DATE: November 7, 2006

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

SUBJECT: Notice of Proposed Rulemaking Regarding *Risk-Based Capital Guidelines; Capital Maintenance: Domestic Capital Modifications*

Proposal: That the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approve the publication of the attached Notice of Proposed Rulemaking regarding *Risk-Based Capital Guidelines; Capital Maintenance: Domestic Capital Modifications* (NPR) in the Federal Register for a 90-day comment period. The NPR would be issued on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (collectively, the Agencies). In the NPR, the Agencies request comment on various revisions to the existing framework for calculating risk-based capital requirements for U.S. banking organizations. A banking organization would be able to elect to adopt these proposed revisions or remain subject to the existing risk-based capital rules.

The Agencies are proposing to expand the number of risk-weight categories, allow the use of external credit ratings to risk weight certain exposures, expand the range of recognized collateral and eligible guarantors, use loan-to-value ratios to risk weight residential mortgages, increase the credit conversion factor on short-term commitments, and assess a charge for early amortizations in securitizations of revolving exposures.

The Agencies have developed a series of questions to elicit comment on whether this NPR should be broadened in scope and modified to apply to Basel II banking organizations

Recommendation: That the Board approve publication of the NPR for comment.

Concur:

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Douglas H. Jones
Acting General Counsel

I. Introduction

The FDIC Board of Directors is being asked to approve for publication in the Federal Register the attached interagency NPR seeking comment on various modifications to the existing capital rules to enhance risk sensitivity without unduly increasing regulatory burden.

On October 20, 2005, the Agencies issued an Advance Notice of Proposed Rulemaking (ANPR) soliciting public comment on possible revisions to U.S. risk-based capital rules that would apply to non-Basel II banking organizations. The proposals in this NPR are based on the approaches discussed in the ANPR and take into consideration the public comments that the Agencies received on the ANPR.

In the development of the ANPR, the Agencies were guided by five general principles in the discussion of potential revisions to the existing rules. Specifically, a revised framework should (1) promote safe and sound banking practices, (2) maintain a reasonable balance between risk sensitivity and operational feasibility, (3) avoid undue regulatory burden, (4) encourage appropriate incentives and risk reduction techniques, and (5) minimize differences in capital requirements that may give rise to competitive imbalances between large and small banking organizations.

The Agencies focused their discussion in the ANPR to exposures that were believed to be common to the vast majority of the almost 9,000 banking organizations operating in the United States. On a larger scale, the Agencies discussed an expansion of the existing risk-bucket system as a way of developing a more robust means of calculating risk-weighted capital for credit risk. In addition, the Agencies discussed providing banking organizations with greater incentives for mitigating credit risk through the recognition of a broader array of collateral types and independent third-party guarantees.

In the ANPR, the Agencies also discussed various revisions to the existing capital treatment of specific asset classes, such as residential mortgage loans, externally rated loans and securities, small business loans, and commercial real estate, and sought comment on a range of other exposures that will enable the Agencies to develop well-constructed proposals based on relevant risk factors common to a particular business line, exposure, or bank activity. Finally, the Agencies discussed new and revised capital requirements on defaulted assets, certain types of short-term commitments, and securitizations of revolving exposures with early amortization features to remedy shortcomings in our present capital framework.

Together, the Agencies received 73 public comments from banking, trade, and other organizations and individuals concerning the issues discussed in the ANPR. Generally, most commenters supported the Agencies' goal to make the risk-based capital rules more risk-sensitive. Commenters generally favored increased risk sensitivity, but stated that many of the proposed revisions should be optional so that banking organizations may weigh the costs and benefits of using the revisions. Some commenters suggested that the U.S. risk-based capital rules should allow banking organizations to use internal assessments of risk to determine their capital requirements. A few commenters endorsed a proposal for a four-tier capital framework that would apply different approaches to banking organizations based on size, complexity, and robustness of their internal ratings systems. Their proposal included an approach that would permit some banking organizations to use their internal rating-based systems.

