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Bank Investment in Other Bank Debt and Capital Securities - Summary of Important Basel III, Small BHC, and TLAC Changes

A number of recent legislative and regulatory changes have significantly affected the treatment of bank investment in other bank debt and capital securities. The most significant changes include the following:

- Increase in the amount of investment in the capital of Unconsolidated Financial Institutions (UFIs) from 10% to 25% of CET1 adjusted for regulatory adjustments and deductions (adjusted CET1) (Stage 1 Cap);
- Elimination of the current 15% Stage 2 Cap in the amount of investment in the capital of UFIs;
- Simplification in the framework to determine the capital deduction and risk weighting for investment in UFIs from using "significant vs. non-significant investment" to using "debt investment vs. equity investment";
- Increase in small BHC size from $1 to $3 billion in assets for the Small Bank Holding Company Policy Statement that exempts BHCs below $3 billion from compliance with Basel III; and
- Elimination of the TLAC deduction for bank investment in global systemically important bank (GSIB) debt otherwise known as the Total Loss Absorbing Capacity (TLAC) capital deduction.

Taken together, these changes have significantly increased the amount of investment in capital issued by UFIs that banks can make without a capital deduction while simplifying the capital treatment for such investment.

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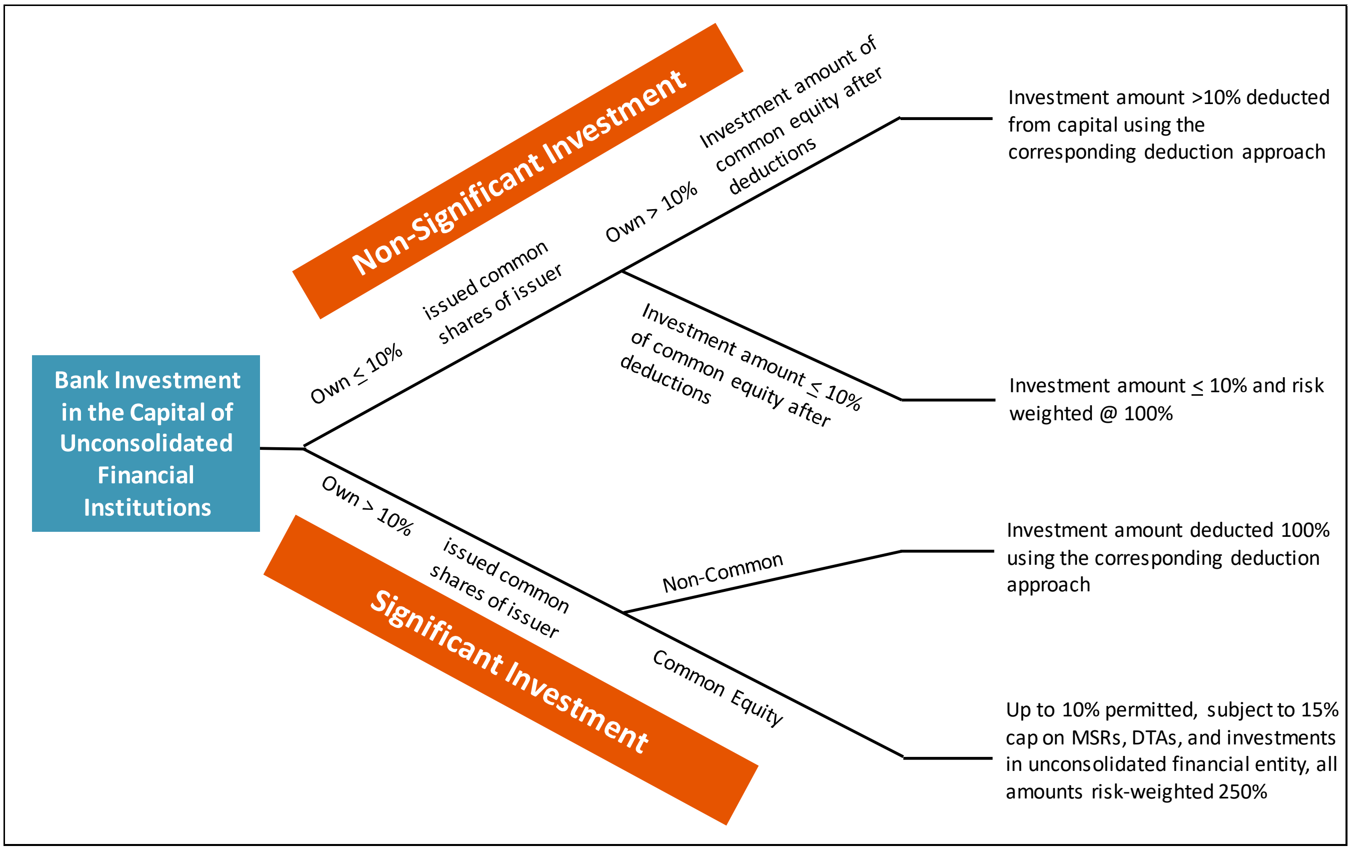
Banks also face a penalty for investment in long-term debt issued by insured depository institutions above 3% of the investing bank's tier 1 capital. This depository institution debt adjustment (DIDA) increases risk assessments by 50 basis points for the amount of investment in the long term debt issued by other insured depository institutions to the extent such investment exceeds 3% of the investing bank's tier 1 capital.

