED

Other provisions

2010 ED	2013 Revised ED
<i>Short term leases</i>	
Simplified approach available to both lessor and lessee; would still require lessee to recognize ROU asset and lease payments.	Both lessor and lessee may elect not to recognize ST leases on balance sheet (similar to existing operating lease accounting).
<i>Sale and leaseback transactions</i>	
Account for a sale and leaseback transaction as a sale and leaseback when specific sale/purchase criteria have been met for the transferred asset.	Retained proposal to account for transaction as sale/leaseback, however, whether a sale has occurred to be based on control principle in the 2011 Revenue Recognition ED.

Basel III



Overview of U.S. Basel III Final Rule

The U.S. banking agencies* have issued a final rule to comprehensively revise the regulatory capital framework for the U.S. banking sector.

- ▶ The U.S. Basel III final rule represents the most complete overhaul of U.S. bank capital standards since the U.S. adoption of Basel I in 1989.
- ▶ The final rule implements many aspects of the Basel III capital framework agreed upon by the Basel Committee, but also incorporates changes required by the Dodd-Frank Act.
- ▶ The U.S. Basel III final rule makes a number of significant changes to the June 2012 U.S. Basel III proposals.

* The Federal Reserve Board approved the final rule on July 2, 2013. The OCC approved the final rule on July 9, 2013. The FDIC approved an interim final rule on July 9, 2013.

Which Organizations Are Affected?

U.S. Basel III Applies to:

- ▶ National banks
- ▶ State member banks
- ▶ State nonmember banks
- ▶ U.S. bank holding companies (BHCs) other than small BHCs
- ▶ State savings associations
- ▶ Federal savings associations
- ▶ Covered savings and loan holding companies (SLHCs)
- ▶ Any of the above that are subsidiaries of foreign banks

U.S. Basel III Does Not Apply to:

- ▶ Small BHCs: BHCs with < \$500 million in total consolidated assets that: are not engaged in significant nonbanking activities;
 - do not conduct significant off-balance sheet activities; and
 - do not have a material amount of SEC-registered debt or equity securities.
- ▶ Non-covered SLHCs:* A grandfathered unitary SLHC substantially engaged in commercial activities (applying a $\geq 50\%$ of assets or revenues test);
 - An SLHC that is an insurance underwriting company; and
 - An SLHC that substantially engages in insurance underwriting activities (applying a $\geq 25\%$ of assets held in insurance underwriting subsidiaries test).
- ▶ Holding companies of industrial loan companies unless designated as systemically important

* The Federal Reserve expects to implement an “appropriate” capital framework for non-covered SLHCs by the time covered SLHCs must comply with the final rule in 2015.

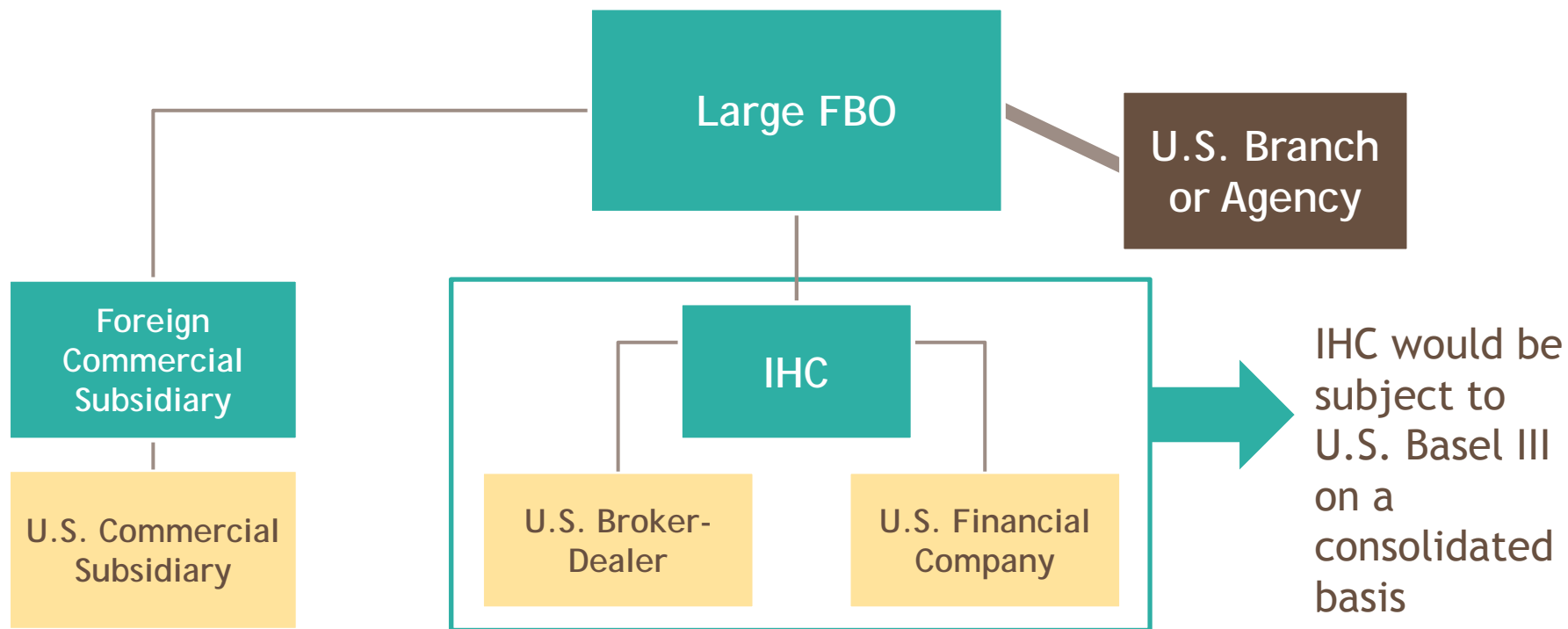


Which Organizations Are Affected?

Using its authority under the Dodd-Frank Act to establish enhanced prudential standards, the Federal Reserve has also proposed to apply U.S. Basel III to:

- ▶ Any U.S. intermediate holding company (IHC) that is required to be established by a large foreign banking organization (FBO) for its U.S. banking and non-banking subsidiaries;
- ▶ U.S. nonbank financial companies that are designated as systemically important by the U.S. Financial Stability Oversight Council (nonbank SIFIs), subject to any case-by-case tailoring; and
- ▶ Any U.S. IHC that is required to be established by a foreign nonbank SIFI, subject to any case-by-case tailoring.

Which Organizations Are Affected?



Which Organizations Are Affected?

Subpart of U.S. Basel III Final Rule	Description of Subpart	Applies to
Subpart A	General provisions and definitions	All banking organizations subject to the final rule
Subpart B	Minimum capital ratios and capital buffers	All banking organizations subject to the final rule
Subpart C	Definition of capital, including regulatory adjustments and deductions	All banking organizations subject to the final rule
Subpart D	Standardized approach for calculating risk-weighted assets (RWAs)	All banking organizations subject to the final rule (capital floor for advanced approaches banking organizations)
Subpart E	Advanced approaches for calculating RWAs	Advanced approaches banking organizations only
Subpart F	RWAs for market risk	Market risk banking organizations only
Subpart G	Transition provisions	All banking organizations subject to the final rule

An advanced approaches banking organization is one that:

- has \geq \$250 billion in total consolidated assets;
- has \geq \$10 billion of on-balance sheet foreign exposures; or
- chooses, with approval by its primary federal banking regulator, to use the advanced approaches to calculate RWAs.

A market risk banking organization is one that:

- has aggregate trading assets and trading liabilities of \geq 10% of total assets or \geq \$1 billion; or
- is required by its primary federal banking regulator to calculate RWAs for market risk because of the level of its market risk.



Key Changes to U.S. Basel III Proposals: Timing of Effectiveness

NON-ADVANCED APPROACHES BANKING ORGANIZATIONS AND COVERED SLHCS

January 1, 2015

- ▶ Compliance with U.S. Basel III minimum regulatory capital ratios and standardized approach for calculating RWAs
- ▶ Start of transition period for definition of regulatory capital and regulatory adjustments and deductions

January 1, 2016

- ▶ Start of transition period for capital conservation buffer*

* If a covered SLHC is an advanced approaches banking organization, transition period for countercyclical capital buffer will also begin on January 1, 2016.



Key Changes to U.S. Basel III Proposals: Timing of Effectiveness

ADVANCED APPROACHES BANKING ORGANIZATIONS OTHER THAN COVERED SLHCS

January 1, 2014

- ▶ Compliance with U.S. Basel III advanced approaches for calculating RWAs
- ▶ Start of transition period for minimum regulatory capital ratios, definition of regulatory capital and regulatory adjustments and deductions
- ▶ Compliance with existing Basel I rules for calculating RWAs as floor

January 1, 2015

- ▶ Compliance with U.S. Basel III standardized approach for calculating RWAs as floor

January 1, 2016

- ▶ Start of transition period for capital conservation and countercyclical capital buffers



Key Changes to U.S. Basel III Proposals: Numerator Proposal

Accumulated other comprehensive income (AOCI) filter

- ▶ Provides non-advanced approaches banking organizations a one-time opportunity to permanently opt-out of the removal of the AOCI filter, i.e., retain AOCI treatment under existing capital rules
- ▶ Removes the AOCI filter for (1) advanced approaches banking organizations and (2) other banking organizations that do not make a timely opt-out election



Key Changes to U.S. Basel III Proposals: Numerator Proposal

Grandfathering and phase-out of non-qualifying capital instruments

- ▶ Permanently grandfathers in Tier 1 capital non-qualifying capital instruments, including trust preferred securities (TruPS) and cumulative perpetual preferred stock, issued prior to May 19, 2010 by depository institution holding companies with < \$15 billion in total assets as of year-end 2009, subject to a limit of 25% of Tier 1 capital (excluding any non-qualifying capital instruments and after applying all regulatory capital deductions and adjustments to Tier 1 capital)
- ▶ Non-qualifying capital instruments issued by other depository institution holding companies must be fully phased out of Tier 1 capital by January 1, 2016
- ▶ Permanently grandfathers in Tier 2 capital non-qualifying capital instruments that are phased out of Tier 1 capital, except that advanced approaches banking organizations must, by January 1, 2022, fully phase out of Tier 2 capital any non-qualifying capital instruments that do not meet the U.S. Basel III Tier 2 eligibility criteria



Key Changes to U.S. Basel III Proposals: Numerator Proposal

Capital conservation buffer

- ▶ Requires an advanced approaches banking organization that has been authorized to exit its parallel run process to use the lower of each risk-based capital ratio calculated under the standardized approach and the advanced approaches to determine:
 - (1) compliance with minimum capital ratios; and
 - (2) the size of its capital conservation buffer



Key Changes to U.S. Basel III Proposals: Numerator Proposal

ELIGIBILITY CRITERIA FOR CAPITAL INSTRUMENTS

Common Equity Tier 1 capital

- ▶ Permits payment of dividends out of surplus related to common stock in addition to net income and retained earnings
- ▶ Accommodations for common equity issued to or for employee stock ownership plans (ESOPs) and for repurchases required by ERISA for non-publicly traded stock
- ▶ Final rule does not modify eligibility criteria to accommodate the payment of a penny dividend



Key Changes to U.S. Basel III Proposals: Numerator Proposal

Additional Tier 1 capital

- ▶ Instruments issued and included in a banking organization's Tier 1 capital before the effective date of the final rule that permit early calls within five years of issuance upon the occurrence of a rating agency event would not be disqualified from Additional Tier 1 capital if they otherwise comply with the eligibility criteria
- ▶ Permits dividend stoppers on common stock instruments and on pari passu capital instruments
- ▶ Permits early calls within five years of issuance upon the occurrence of an investment company event
- ▶ Permits payment of dividends out of surplus related to Additional Tier 1 capital instruments in addition to net income and retained earnings
- ▶ Accommodations for instruments issued to or for ESOPs and for repurchases required by ERISA for non-publicly traded instruments
- ▶ Final rule does not modify eligibility criteria to accommodate the payment of a penny dividend



Key Changes to U.S. Basel III Proposals: Numerator Proposal

Tier 2 capital

- ▶ Preamble to final rule clarifies that Tier 2 capital instruments must be subordinated to the claims of trade creditors, in addition to depositors and general creditors
- ▶ Permits early calls within five years of issuance upon the occurrence of an investment company event
- ▶ Instruments issued and included in a banking organization's regulatory capital before the effective date of the final rule that permit early calls within five years of issuance upon the occurrence a rating agency event would not be disqualified from Tier 2 capital if they otherwise comply with the eligibility criteria
- ▶ For a non-advanced approaches banking organization making an AOCI opt-out election, allows inclusion of 45% of pretax net unrealized gains on available-for-sale (AFS) preferred stock classified as an equity security under GAAP and equity exposures