Most smaller and midsize banking organizations generally asked that any changes to the existing capital rules should be simple and not require large data gathering and monitoring expenses. A number of the smallest banking organizations said that they do not wish to have any changes in the capital rules to apply to them. They noted that they already hold more regulatory capital than the Agencies' risk-based capital rules require and, therefore, amending the rules would have little or no effect.

II. Proposed Modification to the Risk-Based Capital Rules

After consideration of the comments received, the Agencies developed this NPR, which sets forth a number of proposals that should improve the risk sensitivity of the existing risk-based capital rules without unduly increasing regulatory burden.

Opt-In/Opt-Out. The proposed rule would apply to banks, bank holding companies, and savings associations (banking organizations). A banking organization would be able to elect to adopt the revisions to the risk-based capital framework contained in the proposed rule or remain subject to the Agencies' existing risk-based capital rules, unless they are required to use the risk-based capital framework proposed in the Basel II NPR. A banking organization that chooses to adopt the proposed rules would be required to apply all the proposed changes included in the NPR.

Risk Weights. The proposed rule would increase the number of risk-weight categories to which credit exposures may be assigned, specifically by adding risk weights of 35, 75, and 150 percent.

Externally-Rated Exposures. The proposed rule would expand the use of external credit ratings to risk weight most categories of externally-rated exposures, including sovereign and corporate debt securities and rated loans. However, the proposed rule retains the existing risk-based capital treatment for U.S. government and agency exposures, U.S. government-sponsored entity exposures, municipal obligations, and loans that are not externally rated.

A banking organization would risk weight externally-rated exposures, other than those that retain the current risk-based capital treatment, according to Table 1.

Table 1

Proposed Risk Weights Based on External Ratings for Long-Term Exposures

Long-Term Rating Category	Example	Sovereign Risk Weight	Non-Sovereign Risk Weight	Securitization Exposure* Risk Weight
Highest investment grade rating	AAA	0%	20%	20%
Second-highest investment grade rating	AA	20%	20%	20%
Third-highest investment grade rating	A	20%	35%	35%
Lowest investment grade rating – plus	BBB+	35%	50%	50%

Lowest investment grade rating – naught	BBB	50%	75%	75%
Lowest investment grade rating – negative	BBB-	75%	100%	100%
One category below investment grade – plus & naught	BB+, BB	75%	150%	200%
One category below investment grade - negative	BB-	100%	200%	200%
Two or more categories below investment grade	B, CCC	150%	200%	*
Unrated (excludes unrated loans to non-sovereigns)**	n/a	200%	200%	*

* A securitization exposure includes asset- and mortgage-backed securities, recourse obligations, direct credit substitutes, and residuals (other than a credit-enhancing interest-only strip). For securitization exposures that are externally rated more than one category below investment grade or are unrated, the existing risk-based capital treatment would be used. See 12 CFR part 3, appendix A, section 4 (OCC); 12 CFR parts 208 and 225, appendix A, section III.B.3 (Board); 12 CFR part 325, appendix A, section II.B.5 (FDIC); and 12 CFR 567 (OTS).
** Unrated loans to non-sovereigns would continue to be risk weighted under the existing risk-based capital rules.

Recognized Collateral. The proposed rule would expand the range of recognized collateral to include a broader array of externally-rated, liquid, and readily marketable financial instruments. The revised list would incorporate long- and short-term debt securities, including asset and mortgage-backed securities that are:

1. Issued or guaranteed by a sovereign entity including its agencies or ministries (sovereign) where either the sovereign or the debt security is externally rated investment grade or higher; or
2. Issued by non-sovereign entities including multilateral lending institutions and regional development banks, bank and savings and loan holding companies, securities firms, insurance companies, and corporations where the debt security is externally rated investment grade or higher.

Eligible Guarantors. The proposed rule would expand the range of eligible guarantors by recognizing entities that have a long-term senior debt (without credit enhancement) rated at least investment grade by a nationally recognized statistical rating organization or, in the case of sovereign, an issuer rating that is at least investment grade. To ensure that the benefits of the guarantee are fully realizable by the banking organization, the Agencies have established certain additional criteria that must be met before a guarantee may be recognized. For example, the guarantee must be written, unconditional, legally enforceable, and cover all or a pro rata portion of contractual payments of the obligor.

