December 15, 2009

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson
Director

SUBJECT: Final Rule regarding *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues*

Proposal: That the Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) approve the attached joint interagency final rule (Final Rule) titled, *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues*. If approved, the Final Rule would be published in the Federal Register on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System (FRB), the Office of Thrift Supervision (OTS), and the Office of the Comptroller of the Currency (OCC) (together, the Agencies).

This Final Rule amends the Agencies' general risk-based capital standards and the advanced risk-based capital adequacy framework (together, the risk-based capital rules) in recognition of the regulatory capital impact of two recently-issued accounting standards from the Financial Accounting Standard Board (FASB): Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* (FAS

Concur:

____
Michael Bradfield
General Counsel

166), and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167).

The Final Rule permits a banking organization to phase-in the implementation of FAS 166 and FAS 167 for purposes of the Agencies' risk-based capital requirements. Specifically, the Final Rule provides for an optional two-quarter implementation delay followed by an optional two-quarter partial implementation of the effect on risk-weighted assets that will result from changes to U.S. generally accepted accounting principles (GAAP) from FAS 166 and FAS 167; and permits banking organizations to include in Tier 2 capital for purposes of the first two regulatory reporting periods following the implementation of FAS 166 and FAS 167, any increase in the allowance for loan and lease losses (ALLL) attributable to assets consolidated under the requirements of FAS 166 and FAS 167, followed by a two-quarter phase-in of the regulatory restriction on the amount of such ALLL that may be included in Tier 2 capital (collectively, the transition mechanisms). The transition mechanisms will apply only to the Agencies' risk-based capital requirements, and not to the leverage capital ratio.

Consistent with the Notice of Proposed Rulemaking that was published in the Federal Register of September 15, 2009, the Final Rule also eliminates the exclusion of certain consolidated asset-backed commercial paper (ABCP) programs from risk-weighted assets; and provides a reservation of authority to permit the Agencies to require banking organizations to treat entities that are not consolidated under GAAP as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the banking organization to the entity.

Regarding the review of the Final Rule by the Office of Management and Budget (OMB) under the procedures in Executive Order 12866, the OCC and the OTS have determined that the Final Rule is a significant regulatory action for purposes of the Executive Order. Accordingly, the OCC and OTS are developing a regulatory impact analysis of the Final Rule that will be submitted to the OMB for review. The OCC and OTS have informed the FDIC that they intend to implement the emergency situation provision of the Executive Order,[1] which will result in the OMB's not applying its 90-day review authority under the Executive Order. However, because

[1] See Executive Order 12866, section 6(a) (3) (D).

this Final Rule is a "major rule" for purposes of the Congressional Review Act,[2] it can not be implemented until 60 days after the date of publication of this Final Rule in the Federal Register. The Agencies also will provide for a voluntary early adoption of the Final Rule by banking organizations during the 60-day period preceding the implementation date for the Final Rule.

Recommendation: That the Board approve this Final Rule for publication in the Federal Register.

Background

Under GAAP, the treatment for structured finance transactions involving a special purpose entity (SPE) has been governed by the requirements of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), and FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities* (FIN 46(R)). Under FAS 140 (which is in effect through the end of 2009), when certain conditions are met, transfers of assets by a bank to an entity that meets the definition of a qualifying special purpose entity (QSPE) are recognized as sales, which permits the bank to remove the assets from its balance sheet. In addition, FIN 46(R) specifically excludes QSPEs from its scope despite the fact that many QSPEs would have otherwise been deemed variable interest entities (VIEs) subject to possible consolidation.[3] The consolidation requirements of FAS 140 and FIN 46(R) have permitted a number of banks to recognize securitized assets as off-balance sheet exposures, which generally receive more favorable treatment for regulatory capital purposes. At the same time, however, banks have retained significant potential exposure to these assets in the form of non-contractual or implicit recourse.

On June 12, 2009, FASB finalized modifications to FAS 140 and FIN 46(R) through FAS 166 and FAS 167, which are effective for the first annual reporting period that begins after November 15, 2009, for interim periods therein, and for interim and annual periods thereafter. FAS 166 and

[2] See 5 U.S.C. § 801(a)(3).

[3] For these reasons, banks typically establish a QSPE for purposes of their securitizations. Thus, the assets and liabilities in most bank securitizations are currently off-balance sheet.

FAS 167 remove the concept of a QSPE from GAAP and alter the consolidation analysis for VIEs, thereby requiring banks to consolidate many VIEs that are not consolidated under GAAP.

As a result of the implementation of FAS 166 and FAS 167, the categories of securitization and structured finance exposures that are currently off-balance sheet that are likely to be subject to consolidation on the balance sheet of the originating or servicing bank include: ABCP conduits; loan securitizations in which a bank retains a residual interest and servicing rights; revolving securitizations structured as master trusts; and certain tender option bond trusts that were designed as QSPEs. Thus, the implementation of FAS 166 and FAS 167 will for some banks increase the amount of assets and liabilities reported on their balance sheets and may result in significantly higher regulatory capital requirements.