Chart A: Basel III Decision Framework Before Basel III Simplification

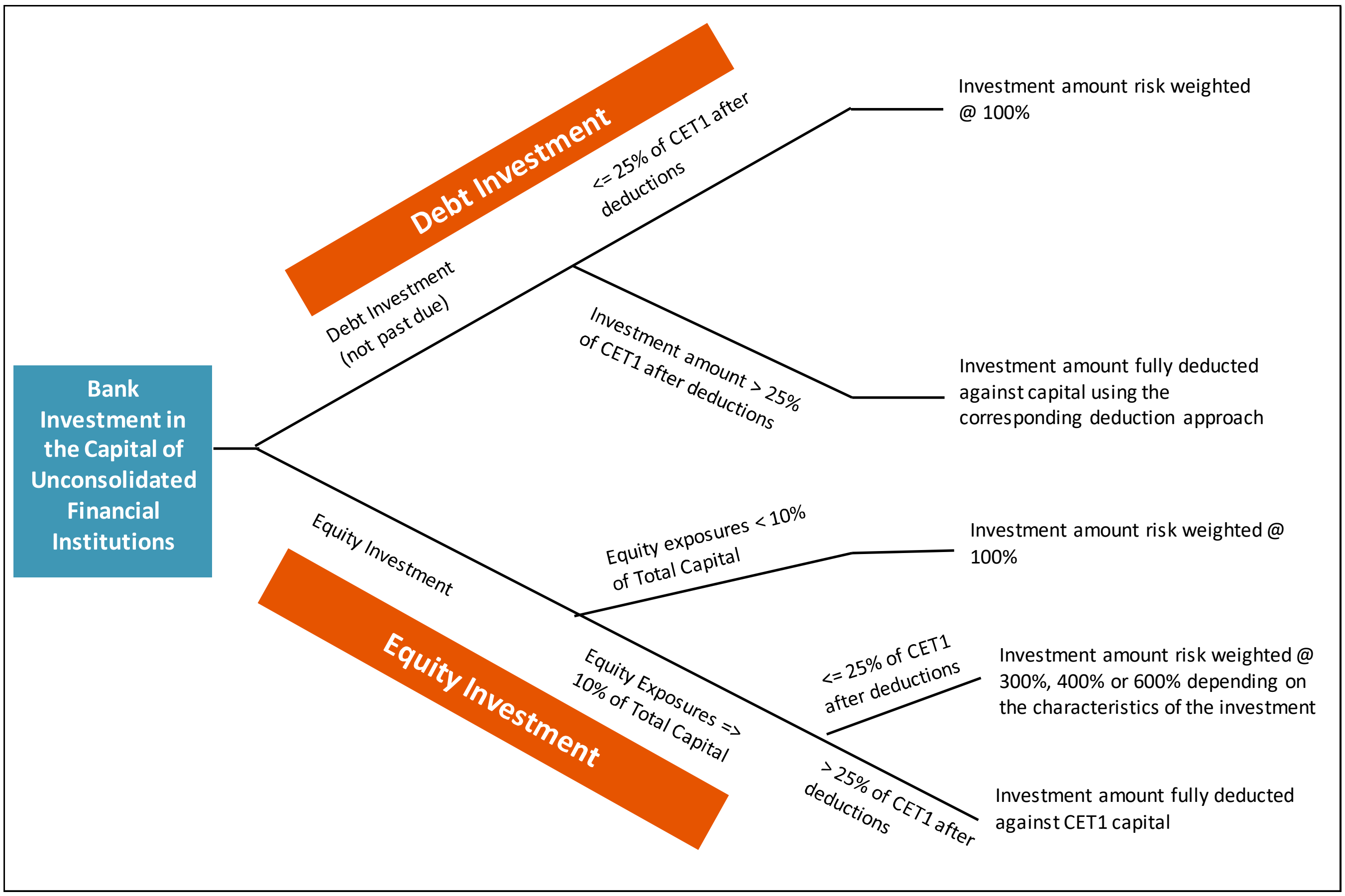


As highlighted above in Chart A, the original Basel III rules required banking organizations to determine if: (i) the UFI investment was significant or non-significant and (ii) the investment amount was greater than 10% of adjusted CET1, and then apply the corresponding deduction approach to deduct any amounts greater than 10% of adjusted CET1 from the banking organization's regulatory capital. Note that for non-significant investments where the investment amount was 10% or less of the bank's adjusted CET1, the risk weighting would be 100%. For significant investments, non-common investments are deducted 100% using the corresponding deduction approach while equity investments of up to 10% of adjusted CET1 are permitted with a risk-weighting of 250%.

On January 1, 2020, the Basel III Simplication Final Rule became effective, which divided measurement of investment in UFIs into "debt and equity investments" rather than "significant or non-significant investments".

Chart B below shows that debt UFI amounts that are less than or equal to 25% of a banking organization's adjusted CET1 will be risk weighted at 100%. Debt UFI amounts greater than 25% of adjusted CET1 will be deducted against bank capital using the corresponding deduction approach. Equity UFI amounts less than 25% of adjusted CET1 will be risk-weighted based on the characteristics of the underlying equity security at either 100%, 250%, 300% for public company stocks, 400% for private company stocks, or 600% for equity UFI amounts greater than 25% of adjusted CET1.

Chart B: Basel III Decision Framework AFTER Basel III Simplification (Q1 2020)



Overall, with debt investments permitted for up to 25% of adjusted CET1, non-Advanced Approaches Banks will have much more flexibility to add UFI investments. Large equity investments of over 25% of adjusted CET1 will be fully deducted while equity exposures of 25% or less of adjusted CET1 will be risk-weighted based on the characteristics of the underlying equity security.

In addition to these potential capital deductions or changes in risk weighting for investment in the capital securities issued by UFIs, there is also a penalty for investment in long-term debt issued by insured depository institutions above 3% of the issuing bank's tier 1 capital. The

DIDA increases risk assessments by 50 basis points for the amount of investment in the long-term debt issued by other insured depository institutions to the extent such investment exceeds 3% of the investing bank's tier 1 capital.

As illustrated in Chart C below, the excess investment amount of $88 million x 50 BP = $440,000 penalty. This penalty is paid through an increase in the bank's FDIC assessment rate from 14 BP to 14.96 BP.

