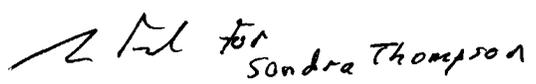


December 14, 2010

MEMORANDUM TO: Board of Directors

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

SUBJECT: *Notice of Proposed Rulemaking Regarding Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor*

Proposal: That the Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) approve the attached Joint Notice of Proposed Rulemaking (proposed rule) titled *Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor*. If approved, the proposed rule would be published by the FDIC, Board of Governors of the Federal Reserve System (FRB), and Office of the Comptroller of the Currency (OCC) in the *Federal Register* for a 60-day public comment period.¹

The proposed rule implements section 171(b)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), which requires the risk-based capital rules in effect for all insured banks regardless of total asset size or foreign exposure (that is, the “generally applicable risk-based capital requirements”) to serve as a floor for any capital requirements the agencies may establish, including for large, internationally active banks and bank holding companies, as well as nonbank financial companies subject to FRB supervision. This requirement applies to the advanced approaches rule which, as currently written, permits banks using it to operate with risk-based capital requirements that are potentially lower than those required under the generally applicable risk-based capital requirements.

Consistent with section 171(b)(2) of the Act, the proposed rule would remove the transitional floor periods in section 21(e) of the advanced approaches rule, and set the generally applicable risk-based capital requirements as a permanent floor for the advanced approaches. It should be noted that the generally applicable risk-based capital requirements can be modified over time but, as also required by section 171(b)(2) of the Act, the resulting capital requirements cannot be quantitatively lower than the generally applicable risk-based capital requirements in effect as of the date of enactment of the Act.

The proposed rule would also amend the agencies’ general risk-based capital rules to allow

Concur:


Michael Krimminget

¹ The Office of Thrift Supervision (OTS) is not a party to this rulemaking for reasons related to timing of its publication. OTS staff have indicated that OTS will produce a substantially similar rulemaking to the one contained herein.

Acting General Counsel

banks to use the Bank Holding Company capital rules in limited circumstances to determine the capital requirements for low-risk assets not typically held by banks. The proposed change is intended to enhance the Federal Reserve's flexibility to address low risk nonbank assets under the Collins amendment without creating material opportunities for capital arbitrage.

Recommendation: That the Board approve publication of this proposed rule in the *Federal Register* for a 60-day public comment period.

Background

In 2007, the agencies adopted the advanced approaches rule to implement an advanced risk-based capital framework that is mandatory for certain U.S. banks and optional for others.² The advanced approaches rule incorporates certain of the Basel Committee on Banking Supervision's (Basel Committee) proposals contained in the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (New Accord) published in June 2006.³ The advanced approaches rule, which includes only the advanced capital methodologies for credit and operational risk in the New Accord, requires qualifying banks to use the internal ratings-based approach for credit risk and the advanced measurement approaches for operational risk (together, the advanced approaches) to calculate their tier 1 and total risk-based capital ratios.

Section 21(e) of the advanced approaches rule establishes a series of transitional floors that apply to banks that receive FDIC approval to exit the parallel run and begin implementation of the advanced approaches rule. Currently, the transitional floors limit the amount by which a bank's risk-based capital requirement could decline over a period of at least three years following completion of a satisfactory parallel run. Each transitional floor equals the lesser of the bank's (i) risk-based capital ratios calculated under the advanced approaches rule, and (ii) risk-based capital ratios calculated under the general risk-based capital rules,⁴ with risk-weighted assets multiplied by transitional floor percentages of 95 percent, 90 percent, and 85 percent during the first, second, and third transitional floor periods, respectively. As of the date of enactment of the Act, all insured depository institutions were required to compute and disclose risk-based capital requirements using the general risk-based capital rules.

In short, the advanced approach explicitly allows for the possibility that the risk-based capital requirements of the institutions using it would be lower than if it calculated its capital requirements solely with the general risk-based capital rules. The potential difference in capital requirements between the two rules increases over a period of three transition years and, pending future agency decisions under the rule, banks under the advanced approach rule could operate without any risk-based capital floor after completing these transitional periods.

As described below, this aspect of the advanced approaches would allow for lower capital requirements than would be required under the agencies' general risk-based capital rules, which are the "generally applicable" risk-based capital requirements as defined by section 171. Section 171 also specifies that the capital requirements that are generally applicable to insured depository institutions shall serve as a floor for the capital requirements of all insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Federal Reserve. Moreover, section 171 specifies that the federal banking

² The FDIC issued the advanced approaches rule on an interagency basis with the Office of the Comptroller of the Currency, the Federal Reserve System, and the Office of Thrift Supervision. The FDIC Board of Directors approved the final rule on November 5, 2007 with an effective of April 1, 2008. See 12 CFR part 325, Appendix D.

³ The Basel Committee is a committee of banking supervisory authorities established by the central bank governors of the G-10 countries in 1975. The Basel Committee issued the New Accord to modernize its first capital Accord, which was endorsed by the Basel Committee members in 1988 and implemented by the FDIC in 1989. The New Accord, the 1988 Accord, and other documents issued by the Basel Committee are available through the Bank for International Settlements' website at www.bis.org.