Key Changes to U.S. Basel III Proposals: Numerator Proposal

DEDUCTIONS FROM AND ADJUSTMENTS TO REGULATORY CAPITAL

Investments in the capital of unconsolidated financial institutions - definition of “financial institution”

- ▶ Adds ownership interest thresholds of \$10 million or > 10% of common equity to the “predominantly engaged” prong of the definition
- ▶ Excludes employee benefit plans, entities registered with SEC under the Investment Company Act of 1940, and their foreign equivalents

Mortgage servicing assets (MSAs)

- ▶ Not subject to the proposed 90% fair value limitation on MSAs
- ▶ Still subject to the threshold deduction treatment, and the 10% individual and 15% aggregate thresholds have not changed



Key Changes to U.S. Basel III Proposals: Standardized Approach Proposal

Residential mortgage exposures

- ▶ Abandons proposed framework and retains the existing standardized risk weights for residential mortgage exposures, i.e., 50% risk weight for most first-lien exposures that are prudently underwritten and are performing according to their original terms; 100% risk weight for other residential mortgage exposures

HVCRE loans

- ▶ Excludes from the definition of high volatility commercial real estate loans to facilitate certain community development projects and loans secured by agricultural land

Cleared transactions

- ▶ Generally incorporates Basel Committee's July 2012 interim framework concerning capital requirements for exposures to central counterparties



Key Changes to U.S. Basel III Proposals: Standardized Approach Proposal

SSFA for securitization exposures:

- ▶ Modifies the delinquency parameter W to recognize common deferral features associated with student and consumer loans that are unrelated to credit risk. Conforming changes to the market risk capital rule have been proposed.
- ▶ Permits alternative gross-up approach for non-market risk banking organizations, subject to same minimum risk weight of 20%
- ▶ Retains 1,250% risk weight for certain securitization exposures, even if this means that capital charge may significantly exceed actual amount of exposure

Credit-enhancing representations and warranties:

- ▶ Safe harbor for (1) early default clauses and warranties that permit the return of, or premium refund clauses covering, residential mortgage loans that qualify for a 50% risk weight for 120 days from date of transfer; (2) premium refund clauses covering assets guaranteed, in whole or in part, by the U.S. government, agency or government-sponsored enterprise (GSE) for 120 days from date of transfer; and (3) warranties permitting return of underlying exposures in instances of misrepresentation, fraud or incomplete documentation.



Key Changes to U.S. Basel III Proposals: Standardized Approach Proposal

Foreign exposures:

- ▶ Modifies risk weight tables to take into account the OECD's decision to no longer assign country risk classifications (CRCs) to certain high-income countries that received a CRC of 0 in 2012. Conforming changes to the market risk capital rule have been proposed.

Equity exposures to investment funds:

- ▶ Clarifies that the risk weight for any equity exposure to an investment fund must be no less than 20%
- ▶ Under both the standardized approach and the advanced approaches, purchaser of stable value protection on separate account must treat portion of investment attributable to stable value protection as exposure to protection provider, and must treat balance as equity exposure to an investment fund
- ▶ Under both the standardized approach and the advanced approaches, provider of stable value protection must treat exposure as if it were equity derivative on an investment fund



Key Changes to U.S. Basel III Proposals: Standardized Approach Proposal

Collateral haircut approach

- ▶ Both the standardized approach and advanced approaches final rules lower the proposed 25% supervisory market price volatility haircut for financial collateral issued by non-sovereign issuers with a 100% risk weight to 4% haircut if residual maturity < 1 year; 8% haircut if residual maturity > 1 year but ≤ 5 years; and 16% haircut if residual maturity > 5 years

Pillar 3 public disclosures:

- ▶ Clarifies that if an advanced approaches banking organization has not completed its parallel run by Q1 2015, it must make the Pillar 3 disclosures required by the standardized approach until it has completed its parallel run, at which time it will be required to make the Pillar 3 disclosures required by the advanced approaches



Key Changes to U.S. Basel III Proposals: Advanced Approaches Proposal

Credit valuation adjustment (CVA) capital requirement

- ▶ Makes technical corrections to clarify that the CVA capital requirement is calculated on a portfolio basis and not on a counterparty-by-counterparty basis
- ▶ U.S. banking agencies declined to exempt central banks, multilateral development banks, corporate-end users or other classes of OTC derivative counterparties from the CVA capital requirement
- ▶ Clarifies that where no market information and no reliable proxy based on the credit quality, industry and region of the counterparty are available to determine LGD_{MKT} , a banking organization may use a conservative estimate when determining LGD_{MKT} , subject to approval by its primary federal banking regulator



Key Changes to U.S. Basel III Proposals: Advanced Approaches Proposal

Asset value correlation factor

- ▶ Makes technical corrections to the correlation factor formulas for wholesale exposures to unregulated and regulated financial institutions by revising a proposed 0.18 coefficient to 0.12 in order to be consistent with Basel III
- ▶ Definition of “unregulated financial institution” disregards the ownership interest thresholds in the “predominantly engaged” prong of the new definition of “financial institution”



Impact on Community Banking Organizations

- ▶ In this memorandum, a community banking organization refers to a U.S. banking organization that has less than \$15 billion in total consolidated assets as of year-end 2009.*
- ▶ Key Compliance Dates (*see* pages 16-17)
 - New minimum capital ratios and risk weight regime will become effective on January 1, 2015
 - Capital conservation buffer and new regulatory adjustments and deductions will be phased in from 2015 to 2019
- ▶ AOCI: To retain the AOCI treatment under existing bank capital rules, a community banking organization must make an AOCI opt-out election in its first regulatory report filed in 2015 (*see* pages 35-37)

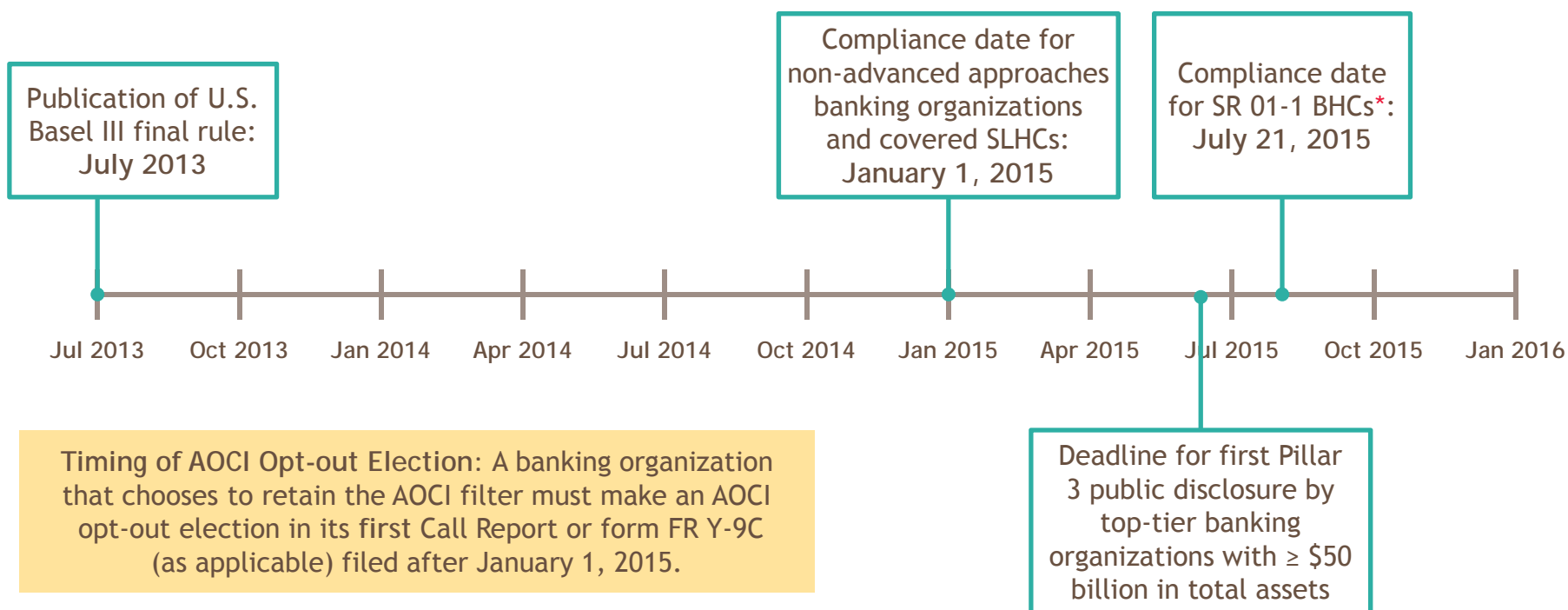
* U.S. Basel III does not apply to small BHCs (<\$500 million in total assets) and non-covered SLHCs



Impact on Community Banking Organizations

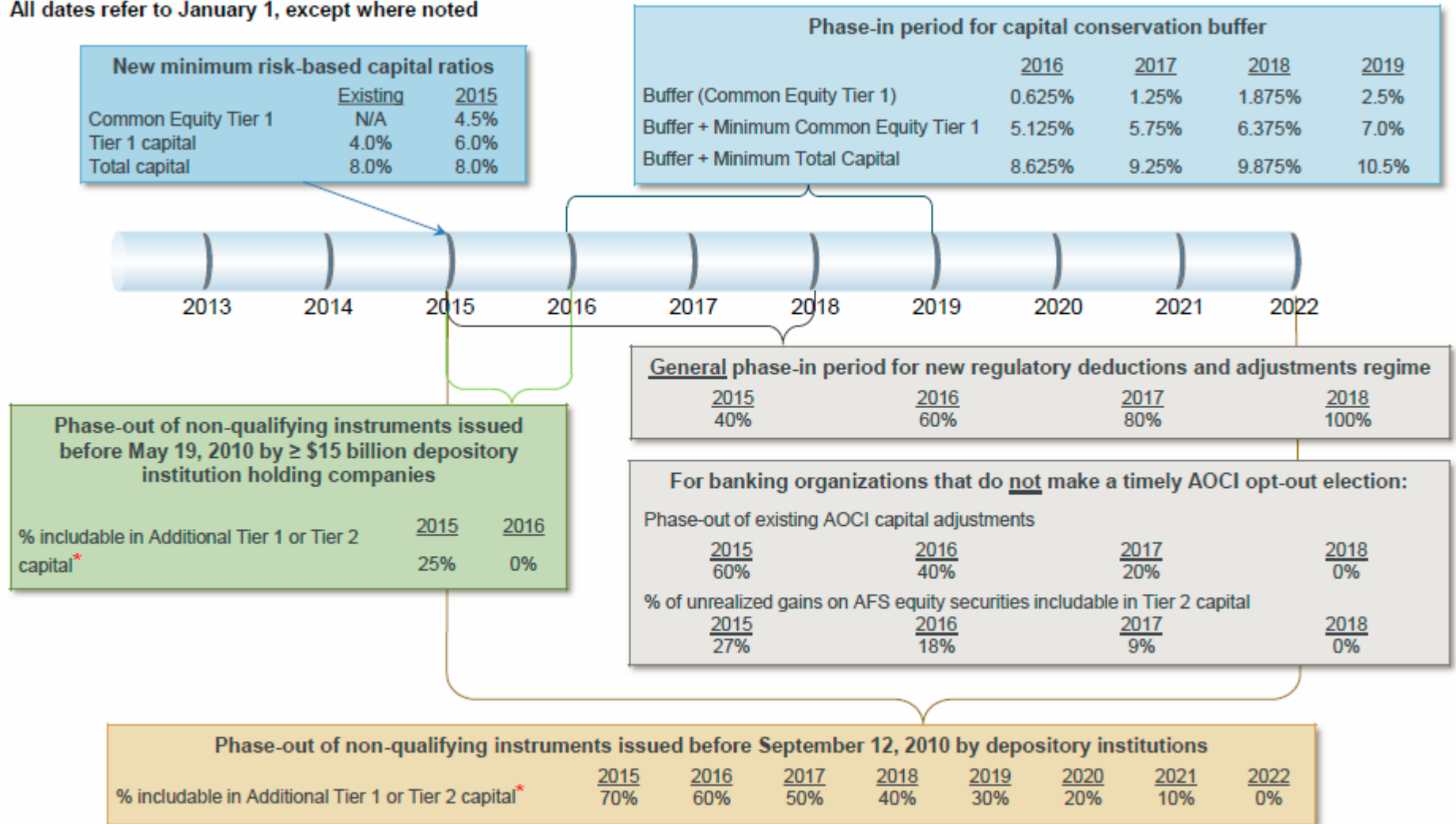
- ▶ Permanent Grandfathering of Non-qualifying Capital Instruments: TruPS, cumulative perpetual preferred stock and other non-qualifying capital instruments issued before May 19, 2010 are permanently grandfathered in Tier 1 capital (subject to a limit of 25% of Tier 1) (*see pages 25-26*)
- ▶ Capital Deductions: U.S. Basel III provides for much more stringent regulatory deductions for MSAs and deferred tax assets (DTAs) than existing bank capital rules (*see page 34*)
- ▶ Risk Weights (*see page 44*)
 - Final rule retains existing capital treatment of residential mortgages (50% risk weight for prudently underwritten first-lien exposures that are performing according to their original terms; 100% risk weight for other residential mortgage exposures)
 - 100% risk weight for most commercial real estate (CRE) loans; 150% for high volatility CRE loans
 - 150% risk weight for past due exposures (except sovereign and residential mortgages)
- ▶ No Pillar 3 public disclosure obligations

