June 12, 2012

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson, Director
Division of Risk Management Supervision

SUBJECT: Notice of Proposed Rulemaking: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, and Transition Provisions*

Proposal: That the Board of Directors ("Board") of the Federal Deposit Insurance Corporation ("FDIC") approve the attached Notice of Proposed Rulemaking titled, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, and Transition Provisions* ("Basel III NPR", "NPR" or "proposed rule"), for publication in the *Federal Register* for a 90-day comment period. If it is approved, the NPR would be issued jointly by the FDIC, the Board of Governors of the Federal Reserve System ("FRB"), and the Office of the Comptroller of the Currency ("OCC") ("the agencies"). The NPR would amend the current general risk-based and leverage capital rules ("current capital rules") to incorporate revisions to the Basel capital framework established by the Basel Committee on Banking Supervision ("BCBS") in *Basel III: A global regulatory framework for more resilient banks and banking systems* ("the Basel III Framework"). This NPR also would implement the phase-out of certain regulatory capital instruments in accordance with the Basel III Framework and requirements of section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The proposed requirements would be implemented gradually, between January 1, 2013 and January 1, 2018, with a phase-out for certain ineligible capital instruments held by smaller bank holding companies extending until 2022.

Today, staff also will present to the Board two additional notices of proposed

Concur:

Richard J. Osterman, Jr.
Acting General Counsel

rulemaking that, if approved, would be published jointly by the agencies in the *Federal Register* on the same day as the Basel III NPR, for a 90-day comment period. One notice, titled, *Standardized Approach for Risk-Weighting Assets; Market Discipline and Disclosure Requirements* ("Standardized Approach NPR") would revise the methodologies for determining total risk-weighted assets under the general risk-based capital rules. The other notice, titled, *Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rules* ("Advanced Approaches NPR"), would revise the advanced approaches risk-based capital rules ("advanced approaches rules") to implement aspects of the Basel III Framework and other recent changes adopted by the BCBS. The FDIC also is proposing to apply market risk capital rules to state savings associations.

The staff is mindful that the changes proposed in this NPR (and the other NPRs) are extensive. To avoid undue cost and complexity to smaller institutions, this NPR proposes to apply several aspects of the proposed Basel III Framework only to institutions that are subject to the advanced approaches rules. The NPR would require only banks subject to the advanced approaches rules to satisfy a Basel III Framework-based leverage requirement and countercyclical capital buffer. It is anticipated, however, that all institutions would incur systems costs to come into compliance with the proposed rule.

The proposals in this Basel III NPR will strengthen the quality of regulatory capital and increase its required level consistent with international agreements. Many banks have elected to strengthen their capital positions in recent years. The staff believes that the proposed rule would help to preserve these gains and would lead to a better capitalized banking system going forward.

Recommendation: That the Board approve publication of the NPR for a 90-day public comment period.

Discussion

Background

To address weaknesses in the existing regulatory capital requirements that were identified during the recent financial crisis, in 2010 the BCBS adopted the Basel III

Framework. The proposed rule would revise and replace the FDIC's general risk-based capital rules in a manner consistent with the Basel III Framework by introducing a new common equity tier 1 minimum capital ratio, a higher minimum tier 1 capital ratio, and, for banks subject to the advanced approaches rules, an additional leverage ratio requirement that incorporates a broader set of exposures in the denominator measure, including certain off-balance sheet items. Additionally, the proposed rule would establish certain limits on capital distributions and discretionary bonus payments for banks that do not hold a specified amount of common equity tier 1 capital in addition to the amount required under the minimum risk-based capital ratios. The proposed rule also would establish more conservative standards for regulatory capital and require the phase-out of certain capital instruments in a manner consistent with the Basel III Framework and the requirements of section 171 of the Dodd-Frank Act ("Section 171"). The proposed rule would apply to all banks and state savings associations (collectively, "banks") that are subject to the FDIC's current risk-based capital rules.

Summary of the NPR

Minimum capital requirements for all banks

Under the general risk-based capital rules, a bank must satisfy a minimum tier 1 risk-based capital ratio of 4 percent, a minimum total risk-based capital ratio of 8 percent, and minimum tier 1 leverage ratio of 4 percent. A bank must maintain compliance with these minimum capital requirements to be considered adequately capitalized for purposes of the agencies' prompt corrective action ("PCA") requirements.

The recent crisis demonstrated that common equity is more capable of absorbing losses relative to other forms of regulatory capital, and that financial markets look predominately at common equity levels to determine the relative strength of an institution during periods of economic stress. Accordingly, the Basel III Framework strengthens the minimum capital requirements by introducing a minimum common equity tier 1 capital ratio, increasing the minimum tier 1 risk-based capital ratio, and establishing a capital conservation buffer.

Consistent with the Basel III Framework, the proposed rule would introduce a new minimum common equity tier 1 capital ratio requirement, equal to 4.5 percent of total risk-weighted assets. The proposed rule also would increase the minimum tier 1 risk-based capital ratio requirement from 4 to 6 percent; however, the total risk-based and tier 1 leverage ratio requirements would remain unchanged.