First Lien One-to-Four Family Residential Mortgages. The proposed rule would allow the use of loan-to-value ratios to risk weight first-lien one-to-four family residential mortgages. For purposes of determining the loan-to-value ratio, a banking organization would be allowed to take into consideration loan-level private mortgage insurance purchased from an insurer that is not affiliated with the banking organization and that has a long-term debt rating within the top three external rating categories (that is, A- or better). The mortgages would be risk weighted in accordance with Table 2.

Table 2

Proposed LTVs and Risk Weights for One-to-Four Family First Liens

Loan-to-Value Ratio	Risk Weight
60% or less	20%
Greater than 60% and less than or equal to 80%	35%
Greater than 80% and less than or equal to 85%	50%
Greater than 85% and less than or equal to 90%	75%
Greater than 90% and less than or equal to 95%	100%
Greater than 95%	150%

Non-Traditional Mortgages. The proposed rule would not distinguish between "traditional" and "non-traditional" mortgages given the difficulty in providing a clear and consistent definition of higher-risk mortgage loans with non-traditional features. However, the proposed rule recognizes that loans with a negative amortization feature pose additional risks to a banking organization in the form of an unfunded commitment. Therefore, the NPR proposes to risk weight mortgage loans with negative amortization features consistent with the risk-based capital treatment for other assets with unfunded commitments (for example, lines of credit). Under the proposed approach, the unfunded maximum negative amortization amount would be risk weighted separately from the funded amount of the loan.

Junior-Lien One-to-Four Family Residential Mortgages. The proposed rule requires a banking organization that holds both the first and junior lien mortgages (including home equity lines of credit, or "HELOCs") on a one-to-four family residential property, where there is no intervening lien, to assign the combined loans to the appropriate risk-weight category in Table 2 above, based on the loans' combined LTV. For a stand-alone junior-lien mortgage, the proposed rule requires a banking organization to use the combined LTV of that loan and all senior loans to determine the appropriate risk weight for the junior lien. Using the combined LTV, banking organizations would risk weight the stand-alone junior lien based on Table 3. In addition, the proposed rule also requires a banking organization to hold risk-based capital against any unfunded portion of a HELOC by applying the appropriate credit conversion factor (CCF) and risk weight to the unfunded portion appropriate for the combined LTV.

Table 3

Proposed LTVs and Risk Weights for One-to-Four Family Junior Liens

Combined Loan to Value Ratio	**Risk Weight**
60% or less	75%
Greater than 60% and less than or equal to 90%	100%
Greater than 90%	150%

Short-Term Commitments. The proposed rule increases the credit conversion factor (CCF) for various commitments with an original maturity of one year or less. Under the proposed rule, short-term commitments are assigned a 10 percent CCF. The resulting credit equivalent amount would then be risk weighted according to the rating of the facility or the underlying asset(s) or the obligor, after considering any applicable collateral and guarantees. However, commitments that are unconditionally cancelable would retain a 0 percent CCF.

Early Amortization. The proposed rule would assess a risk-based capital charge for securitizations of revolving exposures with early-amortization features. Early amortization provisions in securitizations increase the likelihood that investors will be repaid before being subject to any risk of significant credit losses. These provisions raise two concerns: (1) the subordination of the seller's interest in the securitized assets during early amortization to the payment allocation formula, and (2) an early amortization event can increase a banking organization's capital and liquidity needs if new draws on the revolving credit facilities would need to be financed using on-balance sheet sources of funding. The early amortization capital charge would be assessed against the off-balance sheet investors' interest and would be imposed only in the event that the excess spread has declined to a predetermined level as reflected in Table 4. The capital required would increase as the level of excess spread approaches the early amortization trigger.

