July 9, 2013

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Interim final rule: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*

Summary: In June, 2012, the FDIC Board of Directors ("Board"), together with the Board of Governors of the Federal Reserve System ("Federal Reserve") and Office of the Comptroller of the Currency ("OCC") (the "agencies"), approved for publication in the *Federal Register* three joint interagency notices of proposed rulemaking (the "NPRs") that collectively would strengthen the existing risk-based and leverage capital requirements applicable to all banking organizations in a manner consistent with enhancements to the international capital framework adopted by the Basel Committee on Banking Supervision ("BCBS"), including in response to the recent financial crisis, and certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"): *Implementation of Basel III, Minimum Regulatory Capital Ratios and Transition Provisions* (the "Basel III NPR"); *Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements* (the "Standardized Approach NPR"); and *Advanced Approaches Risk-Based Capital Rule and Market Risk Capital Rule* (the "Advanced Approaches NPR").

The agencies received over 2,500 comments on the NPRs from banking organizations, trade associations representing the banking or financial services industry, supervisory authorities,

Concur:

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Acting General Counsel

consumer advocacy groups, private individuals, and public officials, including members of Congress. The majority of commenters expressed concern regarding the potential impact of the proposals, particularly with respect to community banking organizations.

The agencies' staffs have worked together to develop a single, revised capital regulation that consolidates the three NPRs. This revised capital regulation incorporates significant changes in response to concerns raised by community banks during the public comment period. Generally, the three most significant changes for community banking organizations are:

- *1-4 Family Residential Mortgages*: The revised capital regulation would retain the current, longstanding treatment for one-to-four family residential mortgages, including the recognition of private mortgage insurance and the 120-day safe harbor for mortgage (and other) loans transferred pursuant to an early-default provision. Therefore, most one-to-four family residential mortgage exposures that are prudently underwritten would continue to receive a 50 percent risk weight.
- *Accumulated Other Comprehensive Income ("AOCI")*: The revised capital regulation would allow non-advanced approaches banking organizations to make a one-time, irrevocable election to retain the current treatment for AOCI – that is, a non-advanced approaches banking organization that makes such election is not required to recognize in common equity tier 1 capital any unrealized gains and losses on available-for-sale ("AFS") debt securities.
- *Trust Preferred Securities ("TRUPs")*: Consistent with section 171 of the Dodd-Frank Act, the revised capital regulation would retain the current regulatory capital treatment for TRUPs issued by a depository institution holding company with less than $15 billion in total consolidated assets as of December 31, 2009, and a banking organization organized as a mutual holding company as of May 19, 2010. Accordingly, under the revised capital regulation TRUPs issued by these organizations prior to May 19, 2010 may continue to be recognized as additional tier 1 capital.

Staff recommends adopting the revised capital regulation as an interim final rule that is substantively identical to the final rules being issued by the Federal Reserve and the OCC.

Adopting an interim final rule would enable the FDIC to proceed with the revised capital regulation on a unified, expedited basis with the other federal banking agencies, pending consideration of a joint notice of proposed rulemaking to enhance the supplementary leverage ratio requirements for the largest, most interconnected U.S. banking organizations– that is, U.S. bank holding companies ("BHCs") with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody and insured depository institution ("IDI") subsidiaries of such BHCs (the "Supplementary Leverage Ratio NPR").[1] Under the Supplementary Leverage Ratio NPR, an IDI that meets the proposed applicability threshold would be required to satisfy a supplementary leverage ratio requirement of 6 percent to be considered well capitalized for purposes of the agencies' prompt corrective action ("PCA") regulations. Similarly, BHCs that meet the proposed applicability threshold would be required to maintain a leverage capital buffer of at least 2 percent of their total leverage exposure to avoid restrictions on capital distributions and discretionary bonus payments. This interim final rule invites commenters' views on the interaction of the revised capital regulation and the revisions proposed in the Supplementary Leverage Ratio NPR.

The interim final rule would strengthen the quality and quantity of regulatory capital in a manner consistent with international agreements among the BCBS members. In the years following the recent crisis, banking organizations generally improved their capital positions on an industry-wide basis. Staff believes the interim final rule will facilitate the preservation of these gains and result in a safer, more resilient banking system, consistent with the objectives of the proposals.

Recommendation: That the Board approve the issuance of the interim final rule, pursuant to the effective dates and transitional implementation framework set forth in the attached *Federal Register* document, for a 60-day comment period.