Key Compliance Dates for Non-Advanced Approaches Banking Organizations and Covered SLHCs



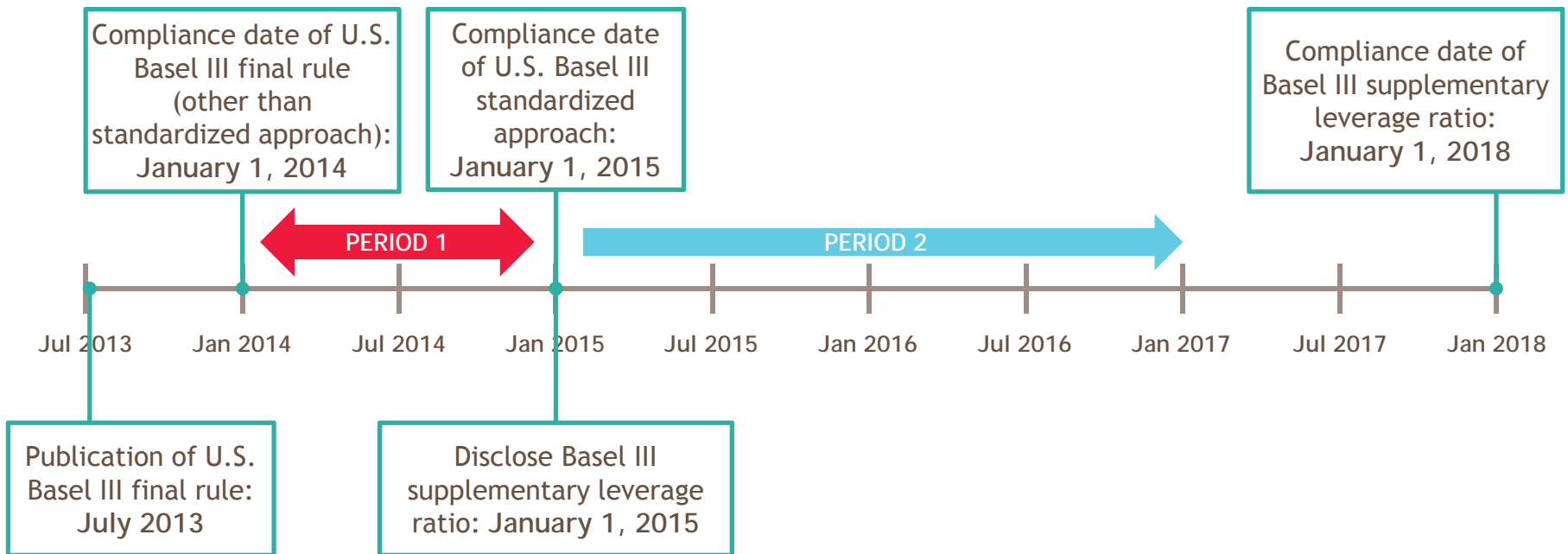
* SR 01-1 BHC refers to a BHC subsidiary of a foreign banking organization that currently relies on the Federal Reserve's Supervision and Regulation Letter (SR) 01-1.

All dates refer to January 1, except where noted



* Percentage includable in Additional Tier 1 capital and Tier 2 capital is based on the aggregate outstanding principal amounts of such non-qualifying Tier 1 and Tier 2 capital instruments, respectively, as of the effective date of the Basel III final rule.

Key Compliance Dates for Advanced Approaches Banking Organizations



Key Compliance Dates for Advanced Approaches Banking Organizations

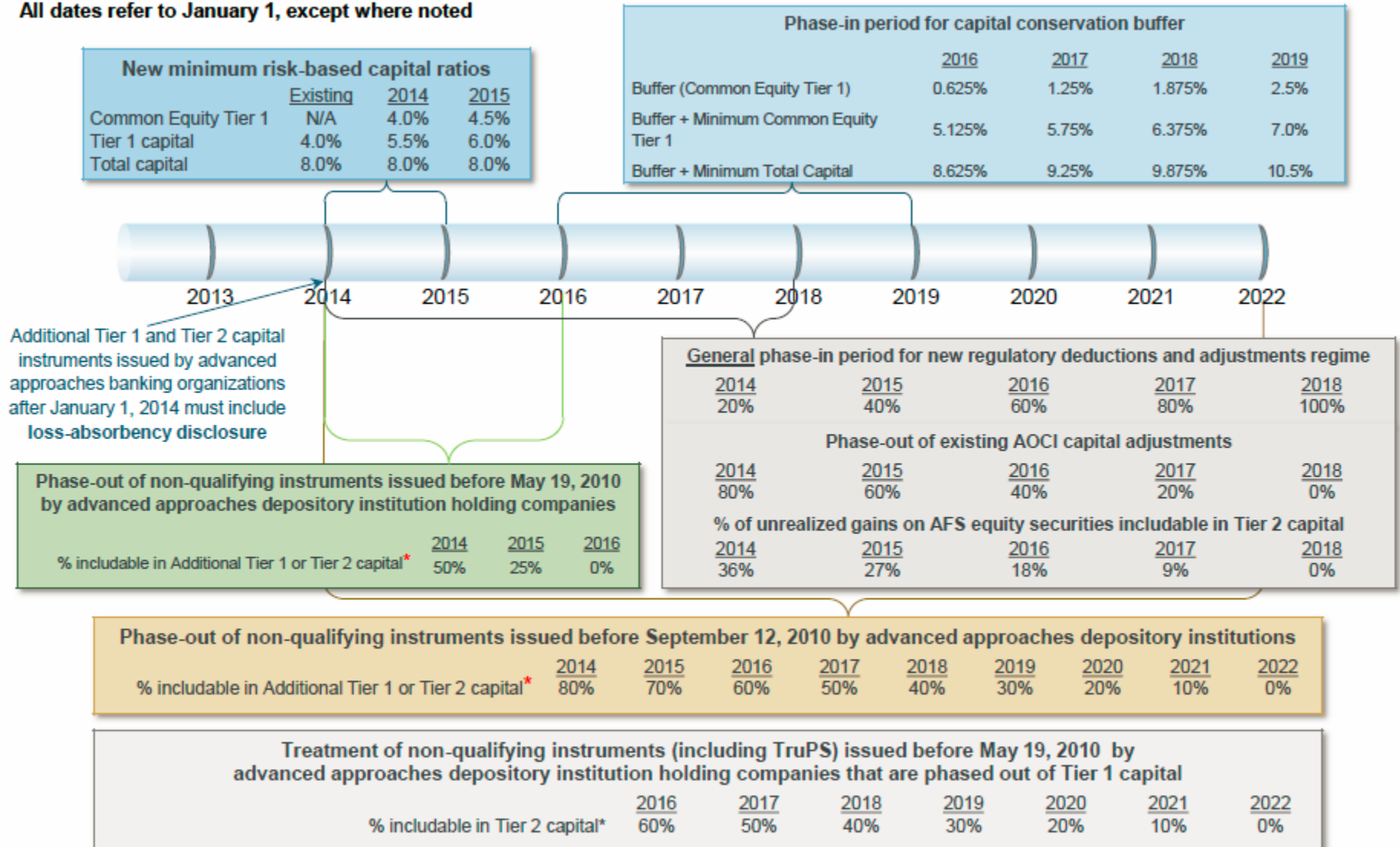
During its parallel run, an advanced approaches banking organization must:

- ▶ for the period between January 1, 2014 and December 31, 2014 (**Period 1**), calculate RWAs using the existing Basel I-based rules for purposes of determining compliance with capital requirements in the U.S. Basel III final rule;
- ▶ for the period beginning on January 1, 2015 (Period 2), calculate RWAs using the Basel III standardized approach for purposes of determining compliance with capital requirements in the U.S. Basel III final rule;
- ▶ for the period beginning on January 1, 2014, calculate RWAs using the Basel III advanced approaches for purposes of confidential reporting to its primary federal banking regulator; and
- ▶ with respect to Q1 2015 and each quarter thereafter, make Pillar 3 public disclosures required by the Basel III standardized approach (assuming the advanced approaches banking organization has not completed its parallel run by Q1 2015).

Upon completing its parallel run, an advanced approaches banking organization must:

- ▶ for the period between January 1, 2014 and December 31, 2014 (**Period 1**), calculate standardized RWAs using the existing Basel I-based rules;
- ▶ for the period beginning on January 1, 2015 (Period 2), calculate standardized RWAs using the Basel III standardized approach;
- ▶ for the period beginning on January 1, 2014, calculate advanced approaches RWAs using the Basel III advanced approaches;
- ▶ calculate risk-based capital ratios using both standardized approach RWAs and advanced approaches RWAs and use the lower of each capital ratio calculated under the two approaches to: (1) determine compliance with minimum capital requirements; and (2) calculate its capital conservation buffer; and
- ▶ make quarterly Pillar 3 public disclosures required by the Basel III advanced approaches.

All dates refer to January 1, except where noted

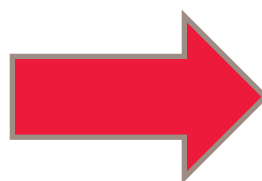


* Percentage includable in Additional Tier 1 capital and Tier 2 capital is based on the aggregate outstanding principal amounts of such non-qualifying Tier 1 and Tier 2 capital instruments, respectively, as of the effective date of the Basel III final rule.

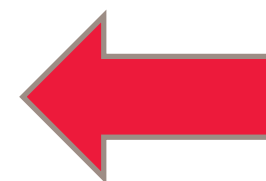
How Will U.S. Basel III Affect the Risk-Based Capital Ratio?



- ▶ Higher minimum capital ratios
- ▶ Requires banking organizations to maintain capital buffer(s) above minimum requirements to avoid restrictions on capital distributions and executive bonus payments



- ▶ Narrows the eligibility criteria for regulatory capital instruments
- ▶ New regulatory adjustments to and deductions from capital that place the focus on tangible common equity



$$\text{Risk-Based Capital Ratio (\%)} = \frac{\text{Regulatory Capital}}{\text{Risk-Weighted Assets}}$$



- ▶ Generally higher RWAs for OTC derivatives, cleared derivatives, high volatility commercial real estate loans and securitizations
- ▶ Collins Amendment capital floor: An advanced approaches banking organization must calculate its risk-based capital ratios under both the advanced approaches and the standardized approach. The advanced approaches banking organization must then use the lower of each capital ratio calculated under the two approaches to:
 - (1) determine compliance with minimum capital requirements; and
 - (2) calculate its capital conservation buffer.

U.S. Basel III: Higher Capital Ratios

Leverage Capital Requirements

U.S. Leverage Ratio: Tier 1 capital to average total consolidated assets (minus amounts deducted from Tier 1 capital) must be at least 4%. Applies to all U.S. banking organizations.

Basel III Supplementary Leverage Ratio: Tier 1 capital to "total leverage exposure," which takes into account both on- and off-balance sheet exposures, must be at least 3%. Applies only to advanced approaches banking organizations.

Future changes: The leverage ratios in the U.S. Basel III final rule may ultimately change as the result of a proposal to impose a higher leverage ratio on certain U.S. banking organizations. This proposal will be considered by the FDIC on July 9, 2013.