Table 4

Early Amortization Credit Conversion Factors

Excess Spread Trapping Point Ratio	**CCF**
133.33 percent of trapping point or more	0 %
Less than 133.33 percent to 100 percent of trapping point	5 %
Less than 100 percent to 75 percent of trapping point	15 %
Less than 75 percent to 50 percent of trapping point	50 %
Less than 50 percent of trapping point	100 %

Removal of Risk-Weight Limits on Certain Derivative Transactions. The proposed rule would remove the 50 percent risk-weight limit that applies to certain derivative contracts. In this proposed rule, the risk weight assigned to the credit equivalent amount of a derivative contract would be the risk weight assigned to the counterparty after consideration of any collateral or guarantees.

III. Other Issues Discussed in the NPR

Use of Credit Scores to Assign Risk Weights. The Agencies continue to evaluate approaches that would consider borrower creditworthiness in risk weighting first-lien and junior-lien mortgages. One such approach would use LTVs and a measure of borrower creditworthiness, such as credit scores, to assign risk weights through the use of a matrix similar to those shown in Tables 5 and 6 below. The effect of these tables would be to assign a lower risk weight to mortgages with lower LTVs that are underwritten to borrowers with a stronger credit history; and a higher risk weight to mortgages with higher LTVs that are underwritten to borrowers with weaker a credit history.

Table 5

Illustrative Risk-Weight Ranges for LTVs and Credit History for One-to-Four Family First Liens

First-Lien Mortgages	**Illustrative Risk-Weight Ranges**		
Loan-to-Value Ratio	**Credit History Group 1**	**Credit History Group 2**	**Credit History Group 3**
60% or less	20%-35%	20%-35%	20%-35%
Greater than 60% and less than or equal to 80%	20%-35%	20%-35%	35%-75%
Greater than 80% and less than or equal to 90%	20%-50%	35%-75%	75%-150%
Greater than 90% and less than or equal to 95%	20%-50%	50%-100%	100%-200%
Greater than 95%	35%-75%	50%-100%	150%-200%

Table 6

Illustrative Risk-Weight Ranges for LTVs and Credit History for Junior-Lien One-to-Four Family Mortgages

Junior Liens/HELOCs	**Illustrative Risk-Weight Ranges**		
Loan-to-Value Ratio	**Credit History Group 1**	**Credit History Group 2**	**Credit History Group 3**
60% or less	20% -50%	75% - 150%	150%-200%
Greater than 60% and less than or equal to 80%	35% - 50%	75% - 150%	150%-200%
Greater than 80% and less than or equal to 90%	35% - 75%	75% - 200%	200%
Greater than 90% and less than or equal to 95%	35% - 75%	75% - 200%	200%
Greater than 95%	35% - 75%	75% - 200%	200%

Small Loans to Businesses. The Agencies are not making a specific proposal in this NPR, but they are, however, seeking further comment on permitting certain small loans to businesses that meet certain criteria to qualify for a 75 percent risk weight. The Agencies believe that the application of the 75 percent risk weight on loans to businesses should be limited to those where the banking organization's consolidated business credit exposure to the individual or company is $1 million or less. Further, the Agencies believe that to qualify for the lower risk weight, these loans should: be personally guaranteed by the owner, or owners, of the business; be fully collateralized by the assets of the business; fully amortize over a period of no more than seven years; be prudently underwritten in a manner that justifies the assessment of a lower-than-100 percent risk weight; and be performing. Finally, the Agencies are considering a minimum debt service coverage ratio requirement of 1.3.

Issues Discussed in the ANPR but Not Incorporated in the Proposed Rule. In the ANPR, the Agencies sought comment on the risk-based capital treatment for multifamily residential mortgages, other retail exposures, loans 90 days or more past due or in nonaccrual, and commercial real estate exposures. After considering the comments that addressed the approaches discussed in the ANPR concerning the risk-based capital treatment for these exposures, the Agencies have decided that any potential increase in risk sensitivity is outweighed by the additional burden that would result from the suggested approaches. Consequently, the Agencies are not proposing any changes in the proposed rule with respect to these exposures. The Agencies will continue to examine these issues and may address the risk-based capital treatment for these exposures at some future time.