The capital conservation buffer is designed to absorb losses throughout the economic cycle so a bank can serve as a financial intermediary during an economic downturn and remain compliant with its minimum risk-based capital requirements. The capital conservation buffer applies to all banks in addition to the minimum risk-based capital ratios. The capital conservation buffer must consist entirely of common equity tier 1 capital, and would apply in addition to and separate from the agencies' prompt corrective action ("PCA") requirements. A bank that fails to maintain compliance with the capital conservation buffer requirement would be subject to restrictions on capital distributions and discretionary bonus payments.

Revised PCA levels; capital requirements for banks subject to the advanced approaches rules

In addition to the minimum regulatory capital requirements described above, a bank subject to the advanced approaches rule also would be required to satisfy an additional ratio of tier 1 capital to total leverage exposure of 3 percent ("supplementary leverage ratio") and a countercyclical capital buffer. The agencies are proposing to apply the supplementary leverage ratio only to banks subject to the advanced approaches rules. Applying the supplementary leverage ratio to smaller organizations would greatly increase the complexity of their capital requirements while resulting in a lower leverage requirement in most cases.

Under the proposed rule, a bank subject to the advanced approaches rules would be required to satisfy a supplementary leverage ratio of 3 percent to be considered adequately capitalized for PCA purposes. The supplementary leverage ratio would apply in addition to the minimum risk-based capital and leverage ratios applicable to all banks, and would include a broader set of exposures in the denominator, including off-balance sheet items. Smaller, less complex banks would remain subject only to the existing leverage requirement (with the numerator amended to reflect the new definition of capital), which, as noted, was relied upon during the crisis by the market and investors to evaluate the solvency of all institutions. This approach is consistent with the agencies' authority under PCA and the requirements of Section 171.

Consistent with the Basel III Framework, the proposed rule also would introduce a countercyclical capital buffer composed of common equity tier 1 capital to augment the capital conservation buffer during periods of excessive credit growth. The countercyclical capital buffer is a macro-prudential tool that is designed to mitigate asset bubbles and excessive increases in leverage that could affect the entire financial system and general economic conditions. The NPR would apply the countercyclical capital buffer only to large, internationally-active banks subject to the advanced approaches rules.

The countercyclical capital buffer amount in the United States would initially be set at zero, but it would increase when the agencies determine that there is excessive credit growth in the financial markets. When the agencies determine such growth reaches a level that poses system-wide risk, the agencies could augment the capital conservation buffer, using the countercyclical capital buffer, by up to 2.5 percent of a bank's total risk-weighted assets. The countercyclical capital buffer would apply in addition to the minimum risk-based capital and leverage ratios, and would effectively serve as a temporary addition to the capital conservation buffer during periods of excessive credit growth.

The tables below depict the revisions to the PCA requirements under the proposed rule.

Current PCA levels

Requirement	Total RBC ratio (percent)	Tier 1 RBC ratio (percent)	Tier 1 leverage ratio (percent)	PCA requirements
Well Capitalized	≥ 10	≥ 6	≥ 5	None
Adequately Capitalized	≥ 8	≥4	≥ 4% [or ≥3 for selected 1-rated][1]	May limit nonbanking activities at DI's FHC / Limits on broker deposits

[1] For banks with a CAMELS rating of 1 and not experiencing or anticipating significant growth, the current tier 1 leverage ratio may be 3 percent.

Undercapitalized	< 8	< 4	< 4 [or < 3 for selected 1 rated]	Restrict asset growth; no dividends; capital plan
Significantly undercapitalized	< 6	< 3	< 3	Restrict sub-debt payments
Critically undercapitalized	Tangible Equity to Total Assets </= 2			Receivership /conservatorship

Proposed PCA levels

Requirement	Total RBC Measure (percent)	Tier 1 RBC measure (percent)	Common Equity Tier 1 RBC Measure (percent)	Leverage Measure (percent)	Supplementary Leverage Measure* (percent)	PCA Requirements
Well Capitalized	≥ 10	≥ 8	≥ 6.5	≥ 5	Not applicable	Unchanged from current
Adequately Capitalized	≥ 8	≥6	≥ 4.5	≥ 4%	≥ 3	"
Undercapitalized	< 8	< 6	< 4.5	< 4	< 3	"
Significantly undercapitalized	< 6	< 4	< 3	< 3	Not applicable	"
Critically Undercapitalized	Tangible Equity (defined as tier 1 capital plus non-tier 1 perpetual preferred stock) to Total Assets </= 2					"

* Applies only to advanced approaches banking organizations

Definition of Capital

The proposed rule would improve the loss-absorption capacity of the regulatory capital base by strengthening the criteria for regulatory capital in a manner consistent with the Basel III Framework. In addition, in accordance with the Basel III Framework and requirements of Section 171, for many institutions the NPR would require the phase-out of certain elements from regulatory capital, such as trust preferred securities and other hybrid capital elements.