Discussion:

Background

To address some of the shortcomings in the international capital standards exposed during the recent crisis, the BCBS issued the *Enhancements to the Basel II Framework* ("2009 Enhancements") in July, 2009 to enhance certain risk-based capital requirements and to

[1] Today, staff is also seeking the Board's approval of the Supplementary Leverage Ratio NPR.

encourage stronger management of credit and market risk. The 2009 Enhancements strengthen the risk-based capital requirements for certain securitization exposures, increase the credit conversion factors for certain short-term liquidity facilities, and require that banking organizations conduct more rigorous credit analysis of their exposures.[2]

In 2010, the BCBS published a comprehensive reform package, titled, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* ("the Basel III Framework"), which is designed to improve the quality and the quantity of regulatory capital and to build additional capacity into the banking system to absorb losses in times of future market and economic stress. The Basel III Framework introduces or enhances a number of capital standards, including a stricter definition of regulatory capital, a minimum tier 1 common equity ratio, the addition of a regulatory capital buffer, leverage ratio, and disclosure requirements for certain regulatory capital instruments.

Together, the NPRs approved by the Board in June 2012 proposed the implementation of the Basel III Framework, certain aspects of the Basel II standardized approach, and 2009 Enhancements, in a manner consistent with sections 171 and 939A of the Dodd-Frank Act. Under the NPRs, for purposes of section 171 of the Dodd-Frank Act, the standardized approach for risk-weighted assets, together with the numerator revisions and minimum leverage and risk-based capital requirements set forth in the Basel III NPR, would serve as the generally applicable capital requirements. Therefore, advanced approaches banking organizations would be required to determine their common equity tier 1, additional tier 1, and total risk-based capital ratios under the standardized approach and advanced approaches, and apply the lower of the each ratio for purposes of determining compliance with the proposed minimum capital requirements.

Basel III NPR

The proposals set forth in the Basel III NPR would improve the quality and quantity of regulatory capital in a manner that promotes risk sensitivity and minimizes implementation burden. Specifically, the proposed rule would strengthen the definition of regulatory capital,

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[2] In July 2009, the BCBS also issued Revisions to the Basel II Market Risk Framework, available at http://www.bis.org/publ/bcbs193.htm. The agencies issued an NPR in January 2011 and supplement in December 2011 that included provisions to implement the market-risk related provisions. 76 FR 1890 (January 11, 2011); 76 FR 79380 (December 21, 2011).

introduce a common equity tier 1 capital ratio as well as a higher minimum tier 1 risk-based capital ratio and, for advanced approaches banking organizations, require compliance with a three percent supplementary leverage ratio that incorporates a broader set of exposures in the denominator measure, including certain off-balance sheet items. Additionally, the Basel III NPR proposed a capital conservation buffer to establish limitations on capital distributions and discretionary bonus payments for banking organizations 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 vast majority of the commenters objected to certain provisions of the Basel III NPR, as they applied to community banking organizations. In general, the commenters maintained that the Basel III Framework was designed primarily for large, internationally active banking organizations and is not appropriate for most community banking organizations, which are characterized by less-complex financial operations.

In view of the comments, staff recommends revising certain aspects of the Basel III NPR that present the most significant concerns to community banking organizations. Accordingly, if it is approved, the interim final rule would adopt the following modifications to the Basel III NPR for such institutions:

- *AOCI*: The interim final rule allows non-advanced approaches banking organizations to make a one-time, irrevocable election to retain the current treatment for AOCI – that is, a non-advanced approaches banking organization that makes such election is not required to recognize in common equity tier 1 capital any unrealized gains and losses on AFS debt securities. The interim final rule describes the process for making such an election, and addresses situations involving a merger or business combination of non-advanced approaches banking organizations with different AOCI elections.
- *TRUPs*: Consistent with section 171 of the Dodd-Frank Act, the interim final rule retains the current regulatory capital treatment for TRUPs issued by a depository institution holding company with less than $15 billion in consolidated total assets as of December 31, 2009, and a banking organization organized as a mutual holding company as of May 19, 2010. Accordingly, under the interim final rule TRUPs issued by these organizations prior to May 19, 2010 may continue to be recognized as additional tier 1

capital. Any TRUPs issued by such organizations after May 19, 2010 may qualify as tier 2 capital only if the instrument satisfies the requirements for tier 2 capital under section 20(d) of the interim final rule.