The Proposed Rule

On September 15, 2009, in anticipation of the implementation of FAS 166 and FAS 167, the Agencies published a notice of proposed rulemaking (NPR) for comment on the effect the accounting changes would have on regulatory capital, the appropriateness of adjusting the risk-based capital treatment of some classes of assets that would be consolidated by banking organizations due to FAS 166 and FAS 167, and the utility of a phase-in of the regulatory capital requirements resulting from the implementation of FAS 166 and FAS 167, among other issues.[4] In addition, the NPR proposed modifying the Agencies' risk-based capital rules by eliminating provisions that permit a banking organization to exclude consolidated ABCP program assets from risk-weighted assets and instead assess a risk-based capital requirement against any contractual exposures of the organization arising from such ABCP programs. It also proposed eliminating an associated provision in the general risk-based capital rules (incorporated by reference in the advanced approaches) that excludes from tier 1 capital the minority interest in a consolidated ABCP program not included in a banking organization's risk-weighted assets. In addition, the NPR proposed a new reservation of authority to the Agencies' risk-based capital rules to permit a banking organization's primary Federal supervisor to treat entities that are not

[4] 74 Fed. Reg. 47138.

consolidated under GAAP as if they were consolidated for risk-based capital purposes, commensurate with the risk relationship of the banking organization to the structure.

Collectively, the Agencies received 41 comment letters from banks, bank holding companies, banking industry associations, mortgage companies, investment and asset management firms, and individuals. A number of commenters indicated that implementation of FAS 166 and FAS 167 without changes to the Agencies' risk-based capital rules would negatively impact financial markets and curtail lending due to higher regulatory capital requirements resulting from the consolidation of significant amounts of assets onto banking organizations' balance sheets. Commenters also argued that such implementation would inappropriately align capital requirements with GAAP's control-based approach to consolidation, in contrast to the credit risk focus of the Agencies' risk-based capital rules. The commenters overwhelmingly supported a delay or phase-in of the regulatory capital requirements resulting from the implementation of FAS 166 and FAS 167.

Commenters generally opposed the proposal to eliminate the ABCP exclusion, particularly with respect to customer-focused, multi-seller ABCP conduits. Commenters also stated that the proposed elimination of the ABCP exclusion would raise significant competitive equity concerns for domestic banking organizations vis-a-vis foreign banks and domestic entities not subject to U.S. banking regulation.

Many commenters recommended the modification or elimination of the current restrictions on including deferred tax assets (DTAs) in tier 1 capital and ALLL in tier 2 capital, to mitigate the effects of FAS 166 and FAS 167. Specifically, some commenters recommended that the current limit (1.25 percent of risk-weighted assets) on the inclusion of ALLL in tier 2 capital be increased, or that any ALLL related to the contractual obligations of third parties to VIEs be includible in tier 2 capital. Other commenters recommended that any ALLL related to losses contractually born by third parties be eligible for inclusion in tier 1 capital. With respect to DTAs, commenters noted that DTA balances will increase along with the ALLL, and requested that either the current limit on DTAs in regulatory capital be removed or that all DTAs arising from ALLL related to the contractual loss absorption responsibilities of third parties to VIEs be includible in tier 1 capital.

The commenters generally did not think that incentive payments under the Treasury's Home Affordable Mortgage Program (HAMP) would independently trigger consolidation under FAS 166 and FAS 167. Most also argued that if such consolidation were to occur as a result of HAMP, regulatory capital treatment should be modified with respect to the relevant consolidated mortgage loan assets.

Final Rule

A. Transition Mechanism for Risk-Based Capital Requirements Associated with the Implementation of FAS 166 and FAS 167

Staff believes that the effect of FAS 166 and FAS 167 on banking organizations' regulatory capital requirements will result in ratios that better reflect the banking organizations actual risk. In recognition of the burdens associated with the implementation of FAS 166 and 167, the Final Rule provides an optional transition mechanism to phase in the impact of FAS 166 and FAS 167 on bank risk-weighted assets. However, the transition mechanism will not apply to the leverage capital ratio.

Under the transition mechanism provided in Final Rule, a banking organization may elect to delay the impact of FAS 166 and FAS 167 on risk-weighted assets through the end of the second quarter after its implementation of FAS 166 and FAS 167. Thereafter, a banking organization that opted for the delay may elect to phase-in the risk-based capital requirements resulting from the implementation of FAS 166 and FAS 167 over two consecutive quarterly regulatory reporting periods. For example, a bank that has its first annual reporting period beginning on January 1, 2010, could choose to exclude from its risk-weighted assets, assets held by VIEs that existed prior to the implementation date of FAS 166 and FAS 167 for the first day of the first calendar quarter reporting period of 2010, i.e., January 1, 2010 (excluded amount). For the third and fourth quarters of 2010, that bank may exclude from risk-weighted assets 50 percent of the excluded amount. Under no circumstances, however, may the bank include in risk-weighted assets an amount less than the aggregate risk-weighted assets it held as of the first day of the first calendar quarter on or after the bank's date for its implementation of FAS 166 and 167.