Risk-Based Capital Requirements

U.S. Basel III Final Rule

G-SIB surcharge and countercyclical buffer only apply to certain large, internationally active U.S. banking organizations

Common Equity Tier 1:
G-SIB surcharge*

1% - 2.5%

Not part of U.S. Basel III final rule; will be addressed in separate proposal

Common Equity Tier 1:
Countercyclical buffer (if deployed)*

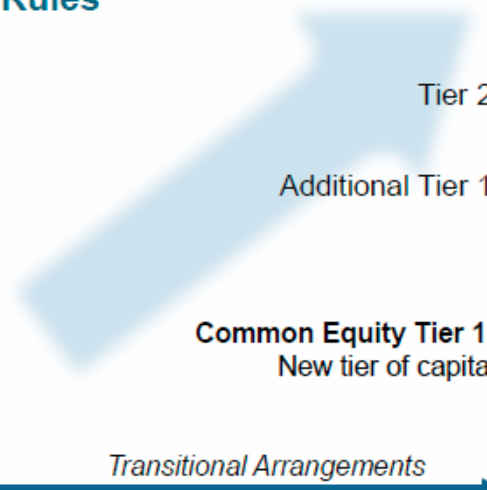
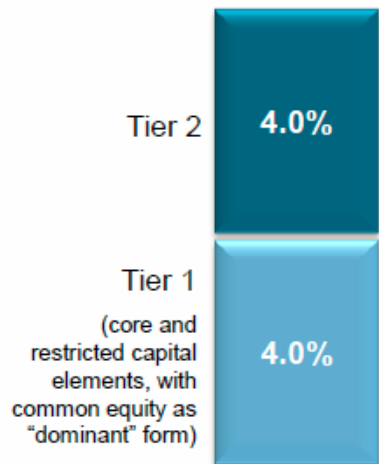
0% - 2.5%

Applies only to advanced approaches banking organizations

Common Equity Tier 1:
Capital conservation buffer*

> 2.5%

Existing Capital Rules



Common Equity Tier 1:
New tier of capital

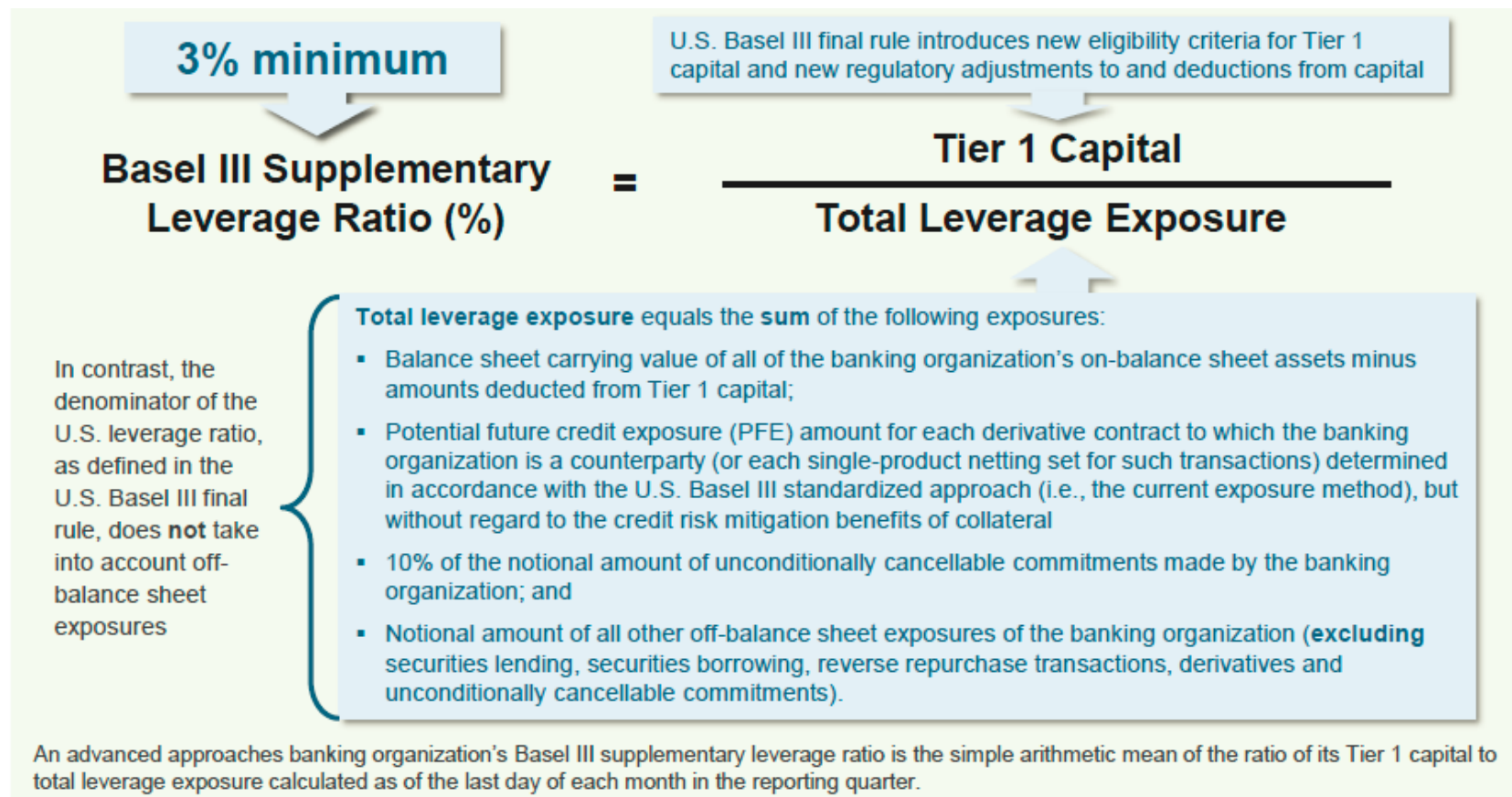
4.5%

8% total capital

6% tier 1 capital

* Technically, the new capital buffers are not minimum capital requirements. However, a banking organization that fails to maintain the applicable capital buffer(s) will be subject to restrictions on capital distributions and executive bonus payments. Therefore, the capital buffers may become *de facto* minimum requirements.

Basel III Supplementary Leverage Ratio for Advanced Approaches Banking Organizations



Future changes: U.S. banking agencies stated that they will consider changes to the Basel III supplementary leverage ratio based on the Basel Committee's revisions to the Basel III leverage ratio.

Revisions to the Prompt Corrective Action Framework

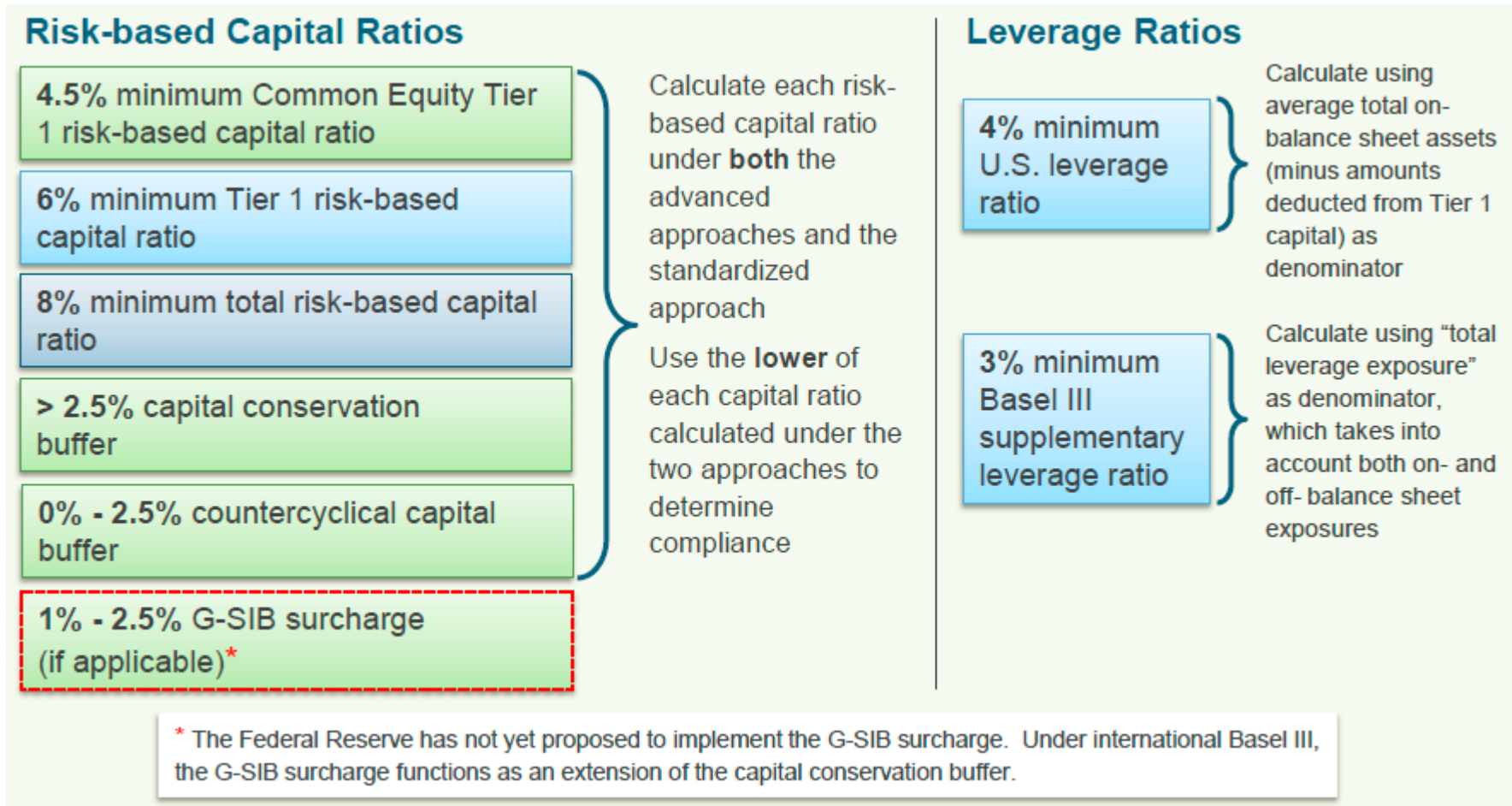
U.S. Basel III final rule revises the capital thresholds for the different prompt corrective action (PCA) categories for insured depository institutions (IDIs)*

The revised PCA thresholds will become effective on January 1, 2015

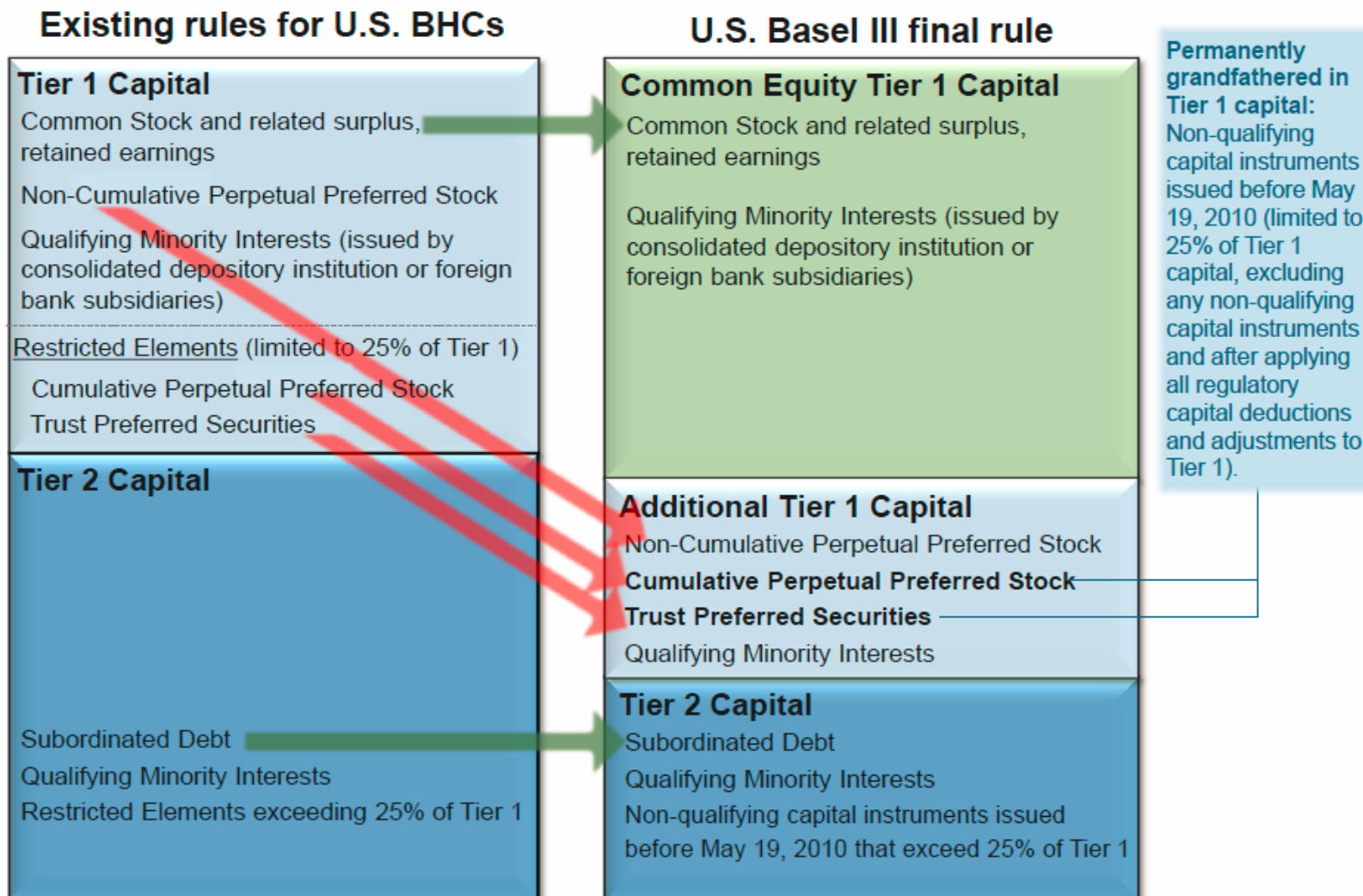
Prompt Corrective Action Threshold	Risk-Based Capital Ratios			U.S. Leverage Ratio	Basel III Supplementary Leverage Ratio
	Total capital (unchanged)	Tier 1 capital	Common Equity Tier 1 capital	All IDIs	Advanced Approaches IDIs Only (1/1/ 2018 effective date)
Well-capitalized	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%	N/A
Adequately Capitalized	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%	≥ 3%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%	< 3%
Significantly Undercapitalized	< 6%	< 4%	< 3%	< 3%	N/A
Critically Undercapitalized	Tangible equity (defined as Tier 1 capital plus non-Tier 1 perpetual preferred stock) to total assets ≤ 2%				N/A

* As a result of the Dodd-Frank Act, in order to elect to become a financial holding company, a BHC and all of its depository institution subsidiaries must be well-capitalized and well-managed. The final rule does not establish the standards for determining whether a BHC is well-capitalized.