Common Equity Tier 1

Under this NPR, a bank's common equity tier 1 capital would be the sum of its outstanding common equity tier 1 capital instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income, and common equity tier 1 minority interest (subject to additional provision set forth in this NPR). Consistent with the Basel III Framework, the agencies propose to require that common equity tier 1 capital instruments issued by a bank satisfy certain conditions to ensure that a bank's common equity tier 1 capital is available to absorb losses as they occur. The agencies are also proposing to require unrealized gains and losses on all available-for-sale ("AFS") securities to flow through to common equity tier 1 capital (instead of including unrealized AFS losses in tier 1 capital and unrealized gains in tier 2 capital). This change would ensure that regulatory capital better reflects an institution's ability to absorb loss, but also would introduce potential volatility in a bank's capital ratios. Consequently, some banks would likely choose to hold higher amounts of capital to address increases in volatility.

Additional Tier 1 Capital

Consistent with the Basel III Framework, the NPR proposes to define additional tier 1 capital as the sum of: additional tier 1 capital instruments that satisfy certain criteria established in the NPR[2], related surplus, and tier 1 minority interest that is not included in a bank's common equity tier 1 capital (subject to certain limitations set forth in the proposed rule); less applicable regulatory adjustments and deductions. Under the NPR, trust preferred securities and cumulative perpetual preferred securities, which are eligible for limited inclusion in tier 1 capital under the current capital rules for bank holding companies, would generally not qualify for inclusion in additional tier 1 capital.

Tier 2 Capital

Under the proposal, tier 2 capital would be the sum of: tier 2 capital instruments that satisfy certain criteria established in the NPR[3], related surplus, total capital minority interests not included in a bank's tier 1 capital (subject to the limitations and requirements on minority interests set forth in the proposed rule), and limited amounts of the allowance for loan and lease losses; less any applicable regulatory adjustments and

[2] The criteria are designed to ensure that additional tier 1 capital instruments are available to absorb losses on a going concern basis. For example, the instruments must be issued and paid-in; subordinate to depositors, general creditors, and subordinated debt holders in receivership; cannot be secured or covered by a guarantee of the bank or an affiliate of the bank; cannot have a maturity date; and cannot include any incentives to redeem. The bank must have full discretion to cancel dividends at all times.

[3] Tier 2 capital instrument have less restrictive requirements than additional tier 1 capital instruments. For example, tier 2 capital instruments must be subordinated to depositors and general creditors of the bank (but not subordinated debt holders as is required for additional tier 1 capital instruments); and are permitted to have a minimum original maturity date of at least five years (additional tier 1 capital instruments are prohibited from having a maturity date).

deductions. The agencies are also proposing to eliminate some existing limits related to tier 2 capital; specifically, there would be no limit on the amount of tier 2 capital that could be included in a bank's total capital and existing limitations on term subordinated debt, limited-life preferred stock, and trust preferred securities within tier 2 would also be eliminated under the NPR. The agencies believe the proposed common equity tier 1 capital requirement would ensure that a bank's regulatory capital base consists predominately of common equity.

Qualifying Capital Instruments Issued by Consolidated Subsidiaries of a Bank

Under the proposal, a bank would be allowed to include in its consolidated regulatory capital limited amounts of minority interests if certain requirements are met. A minority interest would be classified as common equity tier 1, tier 1, or total capital depending on the quality of the underlying capital instrument and the type of issuing subsidiary. For example, a minority interest would qualify as common equity tier 1 capital only if the interest satisfies the requirements described above for common equity tier 1 capital, and does not otherwise exceed certain limits set forth in the proposed rule. Such limits would restrict the amount of minority interest that may be included in the consolidated regulatory capital of a bank and would be based on the amount of capital held by the consolidated subsidiary, relative to the amount of capital the subsidiary would be required to hold to avoid any restrictions on capital distributions and discretionary bonus payments under the capital conservation buffer framework. Common equity tier 1 minority interests may be recognized only if the subsidiary is a depository institution.

Regulatory Adjustments and Deductions

The NPR would require additional deductions from regulatory capital related to mortgage servicing assets, deferred tax assets, and investments in the capital of unconsolidated financial institutions than are required under the current capital rules. The NPR also proposes that accumulated other comprehensive income ("AOCI"), which in most cases is not currently recognized in tier 1 capital, flow through to common equity tier 1 capital.

Transitional framework

To ensure banks have sufficient time to adjust to the proposed rule, the NPR includes a transitional framework that would implement most of the requirements of the proposed rule between January 1, 2013 and January 1, 2018. The proposed transition periods reflect the transition periods agreed by the Basel Committee and, in the case of certain ineligible capital instruments, the Dodd Frank Act.

IV. Recommendation

Staff recommends that the Board approve for publication in the *Federal Register* the attached interagency NPR, which seeks comment on revisions to the current capital rules to incorporate revisions to the Basel capital framework published by the Basel Committee on Banking Supervision ("BCBS") in *Basel III: A global regulatory framework for more resilient banks and banking systems*.

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