Impact Analysis. Although the issue was not addressed in the ANPR, several commenters suggested that the Agencies should conduct a study of the potential effects of any proposed domestic capital revisions. They argued that such a study would help the Agencies better understand the potential costs and benefits of the potential revisions, and help compare the revisions to the Basel II framework.

The Agencies intend to analyze the potential impact of these proposed changes, as well as any changes to the proposals that may result of the public comment process. The Agencies may also make changes to these proposals if warranted based on this impact analysis.

IV. Effects of the Proposed Rule Compared to Basel II

FDIC staff believes that the average risk weights assigned to various exposures pursuant to the proposed rule generally would be higher than those assigned to similar exposures under Basel II. Chart 1, below, shows the risk weights that FDIC staff believes would be typically assigned to various types of exposures under the proposed rule, compared with the risk weights that were reflected in QIS-4 data for the same exposure types.

Chart 1

Credit risk weights would favor Basel II adopters

	Risk weights based on:	
Exposure Type	Proposed Rule (Basel IA)	Basel II Advanced QIS-4 (median)
Small business loans:		
Retail	100%	61%
Other	100%	74%
Commercial real estate:		
High volatility	100%	70%
Other	100%	48%
Other commercial	100%	47%
Typical 1-4 residential mortgage	35%	16%
Typical home equity loan	100%	19%
Credit cards	100%	117%
Other retail loans	100%	56%
AAA-rated Fannie or Freddie MBS	20%	7%

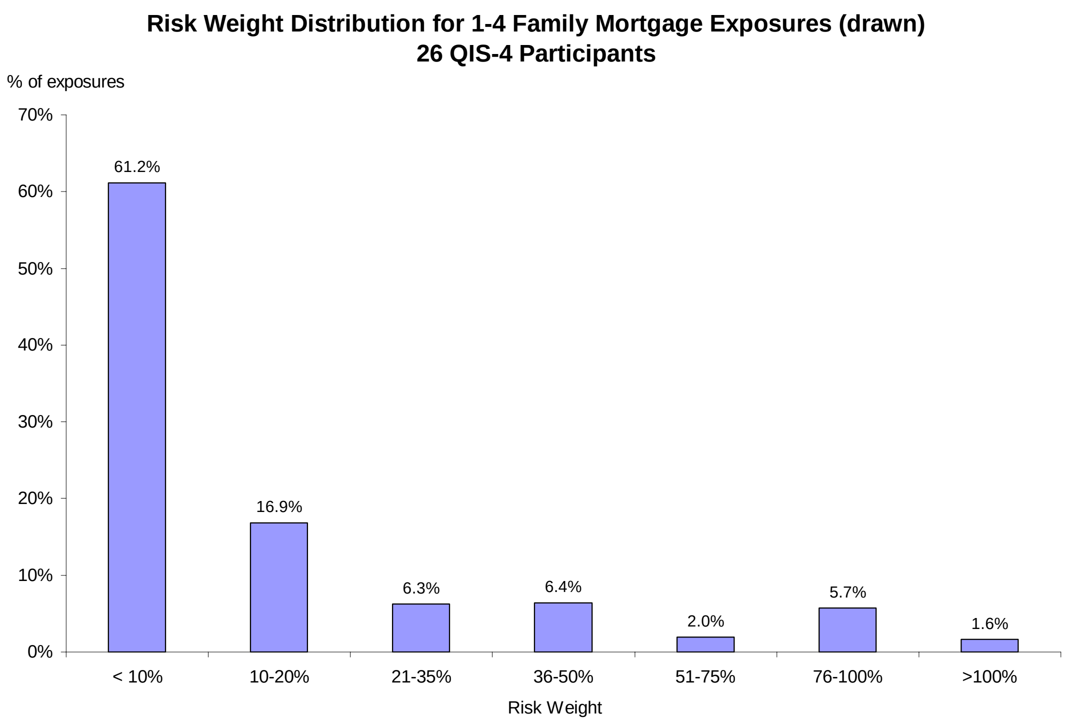
Source: *Summary Findings of the Fourth Quantitative Impact Study* and additional calculations.