Multiple Capital Ratio Calculations for Advanced Approaches Banking Organizations



Eligible Capital Instruments for < \$15 Billion U.S.





Capital Conservation Buffer

- ▶ U.S. Basel III introduces a capital conservation buffer of Common Equity Tier 1 capital above the minimum risk-based capital requirements.
- ▶ The buffer must be maintained to avoid:
 - Limitations on capital distributions (e.g., repurchases of capital instruments or dividend or interest payments on capital instruments); and
 - Limitations on discretionary bonus payments to executive officers such as CEO, president, CFO, CIO, CLO and heads of major lines of business.

Capital Conservation Buffer

- ▶ As a banking organization dips further below its capital conservation buffer, it will be subject to increasingly stringent limitations on capital distributions and bonus payments:

Capital Conservation Buffer	Maximum payout ratio (as a % of eligible retained income)
Buffer > 2.5%	No limit imposed under capital conservation buffer framework
2.5% ≥ Buffer > 1.875%	Up to 60% of eligible retained income
1.875% ≥ Buffer > 1.25%	Up to 40% of eligible retained income
1.25% ≥ Buffer > 0.625%	Up to 20% of eligible retained income
0.625% ≥ Buffer	No capital distributions or discretionary bonus payments allowed

- ▶ No exemption for S-corporation banking organizations (i.e., shareholders may face pass-through taxation without payment of full dividend).



Capital Conservation Buffer

- ▶ Maximum dollar amount that a banking organization is permitted to pay out in the form of capital distributions and discretionary bonus payments during the current calendar quarter

Maximum payout amount = maximum payout ratio x eligible retained income

- ▶ The calculation of the maximum payout amount is made as of the last day of the previous calendar quarter and any resulting restrictions apply during the current calendar quarter.
- ▶ Compliance with the capital conservation buffer is determined prior to any capital distribution or discretionary bonus payment.

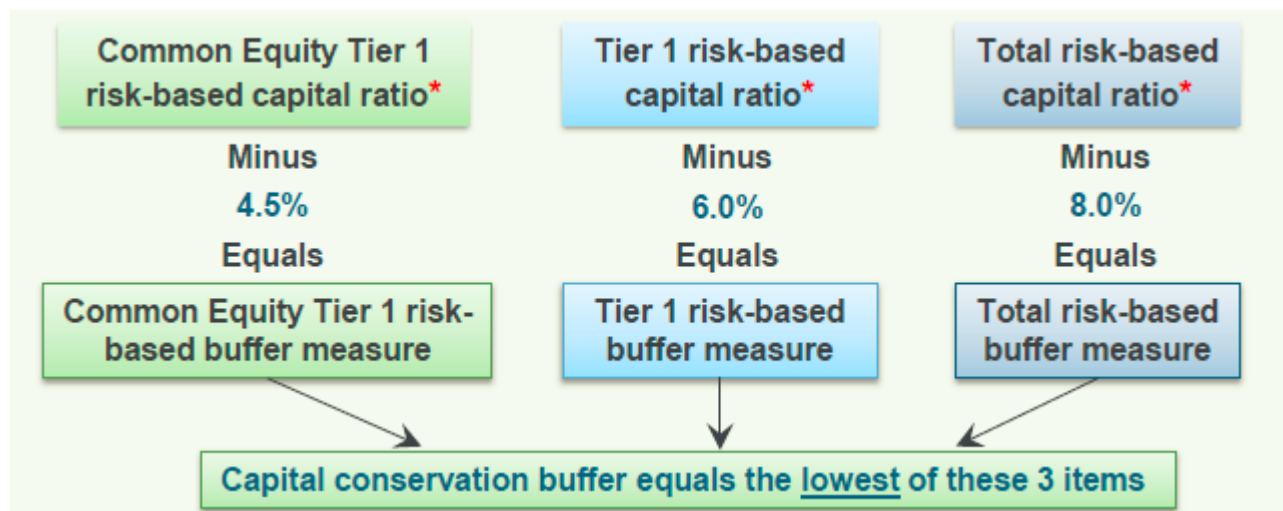


Capital Conservation Buffer

- ▶ Accordingly, a banking organization with a capital buffer of $> 2.5\%$ is not subject to any restrictions on capital distributions or discretionary bonus payments even if such distribution or payment would result in a capital buffer of $\leq 2.5\%$ in the current calendar quarter.
- ▶ However, to remain free of restrictions for any subsequent quarter, the banking organization must restore the buffer to $>2.5\%$ prior to any capital distribution or discretionary bonus payment in any subsequent quarter.
- ▶ The final rule clarifies that a capital distribution does not include a redemption or repurchase of a capital instrument if the banking organization fully replaces that instrument by issuing another eligible capital instrument of the same or better quality (i.e., more subordinate) and such issuance is completed within the same calendar quarter that the redemption or repurchase is announced.

Capital Conservation Buffer

- ▶ Although the capital conservation buffer can only be met with Common Equity Tier 1 capital, it must be calculated relative to each risk-based capital ratio:



* An advanced approaches banking organization that has been authorized to exit its parallel run process must use the lower of each capital ratio calculated under the standardized approach and the advanced approaches to calculate its capital conservation buffer.

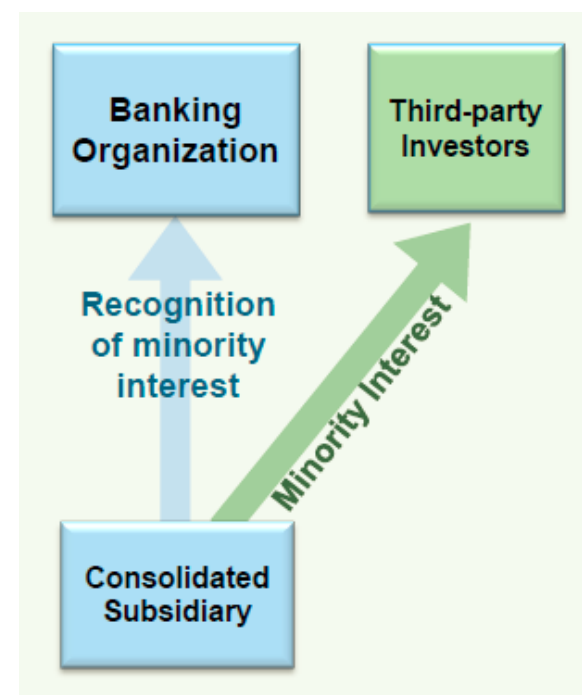


Capital Conservation Buffer

- ▶ **Countercyclical Buffer:** If deployed, the countercyclical buffer will only apply to advanced approaches banking organizations, and will function as an extension of the capital conservation buffer.
- ▶ **G-SIB Surcharge:** Under international Basel III, the G-SIB surcharge also functions as an extension of the capital conservation buffer. The Federal Reserve has not yet proposed to implement the G-SIB surcharge.

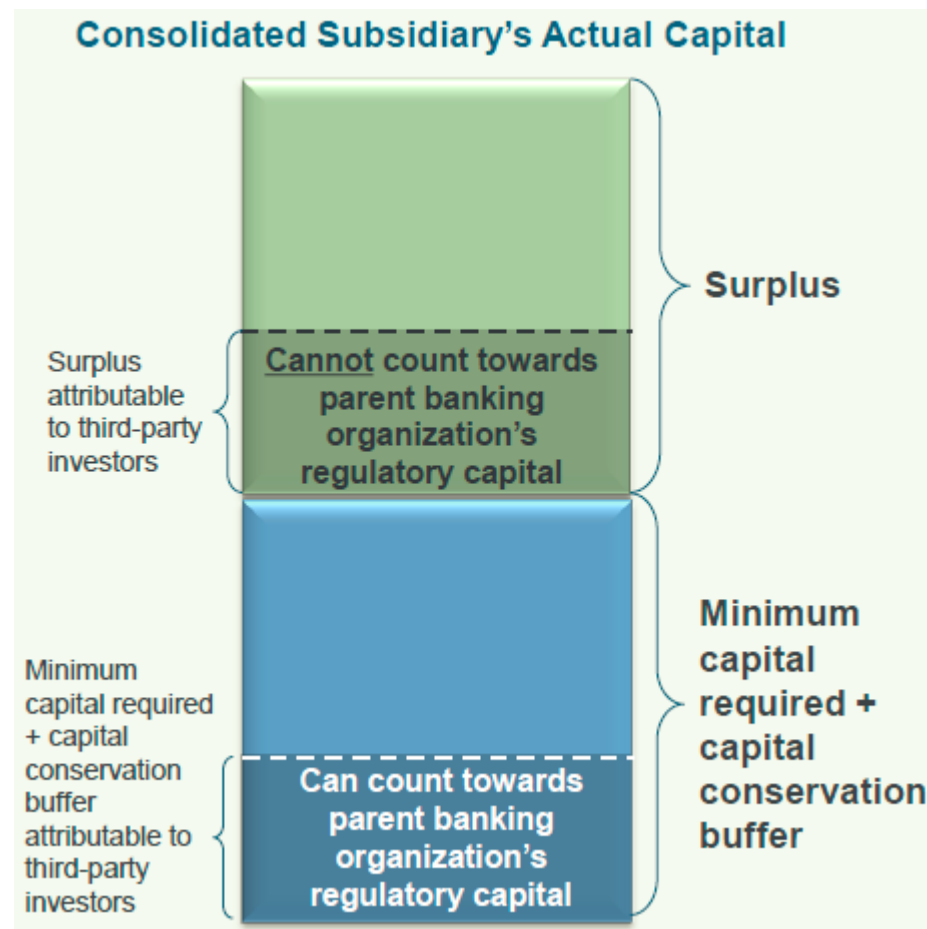
Limited Recognition of Minority Interests

- ▶ Minority interests are capital instruments issued by a consolidated subsidiary of a banking organization to third-party investors.
- ▶ U.S. Basel III places quantitative and qualitative limits on the ability of a banking organization to count minority interests towards its consolidated regulatory capital.
- ▶ Qualitative Limit: The capital instrument giving rise to the minority interest must, if it were issued by the banking organization directly, meet all of the eligibility criteria for the relevant tier of capital.
 - Under the minority interest rules, only Common Equity Tier 1 capital issued by a U.S. depository institution or foreign bank subsidiary to third-party investors can count towards the parent banking organization's consolidated Common Equity Tier 1 capital.