⁴ 12 CFR part 325, Appendix A.

agencies may not establish capital requirements that are quantitatively lower than the generally applicable capital requirements in effect for insured depository institutions as of the date of enactment of the Act.

Floor for Risk-Based Capital Requirements

Section 171(a)(2) defines the term “generally applicable risk-based capital requirements” to mean: “(A) the risk-based capital requirements as established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action regulations implementing section 38 of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure; and (B) includes the regulatory capital components in the numerator of those capital requirements, the risk-weighted assets in the denominator of those capital requirements, and the required ratio of the numerator to the denominator.”

The federal banking agencies have implemented section 38 of Federal Deposit Insurance Act (12 U.S.C. 1831o) by establishing risk-based capital requirements that apply to all insured depository institutions. These requirements were already in effect as of the date of enactment of the Act. These requirements are found at 12 CFR part 325, Appendix A in the case of state nonmember banks. In the advanced approaches rule, the agencies referred to these risk-based capital requirements as “the general risk-based capital rules.”⁵

All insured institutions, regardless of their size, are required to compute their minimum risk-based capital requirements pursuant to prompt corrective action (PCA) using the agencies general risk-based capital rules. Accordingly, these general risk-based capital rules are the generally applicable risk-based capital requirements defined by section 171.

Unlike the agencies’ leverage capital requirement, the risk-based capital requirement for banks operating under the advanced approaches rule finalized in 2007 is *not* the greater of the generally applicable risk-based capital requirement and the capital requirement calculated under the advanced approaches rule. The advanced approaches rule explicitly allows a bank’s minimum risk-based capital requirement during and after a transition period to be less than the risk-based capital requirement calculated under the generally applicable risk-based capital requirement. Thus, the generally applicable risk-based capital requirements do not serve as a floor for the advanced approach rule.

Consistent with section 171(b)(2), the agencies are proposing to replace the “transitional floors” in the advanced approaches rule with a permanent floor equal to the minimum capital requirement computed using the agencies’ general risk-based capital rules. The generally applicable risk-based capital rules may be amended in the future, but may not be “quantitatively lower” than the generally applicable risk-based capital requirements in effect as of the date of enactment of the Act. The agencies do not envision proposing, in the future, that institutions compute two separate sets of “generally applicable risk-based capital requirements (those in effect in July, 2010 and some future version). Instead, the agencies would envision performing a quantitative analysis designed to ensure any future amendments to the generally applicable

⁵ See, e.g., 12 CFR part 325, Appendix D, § 21(e)(2).

capital requirements do not constitute an impermissible quantitative reduction in those requirements relative to the generally applicable requirements in effect as of the date of enactment of the Act. Under such an approach, there would be only one generally applicable risk-based capital regime, and banks subject to the advanced approaches rule would be required to meet the higher of the capital requirement under that regime or the advanced approaches rule.

Amendments for Certain Assets not Typically Held by Banks

Certain institutions subject to the requirements of section 171, such as savings and loan holding companies and nonbank financial companies supervised by the Federal Reserve, have not previously been subject to consolidated risk-based capital requirements. Some of these companies are very likely to be similar in nature to most depository institutions and bank holding companies subject to the general risk-based capital rules. Others may be different and have types of exposures with risks that were not contemplated when the general risk-based capital rules were developed. Going forward, there may be situations where the Federal Reserve needs to evaluate the risk-based capital treatment of specific exposures not typically held by depository institutions, and that do not have a specific risk weight under the generally applicable risk-based capital requirements.

To allow for an appropriate capital requirement for low risk nonbank assets without creating new opportunities for capital arbitrage, the agencies are proposing to amend the general risk-based capital rules to allow for an alternative capital treatment in limited circumstances. The circumstances would be limited to situations where a bank holds an asset under special authority and the asset poses substantially similar risks to an asset with a risk-weight lower than 100 percent. The alternative treatment would be to allow the bank to use the bank holding company capital requirement for the asset.

Request for Comment about Effects on Foreign Banking Organizations

In approving an application by a foreign bank to establish a branch in the United States or to make a bank or nonbank acquisition, the Federal Reserve considers, among other factors, whether the capital of the foreign bank is equivalent to the capital that would be required of a U.S. banking organization. Similarly, in order to make effective a foreign bank's declaration under the BHC Act to be treated as a financial holding company (FHC), the Federal Reserve must apply comparable capital and management standards to the foreign bank "giving due regard to the principle of national treatment and equality of competitive opportunity." National treatment generally means treatment that is no less favorable than that provided to domestic institutions that are in like circumstances.

In this NPR, the Federal Reserve requests comment on how the proposed rule should be applied to foreign banks in evaluating their capital equivalency in the context of applications to establish branches or make bank or nonbank acquisitions in the United States, and in evaluating capital comparability in the context of foreign bank FHC declarations.

Recommendation