Notes: Advanced Approaches median risk weights come from *Summary Findings of the Fourth Quantitative Impact Study*. Tables B and C. The 7 percent risk weight on Fannie Mae and Freddie Mac mortgage backed securities is based on the QIS-4 instructions to treat Fannie and Freddie MBS as senior, AAA-rated asset-backed securities, even if they may not carry an explicit rating. Advanced Approaches capital requirements for credit cards are likely understated in this table because of the large importance of capital requirements for undrawn lines, requirements that are not present in the Basel IA. Basel 1A risk weights for residential mortgages refers to a loan with a current loan-to-value ratio of 80%, after including the effects of loan-level private mortgage insurance.

For comparison purposes, the following charts are provided to show the distribution of risk weights for various exposures as reflected in the QIS 4 data. It should be noted that the risk weights shown in these charts represent the unexpected loss component and do not reflect additional capital charges that may assessed under Basel II for expected loss or operational risk. Including expected loss capital charges would not materially affect the overall picture presented by these charts. Operational risk charges would not be tied directly to loans. Operational risk charges in QIS-4 were about 10 percent of the capital charges for credit risk.

Preliminary analyses indicate that first-lien one-to-four family residential mortgages would be assigned an average risk weight of approximately 35 percent under the proposed rule. The results of the QIS 4 exercise (Chart 2) show that about 61 percent of these exposure types were assigned a risk weight of less than 10 percent under Basel II.

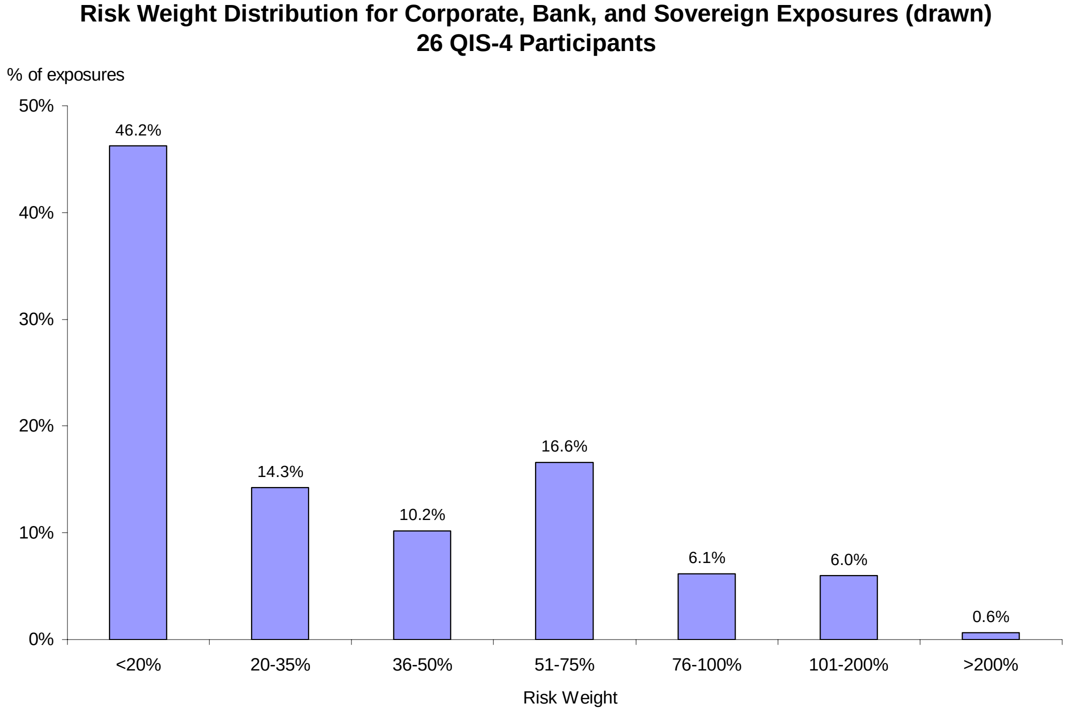
Chart 2



Source: FDIC calculations based on QIS-4 workbooks.