Chart C - Depository Institution Debt Adjustment (DIDA)

Average total assets	**5,000,000,000**
Brokered Deposits	**1,000,000,000**
Domestic Deposits	**3,500,000,000**
Tangible equity (including qualifying tier 1)	**400,000,000**
Current FDIC Assessment Rate (Category II)	**0.14%**
Issuance of Qualifying LT Senior unsecured and subordinated debt	**100,000,000**
Investments in Issuance of Qualifying LT Senior unsecured and subordinated debt not currently subject to DIDA	**100,000,000**

Cost of DIDA adjustment of $440,000

50 BP penalty on investment in other bank debt

Depository Institution Debt Adjustment (DIDA):	
LT senior unsecured debt	100,000,000
3% of Tier 1 Capital	12,000,000
Amount of LT IDI debt > 3% Limit	88,000,000
DIDA adjustment factor	0.500%

88,000,000	x	0.5000%
	/	4,600,000,000
DIDA adjustment		**0.0096%**

DIDA Adjustment increases FDIC risk assessments

Adjusted Average Total Assets	5,000,000,000
Tangible equity (including qualifying tier 1)	400,000,000
Current FDIC Assessment Base	4,600,000,000
Current FDIC Assessment Rate	0.1400%
Plus: Depository Institution Debt Adjustment	0.0096%
Revised FDIC Assessment Rate	**0.1496%**
Revised FDIC Risk Assessment Premiums	6,880,000
Savings/(Expense) After DIDA	**(440,000)**

For more information on the calculation methodology for FDIC risk assessments for small, large and highly complex banking organizations, see https://www.fdic.gov/deposit/insurance/calculator.html

In summary, as highlighted below in Chart D, bank investments in capital issued by UFIs are subject to Basel III capital deductions and banks' purchases of debt issued by insured depository institutions are subject to DIDA increases to the purchasing bank's FDIC risk assessments. The Basel III Simplification, effective January 1, 2020, significantly increased the amount of investment that banks can make without a capital deduction and simplified the framework for determining the amount of deduction or change in risk weighting. The DIDA is equal to 50 BP times the amount of investment greater than 3% of the investing bank's tier 1 capital. This amount is divided by the current FDIC assessment rate to determine the revised FDIC assessment rate. The summary grid provides a useful reference tool for these distinctions.

Chart D - Summary of Bank Investment in Other Bank Debt and Capital Securities

Consideration	Basel III Capital Deductions	FDIC Depository Institution Debt Adjustment (DIDA)
Investment Type	Capital Instruments Including: Trust Preferred Sub Debt Preferred Stock Common Stock	Long Term Debt
Issuance By	Financial Institutions (1)	U.S. Banks
Investment By	U.S. Banks U.S. BHCs >= $3 B	U.S. Banks(2)
Constraint	Total inv. amt. > 25% CET1	Inv. amt. > 3% Tier 1
Impact	Deduction from regulatory capital using the corresponding deduction approach for amt. > 25%	50 BP increase in FDIC risk assessments for the amount > 3%
Start Date Full Phase-in Date	1-Jan-20 1-Jan-20	1-Apr-11 1-Apr-11

(1) Financial institutions include those businesses primarily engaged (85% or more in the assets or revenues) in banking, insurance, investing and trading as per Basel III.
(2) Bank holding companies can invest in long-term debt issued by banks without the DID premium.

To reference the Basel III Simplification Final Rules please see:
https://www.govinfo.gov/content/pkg/FR-2019-07-22/pdf/2019-15131.pdf

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He represented Sandler O'Neill in conferences with the Federal Financial Institutions Examinations Council, the Federal Reserve, and the Federal Deposit Insurance Corporation among others to discuss capital structure, CECL, Dodd-Frank and Basel III related issues. His articles have appeared in Bank Accounting and Finance, U.S. Banker and Modern Bankers, a publication of the Peoples Bank of China. Mr. Killian holds a Bachelor of Science from the University of North Carolina at Chapel Hill, where he was a John Motley Morehead Merit Scholar, and a Masters in Business Administration from Northwestern University's J.L. Kellogg Graduate School of Management.

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