- *Mortgage Servicing Assets ("MSAs")*: The interim final rule recognizes the agencies' discretion under section 475 of Federal Deposit Insurance Corporation Improvement Act to allow banking organizations to include 100 percent of the fair value of MSAs in regulatory capital. Therefore, under the interim final rule, the agencies would not require a banking organization to apply a 10 percent haircut to the fair value of any MSAs that may be recognized in regulatory capital. However, the interim final rule requires banking organizations to deduct MSAs above a specified threshold from common equity tier 1 capital and also requires banking organizations to apply a 250 percent risk weight to MSAs that are not deducted from common equity tier 1 capital.
- *Transition Schedule*: The transitional arrangements provided in the interim final rule delay the start of the transition period for community banking organizations until January 1, 2015. In contrast, the transition period for advanced approaches banking organizations would begin on January 1, 2014.

Standardized Approach NPR

Under the Standardized Approach NPR, the agencies sought comment on a proposal to implement aspects of the Basel II standardized approach, as well as the central counterparty treatment proposed by the BCBS subsequent to the publication of the Basel III framework. Consistent with section 939A of the Dodd-Frank Act, the Standardized Approach NPR proposed various methodologies for determining risk weights for assets that do not rely on credit ratings. For sovereign and securitization exposures, these methodologies are generally consistent with the treatments under the market risk final rule (at the time it was approved by the Board in June, 2012) for sovereign debt and securitization positions. The Standardized Approach NPR also proposed significant modifications to the risk-based capital treatment of residential mortgage loans.

A number of commenters criticized the proposed treatment of 1-4 family residential mortgages and the removal of the 120-day safe harbor for mortgage loans sold pursuant to a contract including an early default provision or other credit enhancing representations and warranties.

According to these commenters, the combined effect of these provisions, together with the proposals set forth in the Basel III NPR, would make mortgage lending unsustainable for many community banking organizations. As a result, the commenters maintained, mortgage lending and servicing would become further concentrated among the largest institutions and migrate to and expand the proliferation of the shadow banking industry.

In view of the comments, staff has significant concerns regarding the potential *cumulative* impact of the proposed treatment for 1-4 family residential mortgage exposures and other mortgage reform and regulatory actions implementing the Dodd-Frank Act. Staff believes the objectives of the proposal – that is, to provide disincentives for the type of mortgage lending activity that gave rise to the recent financial crisis – may be largely addressed through other regulatory initiatives, such as the qualified mortgage standards issued by the Consumer Financial Protection Bureau,[3] and the qualified residential mortgage[4] standard when it is adopted in final form. Accordingly, staff believes it is appropriate to retain the current treatment for these exposures while the agencies monitor the behavior and performance of the residential mortgage industry going forward. Therefore, for purposes of the interim final rule, most one-to-four family residential mortgage exposures that are prudently underwritten would continue to receive a 50 percent risk weight. In addition, the interim final rule would continue to recognize private mortgage insurance for purposes of determining the loan-to-value ratio of a residential mortgage exposure and retain the 120-day safe harbor for mortgage loans transferred under a contract that includes an early default provision.

The interim final rule also would include the following revisions. Other, more technical changes are set forth in the attached *Federal Register* document.

- *Sovereign Exposures*: The interim final rule modifies the use of country risk classification ratings issued by the Organization for Economic Cooperation and Development ("OECD"). Following the issuance of the Standardized Approach NPR, the OECD revised the country risk classification ("CRC") rating system, and is no longer assigning a CRC to certain high-income, high-credit quality nations within the OECD. The interim

[3] See 77 Fed. Reg. 6408 (Jan. 30, 2012).
[4] See 76 Fed. Reg. 24090 (April 29, 2011). This notice of proposed rulemaking was issued by the agencies for purposes of implementing section 941 of the Dodd-Frank Act.

final rule adjusts the treatment for exposures to these sovereign entities and assigns a zero percent risk weight to exposures to sovereign members of the OECD that do not have a country risk classification rating.