Further, staff expects that most corporate exposures will receive a risk weight of approximately 100 percent under the proposed rule. The results of the QIS 4 exercise (Chart 3) show that more than 87 percent of these exposures were assigned a risk weight of 75 percent or less under Basel II; 60 percent of the exposures were assigned a risk weight of less than 35 percent.

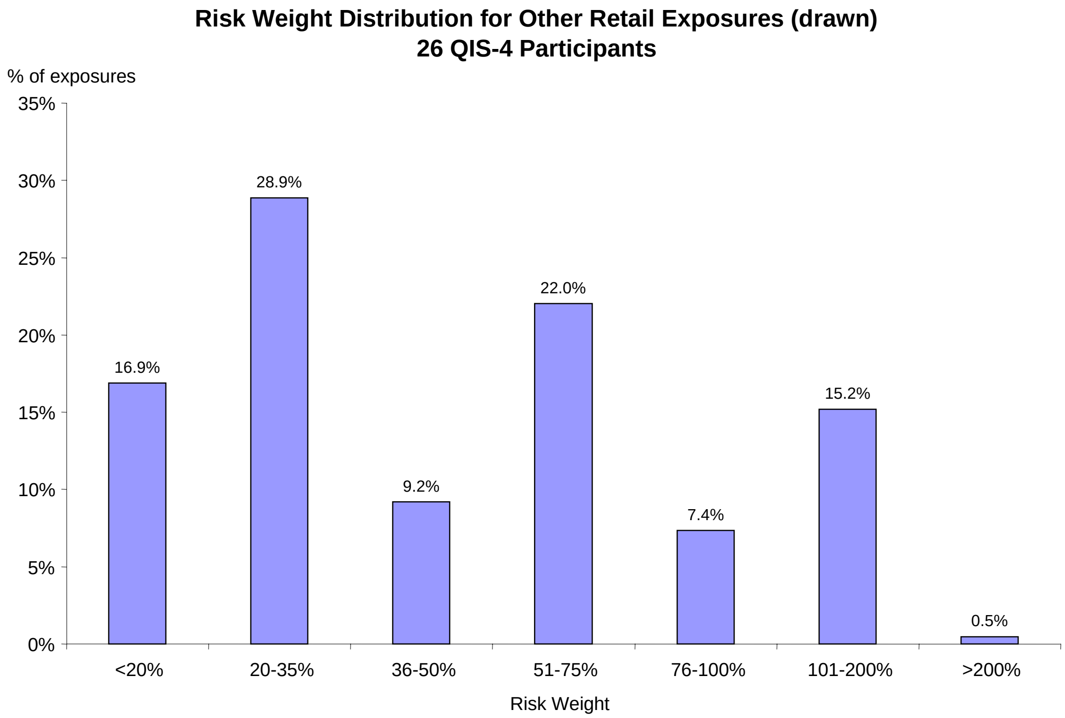
Chart 3



Source: FDIC calculations based on QIS-4 workbooks.