Limited Recognition of Minority Interests

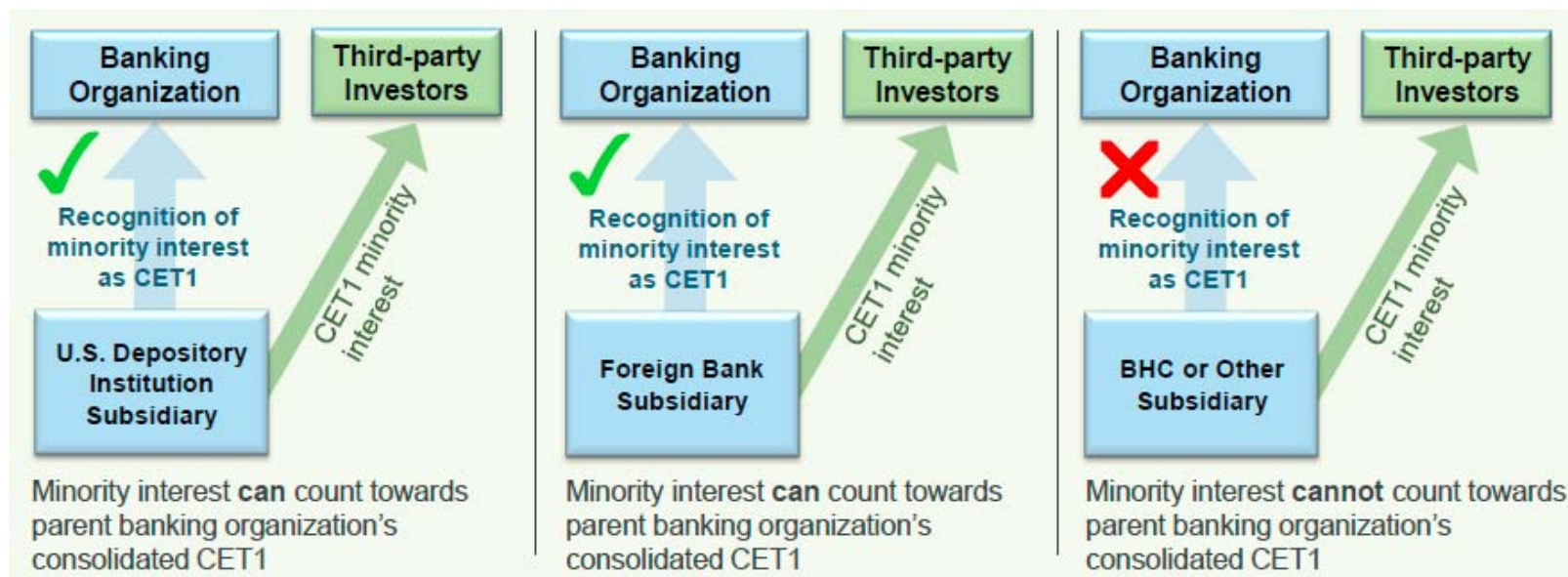
- ▶ **Quantitative Limit:** The amount of a subsidiary's surplus capital that is attributable to third-party investors cannot count towards the parent banking organization's consolidated regulatory capital.
 - Surplus = amount by which subsidiary's actual capital exceeds the subsidiary's minimum capital requirements + capital conservation buffer (or equivalent standards established by the subsidiary's home country supervisor).
 - If a subsidiary is not subject to capital adequacy standards "similar" to those of the parent banking organization, the parent banking organization must assume that the capital adequacy standards of the parent banking organization apply to the subsidiary.



Limited Recognition of Minority Interests

Under the U.S. Basel III minority interest rules, only Common Equity Tier 1 capital (CET1) issued by a U.S. depository institution or foreign bank subsidiary to third-party investors can count towards the parent banking organization's consolidated CET1 (subject to quantitative limit).

CET1 issued by any other type of consolidated subsidiary to third-party investors cannot count towards the parent banking organization's consolidated CET1, but can count towards the parent's consolidated Additional Tier 1 capital (subject to quantitative limit).





Regulatory Adjustments to and Deductions from Capital

- ▶ Most of the new regulatory deductions from and adjustments to capital apply to Common Equity Tier 1 capital.
- ▶ Purpose of such deductions and adjustments is to focus bank regulatory capital on tangible common equity.
- ▶ Deductions from Common Equity Tier 1 capital include, among other items:
 - Goodwill and other intangibles, other than mortgage servicing assets (MSAs), net of associated deferred tax liabilities (DTLs);
 - Deferred tax assets (DTAs) that arise from operating loss and tax credit carryforwards, net of associated DTLs; and
 - Defined benefit pension fund net assets, net of associated DTLs*

* IDIs are not required to deduct defined benefit pension fund net assets.



Regulatory Adjustments to and Deductions from Capital

- ▶ U.S. Basel III provides for limited recognition in Common Equity Tier 1 capital of the following items, subject to a 10% individual threshold and a 15% aggregate threshold based on a banking organization's Common Equity Tier 1 capital (after applying certain regulatory adjustments and deductions):
 - DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of any related valuation allowances and net of DTLs;
 - MSAs net of associated DTLs; and
 - Significant investments in unconsolidated financial institutions in the form of common stock, net of associated DTLs.
- ▶ As proposed, adjustments would have included unrealized gains and losses on AFS debt securities (i.e., recognition of AOCI)



AOCI Opt-out for Non-Advanced Approaches Banking Organizations

- ▶ AOCI includes unrealized gains and losses on available-for-sale (AFS) securities.

Existing Capital Rules

- ▶ Unrealized gains and losses on AFS debt securities are not included in regulatory capital, i.e., these unrealized gains and losses are filtered out of regulatory capital (AOCI filter).
- ▶ Unrealized losses on AFS equity securities are included in Tier 1 capital.
- ▶ Up to 45% of any unrealized gains on AFS equity securities are included in Tier 2 capital.



AOCI Opt-out for Non-Advanced Approaches Banking Organizations

Opt-Out Election for Non-Advanced Approaches Banking Organizations

- ▶ Non-advanced approaches banking organizations can make a one-time, permanent election to continue AOCI treatment under existing capital rules.
- ▶ Election must be made in first regulatory report after the banking organization becomes subject to the U.S. Basel III final rule.
- ▶ If a top-tier banking organization makes an AOCI opt-out election, any consolidated banking organization subsidiary must make the same AOCI opt-out election as the parent.

Advanced Approaches and Non-Opt-Out Banking Organizations

- ▶ Unrealized gains and losses on all AFS securities will flow through to Common Equity Tier 1 capital.



AOCI Opt-out Election: M&A Consequences

- ▶ In case of M&A transaction between two AOCI opt-out banks: surviving bank must continue with AOCI opt-out (unless it is an advanced approaches banking organization)
- ▶ In case of M&A transaction between two banks that have each not made an AOCI opt-out election: surviving bank may not make an AOCI opt-out election
- ▶ In case of M&A transaction between an AOCI opt-out bank and a bank that has not made an AOCI opt-out election: surviving bank must decide whether to make AOCI opt-out election by first regulatory reporting date following transaction
- ▶ Banking supervisory has discretion to allow new AOCI opt-out election in case of a transaction between an AOCI opt-out bank and a bank that has not made an AOCI opt-out election where the transaction did not involve all or substantially all of the assets or voting stock of acquired bank

AOCI Adjustments to Common Equity Tier 1 Capital

A banking organization that makes an AOCI **opt-out election** must adjust its Common Equity Tier 1 capital as follows:

+ Additions to CET1:	– Subtractions from CET1:
Any net unrealized losses on AFS securities	Any net unrealized gains on AFS securities
	Any unrealized loss on AFS preferred stock classified as an equity security under GAAP and equity exposures
Any accumulated net loss on cash-flow hedges	Any accumulated net gain on cash-flow hedges
	Any amounts recorded in AOCI attributed to defined benefit postretirement plans resulting from the initial and subsequent application of the relevant GAAP standards that pertain to such plans
Any net unrealized losses on held-to-maturity securities that are included in AOCI	Any net unrealized gains on held-to-maturity securities that are included in AOCI

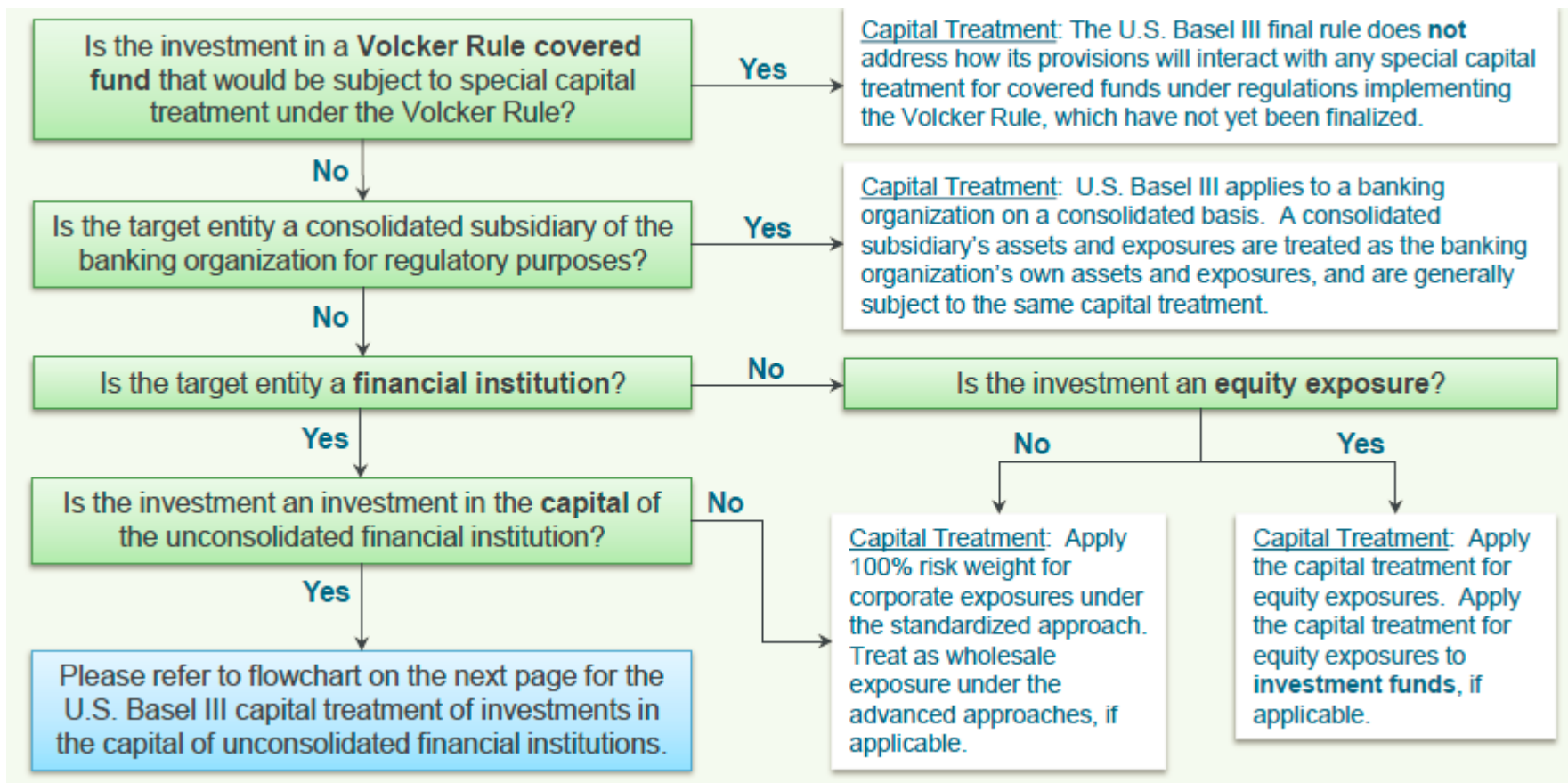
Tier 2 capital: A banking organization that makes an AOCI opt-out election may incorporate up to 45% of any net unrealized gains on AFS preferred stock classified as an equity security under GAAP and equity exposures into its Tier 2 capital

An **advanced approaches banking organization** and a banking organization that does **not opt-out** must adjust its Common Equity Tier 1 capital as follows, net of associated deferred tax effects:

+ Additions to CET1:	– Subtractions from CET1:
Any accumulated net loss on cash flow hedges included in AOCI that relate to the hedging of items that are not recognized at fair value on the balance sheet	Any accumulated net gain on cash flow hedges included in AOCI that relate to the hedging of items that are not recognized at fair value on the balance sheet