- *High Volatility Commercial Real Estate ("HVCRE") Exposures*: The interim final rule would revise the proposed definition of HVCRE to exclude from the HVCRE treatment certain agricultural loans and public welfare project loans to benefit low-and-moderate income borrowers. Accordingly, under the interim final rule, such loans generally would be assigned a 100 percent risk weight (instead of a 150 percent risk weight for HVCRE exposures).
- *Securitization Exposures*: Under the proposed simplified supervisory formula approach ("SSFA"), a banking organization would be required to hold more capital for a securitization exposure supported by loans that have defaulted or are experiencing a delay in principal and interest payments. The commenters criticized this latter feature of the SSFA, as it would effectively penalize credit facilities such as federally guaranteed student loans, which provide the borrower a contractual right to defer principal and interest payments. In view of this concern and to support an active and liquid market for student loan securitizations, for purposes of the interim final rule staff is proposing to revise the SSFA so that student loans and other consumer credit facilities do not trigger higher capital requirements in the event a borrower elects to defer payments of principal and interest pursuant to the terms of the documentation governing the facility.
- *Definition of "Financial Institution"*: The proposed definition of financial institution was designed to capture entities whose activities and primary business are financial in nature and, therefore, could contribute to interconnectedness and systemic risk. Under the proposed rule, a financial institution would include any company "predominately engaged" in financial activities. The commenters criticized the proposed predominately engaged standard for determining whether a company is a financial institution, as it would impose significant operational burden on banking organizations. In view of this concern, staff is proposing to revise the definition of financial institution for purposes of the interim final rule, to recognize companies predominately engaged in financial activities only if the banking organization has an investment in the company's GAAP

equity instruments of $10 million or more, or an investment of more than 10 percent of the company's issued and outstanding common shares (or similar equity interest).

Advanced Approaches NPR

Under the Advanced Approaches NPR, the agencies sought comment on a proposal to revise the advanced approaches rules to improve and strengthen modeling standards, the treatment of counterparty credit risk and securitization exposures, as well as disclosure requirements, in a manner consistent with the 2009 Enhancements, Basel III, and recent BCBS publications, as well as sections 171 and 939A of the Dodd-Frank Act. The Advanced Approaches NPR also proposed the implementation of the BCBS central counterparty framework.

Comments submitted by or on behalf of advanced approaches banking organizations expressed concern regarding their ability to remain internationally competitive given the composite burden placed on advanced approaches institutions from overlapping regulatory requirements and discrepancies between the Advanced Approaches NPR and international capital standards. In addition, the commenters maintained that issues concerning interconnectivity and systemic risk are more effectively addressed through more targeted regulations, such as counterparty credit limitations, than risk-based capital requirements. For example, commenters requested that the agencies reconsider the necessity of a multiplier to the asset value correlation ("AVC") factor and the agencies' expansive definition of financial institution.

Although staff recognizes that certain aspects of the Advanced Approaches NPR departed from international capital standards, staff believes that such requirements support the objectives of the proposed rule and are necessary to implement certain provisions of the Dodd-Frank Act, for example, the removal of the use of credit ratings consistent with section 939A. Moreover, the Basel III framework specifically addresses interconnectivity and systemic risk through, for example, the implementation of the AVC multiplier and the capital deduction requirements for exposures to financial institutions. Staff believes these are critical components of the Basel III framework and, therefore, proposes to retain them for purposes of the interim final rule

The commenters also encouraged the agencies to revise the calculation of capital for cleared transactions to better incentivize clearing, streamline the process for recognizing qualified clearinghouses, and adopt the BCBS's interim framework on cleared transactions. In view of the commenters' concerns, staff proposes to revise the central counterparty ("CCP") framework under the advanced approaches rule, by allowing a banking organization to select among two methods for determining the capital requirement for a default fund contribution to a CCP. The optionality provided under the interim final rule is consistent with the BCBS central counterparty framework.

The Interim final rule:

If it is approved, the interim final rule would implement the Basel III, Standardized Approach, and Advanced Approaches NPRs, including the revisions summarized above and detailed in the attached *Federal Register* document. Consistent with the revised proposals, upon implementation of the interim final rule, the standardized approach for risk-weighted assets, together with the numerator revisions and minimum leverage and risk-based capital requirements set forth in the interim final rule, would serve as the generally applicable capital requirements for purposes of section 171 of the Dodd-Frank Act. Advanced approaches banking organizations would begin transitioning to these capital rules on January 1, 2014. The transition period for all other banking organizations begins on January 1, 2015. Under the transition schedule set forth in the regulation, these capital rules would be fully phased-in by January 1, 2019.

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