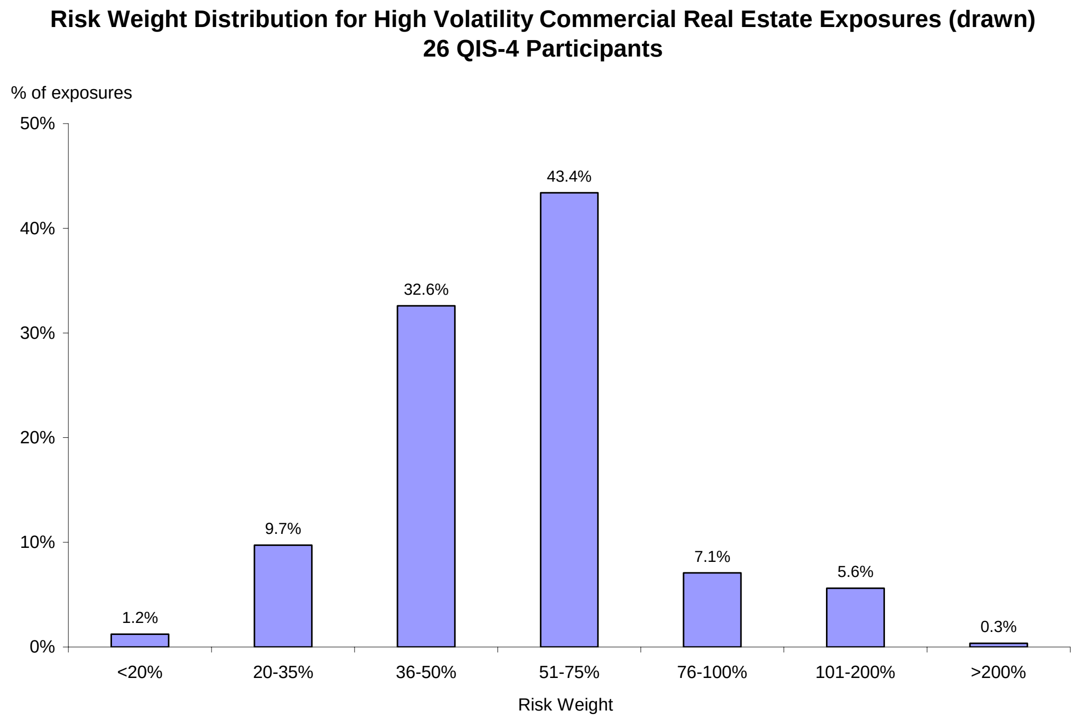
Additionally, staff expects that most other retail exposures and high-volatility commercial real estate will receive risk weights that are significantly lower under Basel II than under the proposed rule, which retains their existing risk weights of 100 percent. The results of the QIS 4 exercise (Charts 4 and 5) show that more than 77 percent of the other retail exposures and approximately 87 percent of the high-volatility commercial real estate were assigned a risk weight of 75 percent or less under Basel II. It should be noted that the proposed Basel II rules would allow certain small loans to businesses to be included in the other retail exposures category. While the proposed rule would retain a 100 percent risk weight for these exposures, the Agencies are seeking comment on whether certain small loans to businesses may warrant a 75 percent risk-weight charge.

Chart 4



Source: FDIC calculations based on QIS-4 workbooks.

Chart 5



Source: FDIC calculations based on QIS-4 workbooks.

V. Industry Concerns and Requests for Options

Recently, a number of banking organizations, industry trade associations, regulators, and other commentators requested that the Agencies provide core banks[1] with the option of using the standardized approach, as described in the new Basel accord entitled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," published in June 2004 by the Basel Committee on Banking Supervision.

Staff believes that additional consideration of these requests, which essentially are that Basel II banks should be allowed to use a standardized approach to compute their risk-based capital requirements, has merit. To that end, the Agencies have included a series of questions in

[1] The Basel II NPR identifies three types of U.S. banking organizations: (1) institutions subject to the proposed Basel II rule on a mandatory basis (core banks); (2) institutions not subject to the proposed Basel II rule on a mandatory basis, but that choose to voluntarily apply those approaches (opt-in banks); and (3) institutions that are not subject to and do not apply the proposed Basel II rule (general banks). In general a core bank is defined as a depository institution with consolidated total assets of $250 billion or more, with consolidated on-balance sheet foreign exposure of $10 billion or more, or a subsidiary of a bank or bank holding company that applies the proposed Basel II rule.

this NPR that seek comment on the extent to which the Agencies should consider allowing core banks to calculate their risk-based capital requirements using approaches other than the Advanced Internal Ratings Based (A-IRB) approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk. The Agencies also seek comment on what modifications would be needed to the proposal rule to ensure that regulatory capital requirements adequately reflect risk exposures and what, if any, additional requirements should be considered to encourage large and complex banking organizations to enhance their risk management practices or their financial disclosures, if they are permitted to use alternative approaches.