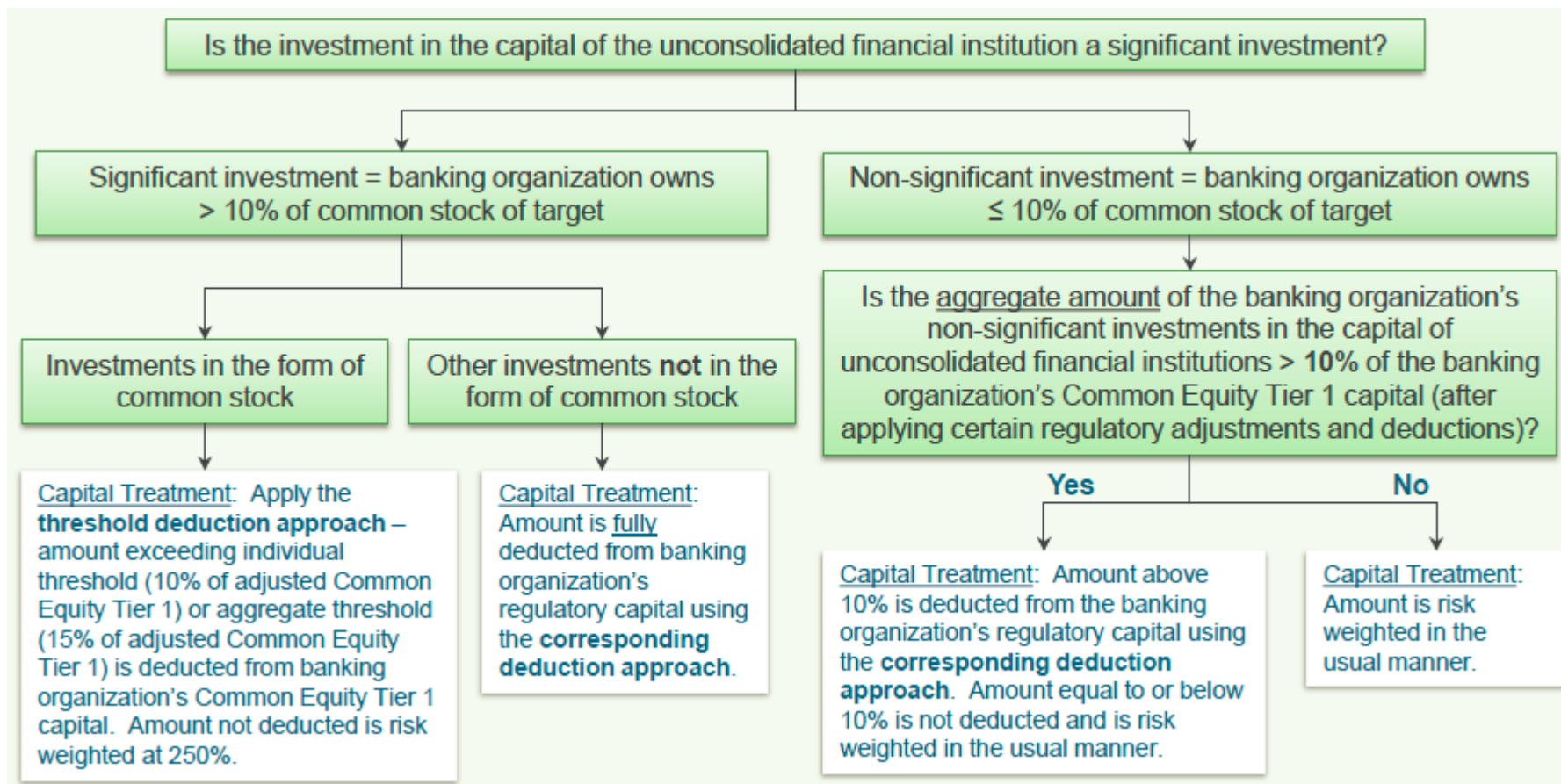
Flowchart: Capital Treatment of Investments in Entities

Terms in bold are defined later in this document. Flowchart assumes U.S. Basel III rules are fully phased in.



Flowchart: Capital Treatment of Investments in the Capital of Unconsolidated Financial Institutions


Terms in bold are defined later in this document. Flowchart assumes U.S. Basel III rules are fully phased in.



Capital Treatment of Investments in Entities: Key Definitions

Term	Definition
Capital of an unconsolidated financial institution	<ul style="list-style-type: none"> ▪ An investment in the capital of an unconsolidated financial institution means a net long position: <ul style="list-style-type: none"> ▪ in an instrument that is recognized as capital for regulatory purposes by the primary supervisor of an unconsolidated regulated financial institution; or ▪ in an instrument that is part of the GAAP equity of an unconsolidated unregulated financial institution. ▪ An investment in the capital of an unconsolidated financial institution includes direct, indirect, and synthetic exposures to such instruments, but excludes underwriting positions held by the banking organization for 5 business days or less. ▪ Indirect exposure means an exposure that arises from the banking organization's investment in an investment fund which holds investment in the capital of an unconsolidated financial institution.
Corresponding deduction approach	<ul style="list-style-type: none"> ▪ Under the corresponding deduction approach, a banking organization must make deductions from the component of capital (i.e., Common Equity Tier 1, Tier 1, Tier 2) for which the underlying instrument would qualify if it were issued by the banking organization itself.
Equity exposure	<ul style="list-style-type: none"> ▪ An equity exposure includes, among other things, a security or instrument (whether voting or non-voting) that represents a direct or an indirect ownership interest in, and is a residual claim on, the assets and income of an unconsolidated company, provided that the ownership interest is not a securitization exposure.

Capital Treatment of Investments in Entities: Key Definitions

Term	Definition
<p>Financial institutions</p> 	<ul style="list-style-type: none"> ▪ BHC, SLHC, nonbank SIFI, depository institution, foreign bank, credit union, industrial loan company, industrial bank, insurance company, securities holding company, SEC-registered broker-dealer, futures commission merchant, swap dealer, security-based swap dealer, designated financial market utility ▪ Any non-U.S. entity that is supervised and regulated in a manner similar to the entities described above ▪ Any other company of which the banking organization owns (A) an investment in GAAP equity instruments of the company with an adjusted carrying value or exposure amount \geq \$10 million; or (B) >10% of the company's issued and outstanding common shares (or similar equity interest), which is "predominantly engaged" (85% or more of consolidated annual gross revenues or consolidated total assets for either of two most recent calendar quarters) in any of the following activities: <ul style="list-style-type: none"> ▪ Lending money, securities or other financial instruments, including servicing loans; ▪ Insuring, guaranteeing, indemnifying against loss, harm, damage, illness, disability, or death, or issuing annuities; ▪ Underwriting, dealing in, making a market in, or investing as principal in securities or other financial instruments; or ▪ Asset management activities (not including investment or financial advisory activities). ▪ Any other company that the banking organization's primary federal banking regulator determines is a financial institution based on activities similar in scope, nature or operation to the entities described above <p>Exclusions</p> <ul style="list-style-type: none"> ▪ GSEs, small business investment companies, community development financial institutions, entities the investment in which would qualify as a community development investment, employee benefit plans ▪ Entities registered with the SEC under the Investment Company Act of 1940 or foreign equivalents ▪ Investment or financial advisers (whether they provide discretionary or non-discretionary advisory services)

Capital Treatment of Investments in Entities: Key Definitions

Term	Definition
Investment fund	<ul style="list-style-type: none"> ▪ A company (corporation, partnership, LLC, business trust, SPE, association or similar organization): <ul style="list-style-type: none"> (1) where all or substantially all of the assets of the company are financial assets; <i>and</i> (2) that has no material liabilities
Threshold deduction approach	<ul style="list-style-type: none"> ▪ The threshold deduction treatment provides for limited recognition as Common Equity Tier 1 capital of the following 3 items, subject to a 10% individual limit and a 15% aggregate limit based on the banking organization's Common Equity Tier 1 capital (after applying certain regulatory adjustments): <ul style="list-style-type: none"> ▪ DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of any related valuation allowances and net of DTLs; ▪ MSAs net of associated DTLs; and ▪ Significant investments in unconsolidated financial institutions in the form of common stock, net of associated DTLs. ▪ If an item exceeds the 10% individual limit, the excess is fully deducted from Common Equity Tier 1. If the 3 items combined (excluding amounts deducted after applying the individual 10% limit) exceeds the 15% aggregate limit, the excess is deducted from Common Equity Tier 1. ▪ The amount of the 3 items not deducted from Common Equity Tier 1 is risk weighted at 250%. ▪ DTAs that arise from temporary differences that a banking organization may realize through net operating loss carrybacks are not subject to the deduction thresholds and are subject to a 100% risk weight.

Capital Treatment of Investments in Entities: Key Definitions

Term	Definition
Volcker Rule covered fund	<ul style="list-style-type: none"> ▪ An entity that is a “covered fund” under regulations to implement the Volcker Rule. ▪ Subject to exceptions and a conformance period, the Volcker Rule prohibits banking entities from, among other things, investing in or sponsoring covered funds. Final regulations to implement the Volcker Rule have not yet been issued. ▪ Proposed Volcker Rule regulations include a broad definition of “covered fund” that captures hedge funds, private equity funds, commodity pools and other similar funds. ▪ Proposed capital treatment: Under proposed Volcker Rule regulations, an investment in a covered fund made pursuant to the asset management exception must be deducted from a banking entity’s Tier 1 capital. The proposed regulations do not require a capital deduction for an investment in a covered fund made pursuant to any other exception. ▪ In the U.S. Basel III proposals, the U.S. banking agencies indicated that any investment in a covered fund that is subject to special capital treatment under final Volcker Rule regulations would not also be subject to capital treatment under U.S. Basel III. ▪ This position is not expressly restated in the U.S. Basel III final rule. The preamble to the final rule merely states that the U.S. banking agencies intend to address any special capital treatment under the Volcker Rule “within the context of the agencies’ entire regulatory capital framework, so that its potential interaction with all other regulatory capital requirements can be fully assessed.” ▪ While the U.S. Basel III proposals expressly included Volcker Rule covered funds in the definition of financial institution, the U.S. Basel III final rule removes that reference. However, certain covered funds may still satisfy the “predominantly engaged” prong of the definition of “financial institution.”

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach
Cash	0%	0%
Exposures to, and portions of exposures that are directly and unconditionally guaranteed by, the U.S. government, its agencies and the Federal Reserve	0% <ul style="list-style-type: none"> This category includes the portion of a deposit or other exposure insured or otherwise unconditionally guaranteed by the FDIC or the National Credit Union Administration. 	0% <ul style="list-style-type: none"> This category includes the portion of a deposit or other exposure insured or otherwise unconditionally guaranteed by the FDIC or the National Credit Union Administration.
Portions of exposures that are <u>conditionally</u> guaranteed by the U.S. government, its agencies and the Federal Reserve	20% <ul style="list-style-type: none"> This category includes the portion of an exposure that is conditionally guaranteed by the FDIC or National Credit Union Administration. 	20% <ul style="list-style-type: none"> This category includes the portion of an exposure that is conditionally guaranteed by the FDIC or National Credit Union Administration.

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach																		
Exposures to foreign governments and their central banks	<ul style="list-style-type: none"> 0% for direct and unconditional claims on OECD governments 20% for conditional claims on OECD governments 100% for claims on non-OECD governments that entail some degree of transfer risk 	Risk weight depends on the sovereign's OECD Country Risk Classification (CRC) <table border="1"> <thead> <tr> <th>Sovereign CRC</th> <th>Risk Weight</th> </tr> </thead> <tbody> <tr> <td>0-1</td> <td>0%</td> </tr> <tr> <td>2</td> <td>20%</td> </tr> <tr> <td>3</td> <td>50%</td> </tr> <tr> <td>4-6</td> <td>100%</td> </tr> <tr> <td>7</td> <td>150%</td> </tr> <tr> <td>OECD Member with No CRC</td> <td>0%</td> </tr> <tr> <td>Non-OECD Member with No CRC</td> <td>100%</td> </tr> <tr> <td>Sovereign Default</td> <td>150%</td> </tr> </tbody> </table>	Sovereign CRC	Risk Weight	0-1	0%	2	20%	3	50%	4-6	100%	7	150%	OECD Member with No CRC	0%	Non-OECD Member with No CRC	100%	Sovereign Default	150%
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Sovereign Default	150%																			
Exposures to certain supranational entities and multilateral development banks (MDBs)	20%	0%																		
Exposures to U.S. government-sponsored entities (GSEs)	20%	20%																		