Under the general risk-based capital rules, the amount of the ALLL that may be included in tier 2 capital is restricted to 1.25 percent of total risk-weighted assets.[5] Staff believes that the implementation of FAS 166 and FAS 167 will result in significant increases in the ALLL of some banks. Accordingly, the Final Rule permits a banking organization to include in tier 2 capital for the first two quarterly reporting periods following the implementation of FAS 166 and FAS 167, any increase in ALLL that is attributable to assets that have been consolidated on the bank's balance sheet under the requirements of FAS 166 and FAS 167 (the includable ALLL). For purposes of the third and fourth quarter reporting periods after the implementation of FAS 166 and 167, a banking organization that elected the ALLL component of the transition mechanism for the first two reporting periods after the implementation of FAS 166 and 167 may recognize in tier 2 capital 50 percent of the includable ALLL. During the four quarters after the implementation of FAS 166 and 167 and thereafter, a banking organization may not include in regulatory capital ALLL beyond the 1.25 percent limit that is associated with assets of a VIE to which it has provided implicit support.

B. Regulatory Capital Requirements Associated with the Implementation of FAS 166 and FAS 167

1. Risk-Weighted Assets

Experience from the recent financial crisis demonstrated that credit risk exposure of sponsoring banking organizations to VIEs (and their related securitization assets) has in fact been greater than the Agencies previously estimated. Therefore, staff is not recommending modifications to the risk-based capital rules to provide an alternative risk-based capital treatment for assets that will be newly consolidated on banking organizations' balance sheets following the implementation of FAS 166 and FAS 167.

[5] 12 CFR part 325, Appendix A, section I.A.2.

2. Qualifying Total Capital

Staff recognizes the effects on tier 1 and tier 2 capital of the increased ALLL provisioning that will result from the consolidation of VIEs, and is aware of the concern raised by the industry that, in some cases, the provisioning may be disproportionate to the actual risks borne by the institution with respect to the consolidated assets. However, the 1.25 percent limit on the ALLL included in tier 2 capital is an international standard included by amendment in the first capital accord of the Basel Committee on Banking Supervision and staff does not believe that it should be amended. In addition, the current limit on DTAs includable in tier 1 capital is currently being considered as part of an international review of the components of regulatory capital. As described above, due to the significant increases in ALLL that would result for some banks from the implementation of FAS 166 and FAS 167, staff recommends that banking organizations may include in tier 2 capital for the first two quarterly reporting periods following the implementation of FAS 166 and FAS 167, any increase in the includable ALLL. For purposes of the third and fourth quarter reporting periods, a banking organization that elected the ALLL component of the transition mechanism for the first two reporting periods may recognize in tier 2 capital 50 percent of the includable ALLL.

3. Leverage Requirement

Under the Agencies' leverage capital requirements, tier 1 capital is assessed against a measure of a banking organization's total on-balance sheet assets, net of ALLL and certain other exposures (leverage ratio). Therefore, previously unconsolidated assets that now must be recognized on a banking organization's balance sheet due to FAS 166 and FAS 167 will increase the denominator of the banking organization's leverage ratio. The Agencies have maintained the leverage ratio as a balance-sheet assessment to supplement the risk-based capital rules and limit the degree to which a banking organization can leverage its equity capital base. Staff has concluded that a delay or phase-in of the effect of FAS 166 and FAS 167 on the leverage ratio is not justified.

C. Asset-Backed Commercial Paper Programs

The Rule eliminates existing provisions in the risk-based capital rules that permit a banking organization to exclude from risk-weighted assets the assets of an ABCP program that the banking organization is required to consolidate under GAAP and for which the banking organization acts as sponsor (the ABCP exclusion). The elimination of the ABCP exclusion is subject to the transition mechanism.

D. Reservation of Authority

Consistent with the NPR, the Final Rule includes a new reservation of authority for the risk-based capital rules specifying that a banking organization's primary Federal supervisor would have the authority to require the banking organization to treat an off-balance sheet entity as if it were consolidated onto the banking organization's balance sheet and to hold capital against the entity's exposures for risk-based capital purposes. This reservation of authority must be based on the determination that the banking organization's exposure or other relationship to the entity is not commensurate with the actual risk relationship of the banking organization to the entity.

E. Other Related Matters

Staff agrees with commenters' assessment that it is unlikely that incentive payments under the HAMP independently would cause servicers participating in the HAMP to consolidate VIEs holding mortgage loans modified under the HAMP.

DSC Contacts:	Nancy Hunt (ext. 86643) James Weinberger (ext. 87034)
Legal Division Contacts:	Mark Handzlik (ext. 83990) Michael Phillips (ext. 83581)