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach																																								
Exposures to U.S. public sector entities (PSEs), including U.S. states and municipalities	<ul style="list-style-type: none"> 20% for general obligations 50% for revenue obligations 	<ul style="list-style-type: none"> 20% for general obligations 50% for revenue obligations 																																								
Exposures to foreign PSEs	<ul style="list-style-type: none"> 20% for general obligations of states and political subdivisions of OECD countries 50% for revenue obligations of states and political subdivisions of OECD countries 100% for all obligations of states and political subdivisions of non-OECD countries 	<p>Risk weight depends on the home country's CRC</p> <table border="1"> <thead> <tr> <th colspan="3">Risk Weight for General Obligations</th> </tr> </thead> <tbody> <tr> <td rowspan="4">Sovereign CRC</td> <td>0-1</td> <td>20%</td> </tr> <tr> <td>2</td> <td>50%</td> </tr> <tr> <td>3</td> <td>100%</td> </tr> <tr> <td>4-7</td> <td>150%</td> </tr> <tr> <td colspan="2">OECD Member with No CRC</td> <td>20%</td> </tr> <tr> <td colspan="2">Non-OECD Member with No CRC</td> <td>100%</td> </tr> <tr> <td colspan="2">Sovereign Default</td> <td>150%</td> </tr> </tbody> </table> <table border="1"> <thead> <tr> <th colspan="3">Risk Weight for Revenue Obligations</th> </tr> </thead> <tbody> <tr> <td rowspan="3">Sovereign CRC</td> <td>0-1</td> <td>50%</td> </tr> <tr> <td>2-3</td> <td>100%</td> </tr> <tr> <td>4-7</td> <td>150%</td> </tr> <tr> <td colspan="2">OECD Member with No CRC</td> <td>50%</td> </tr> <tr> <td colspan="2">Non-OECD Member with No CRC</td> <td>100%</td> </tr> <tr> <td colspan="2">Sovereign Default</td> <td>150%</td> </tr> </tbody> </table>	Risk Weight for General Obligations			Sovereign CRC	0-1	20%	2	50%	3	100%	4-7	150%	OECD Member with No CRC		20%	Non-OECD Member with No CRC		100%	Sovereign Default		150%	Risk Weight for Revenue Obligations			Sovereign CRC	0-1	50%	2-3	100%	4-7	150%	OECD Member with No CRC		50%	Non-OECD Member with No CRC		100%	Sovereign Default		150%
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U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach																					
Exposures to U.S. depository institutions and credit unions	20%	20%																					
Exposures to foreign banks	<ul style="list-style-type: none"> 20% for claims on banks in OECD countries 20% for short-term claims on banks in non-OECD countries 100% for long-term claims on banks in non-OECD countries 	Risk weight depends on the home country's CRC <table border="1"> <thead> <tr> <th colspan="2"></th> <th>Risk Weight</th> </tr> </thead> <tbody> <tr> <td rowspan="4">Sovereign CRC</td> <td>0-1</td> <td>20%</td> </tr> <tr> <td>2</td> <td>50%</td> </tr> <tr> <td>3</td> <td>100%</td> </tr> <tr> <td>4-7</td> <td>150%</td> </tr> <tr> <td colspan="2">OECD Member with No CRC</td> <td>20%</td> </tr> <tr> <td colspan="2">Non-OECD Member with No CRC</td> <td>100%</td> </tr> <tr> <td colspan="2">Sovereign Default</td> <td>150%</td> </tr> </tbody> </table>			Risk Weight	Sovereign CRC	0-1	20%	2	50%	3	100%	4-7	150%	OECD Member with No CRC		20%	Non-OECD Member with No CRC		100%	Sovereign Default		150%
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OECD Member with No CRC		20%																					
Non-OECD Member with No CRC		100%																					
Sovereign Default		150%																					
Exposures to qualifying securities firms	20%	100%																					
Corporate exposures	100%	100%																					

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach
Retail exposures	100%	100%
Residential mortgage exposures	<ul style="list-style-type: none"> ▪ 50% for a first-lien residential mortgage exposure that is: <ul style="list-style-type: none"> ▪ secured by a property that is either owner-occupied or rented; ▪ made in accordance with prudent underwriting standards; ▪ not 90 days or more past due or carried in nonaccrual status; and ▪ not restructured or modified (unless modified or restructured solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program). ▪ 100% for all other residential mortgage exposures 	<ul style="list-style-type: none"> ▪ Retains existing capital treatment ▪ 50% for a first-lien residential mortgage exposure that is: <ul style="list-style-type: none"> ▪ secured by a property that is either owner-occupied or rented; ▪ made in accordance with prudent underwriting standards; ▪ not 90 days or more past due or carried in nonaccrual status; and ▪ not restructured or modified (unless modified or restructured solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program). ▪ 100% for all other residential mortgage exposures

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach
High-volatility commercial real estate (HVCRE) loans	100%	150% <ul style="list-style-type: none"> The definition of HVCRE only captures a specific subset of acquisition, development and construction loans; not all commercial real estate loans
Past due exposures	Risk weight of a loan generally does not change if the loan becomes past due, except for certain residential mortgage loans.	150% risk weight applies to the portion of an exposure that is not guaranteed or secured and that is not a sovereign exposure or a residential mortgage exposure if it is 90 days or more past due or on nonaccrual.
OTC derivatives	<ul style="list-style-type: none"> Risk weight depends on category of counterparty category (e.g., bank, securities firm or general corporation), subject to a 50% risk weight ceiling. Current Exposure Method (CEM): Exposure amount for a derivative is the sum of the current credit exposure (greater of zero and mark-to-market value) and potential future exposure (effective notional amount multiplied by a credit conversion factor based on the type of derivative and the remaining maturity). The CEM takes into account, to a limited extent, the effects of netting under qualifying master netting agreements. 	<ul style="list-style-type: none"> Removes the 50% risk weight ceiling for OTC derivatives. Retains the CEM Unlike the standardized approach under international Basel II, the U.S. Basel III standardized approach does not permit using the internal models methodology (IMM) to calculate exposure amount of derivatives. International Developments: The Basel Committee has proposed a non-internal model method to replace the CEM. The U.S. banking agencies may consider implementing this new method after it is finalized by the Basel Committee.

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach
Collateralized transactions, including derivatives and securities financing transactions	<ul style="list-style-type: none"> ▪ Simple approach: With respect to the portion of a transaction that is secured by eligible collateral, substitute risk weight associated with collateral for risk weight associated with the counterparty, sometimes subject to a 20% risk weight floor. 	<ul style="list-style-type: none"> ▪ Retains the simple approach subject to a general risk weight floor of 20% ▪ Collateral haircut approach: In determining the exposure amount of a securities financing transaction (referred to in the bank capital rules as "repo-style transactions"), eligible margin loan or collateralized derivative transaction, a banking organization may take into account the market value of eligible collateral securing such transaction, subject to supervisory or own estimates of haircuts. ▪ Collateral haircut approach also takes into account qualifying master netting agreements.
Cleared derivatives and securities financing transactions	<ul style="list-style-type: none"> ▪ No separate capital framework for cleared transactions ▪ Exchange-traded derivative contracts requiring daily margining effectively assigned a 0% risk weight ▪ Risk weight otherwise depends on the counterparty category (e.g., bank, securities firm or general corporation) to which the central counterparty belongs 	<ul style="list-style-type: none"> ▪ Contains a new capital framework for cleared derivative and securities financing transactions, which is broadly based on the Basel Committee's July 2012 interim framework. ▪ Provides preferential capital treatment for cleared transactions (as compared to requirements for non-cleared transactions) with qualifying central counterparties (CCPs): 2% or 4% risk weight for trade exposures to qualifying CCPs (QCCPs) ▪ Requires a clearing member to calculate a capital charge for its default fund contributions to the CCP ▪ International Developments: The Basel Committee has proposed further revisions to the cleared transactions framework

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach
Securitization exposures	<ul style="list-style-type: none"> ▪ Ratings-based approach: Risk weight depends on the external credit rating assigned to the securitization exposure ▪ Gross-up approach: RWA amount is calculated using the risk weight of the underlying assets amount of the position and the full amount of the assets supported by the position 	<ul style="list-style-type: none"> ▪ General 20% risk weight floor for securitization exposures ▪ Retains the gross-up approach ▪ Replaces the ratings-based approach with the simplified supervisory formula approach (SSFA) ▪ The SSFA takes into account, among other things, the risk weight applicable to the underlying exposures, the relative position of the securitization exposure in the structure and measures of delinquency and loss on the securitized assets. Under the SSFA, certain junior tranches may be assigned a risk weight of 1,250%. ▪ Due diligence requirement: A banking organization is required to demonstrate, to the satisfaction of its primary federal banking regulator, a comprehensive understanding of the features of a securitization exposure that would materially affect its performance. Failure to satisfy this requirement will result in a 1,250% risk weight for the securitization exposure. ▪ International developments: The Basel Committee has proposed revisions to the capital framework for securitization exposures.

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach
Equity exposures	<ul style="list-style-type: none"> Deduct a portion of non-financial equity investments from Tier 1 capital, based on the aggregate adjusted carrying value of all non-financial equity investments held directly or indirectly by the banking organization as a percentage of its Tier 1 capital. Equity exposures that are not deducted generally attract a 100% risk weight. 	<ul style="list-style-type: none"> 0%: Equity exposures to a sovereign, certain supranational entities or an MDB whose debt exposures are eligible for 0% risk weight 20%: Equity exposures to a PSE 100%: Equity exposures to community development investments and small business investment companies, effective portion of a hedge pair and non-significant equity investments 250%: Significant investments in the capital of unconsolidated financial institutions that are not deducted from capital 300%: Publicly-traded equity exposures, including the ineffective portion of a hedge pair 400%: Non-publicly traded equity exposures 600%: Equity exposures to certain investment firms that would otherwise meet the definition of "traditional securitization" and have greater than immaterial leverage

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach
Equity exposures to investment funds	<ul style="list-style-type: none"> ▪ General approach: Risk weight is the same as the highest risk weight investment the fund is permitted to hold ▪ Optional approach: May assign risk weights pro rata according to the investment limits in the fund's prospectus. If the sum of the investment limits in the fund's prospectus exceeds 100%, risk weights must be assigned in descending order ▪ 20% risk weight floor for equity exposures to investment funds ▪ If a fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weight assigned to the fund's assets, then equity exposures to the fund are assigned a 100% risk weight. 	<ul style="list-style-type: none"> ▪ Full look-through approach: Aggregate RWA amount of the exposures held by the fund (as if held directly by the banking organization) multiplied by the banking organization's proportional ownership share of the fund ▪ Simple modified look-through approach: Multiply the banking organization's exposure by the risk weight of the highest risk weight asset in the fund. Derivatives held by the fund that are used for hedging and that do not constitute a material portion of the fund's exposures may be excluded. ▪ Alternative modified look-through approach: Assign risk weight on a pro rata basis according to the investment limits in the fund's prospectus. If the sum of the investment limits in the fund's prospectus exceeds 100%, risk weights must be assigned in descending order. Derivatives held by the fund that are used for hedging and that do not constitute a material portion of the fund's exposures may be excluded. ▪ 20% risk weight floor for equity exposures to investment funds ▪ International developments: The Basel Committee has proposed revisions to the capital framework for equity exposures to investment funds

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach										
Unsettled transactions (excludes: (1) cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin; (2) repo-style transactions; (3) one-way cash payments on OTC derivative contracts; or (4) transactions with a contractual settlement period that is longer than the normal settlement period, which is defined as the lesser of market standard or 5 business days)	No specific capital treatment	Delivery-versus-payment (DvP) and payment-versus-payment (PvP) transactions <ul style="list-style-type: none"> ≥ 5 business days past settlement date: RWA = positive current exposure x risk weight <table border="1" data-bbox="1060 678 1816 852"> <thead> <tr> <th>Business days after settlement date</th> <th>Risk Weight</th> </tr> </thead> <tbody> <tr> <td>From 5 to 15</td> <td>100%</td> </tr> <tr> <td>From 16 to 30</td> <td>625%</td> </tr> <tr> <td>From 31 to 45</td> <td>937.5%</td> </tr> <tr> <td>46 or more</td> <td>1,250%</td> </tr> </tbody> </table> Non-DvP and non-PvP transactions <ul style="list-style-type: none"> ≤ 5 business days past the settlement date: RWA = current fair value of deliverables owed x risk weight applicable to counterparty > 5 business days past the settlement date: RWA = current fair value of deliverables owed x 1,250% risk weight 	Business days after settlement date	Risk Weight	From 5 to 15	100%	From 16 to 30	625%	From 31 to 45	937.5%	46 or more	1,250%
Business days after settlement date	Risk Weight											
From 5 to 15	100%											
From 16 to 30	625%											
From 31 to 45	937.5%											
46 or more	1,250%											
Default risk weight for items not specifically assigned to a risk weight category	100%	100%										

U.S. Basel III Standardized Risk Weights for Credit Risk: Comparison with Existing Basel I Risk Weights

Type of Exposure	Basel I	U.S. Basel III Standardized Approach
Conversion factors for off-balance sheet items	<ul style="list-style-type: none"> 0% for the unused portion of a commitment with an original maturity of one year or less, or which is unconditionally cancellable at any time 10% for unused portion of an eligible asset-backed commercial paper liquidity facility with an original maturity of one year or less 20% for self-liquidating, trade-related contingent items 50% for the unused portion of a commitment with an original maturity of more than one year that is not unconditionally cancellable 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit) 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit and forward agreements 	<ul style="list-style-type: none"> 0% for the unused portion of a commitment that is unconditionally cancellable by the banking organization 20% for the amount of a commitment with an original maturity of one year or less that is not unconditionally cancellable by the banking organization 20% for self-liquidating trade-related contingent items, with an original maturity of one year or less 50% for the amount of a commitment with an original maturity of more than one year that is not unconditionally cancellable by the banking organization 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit) 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, credit-enhancing representations and warranties that are not securitization exposures, financial standby letters of credit and forward agreements