November 14, 2017

MEMORANDUM TO: Board of Directors

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

SUBJECT: Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations That Are Not Subject to the Advanced Approaches Capital Rules

Summary: In 2013, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, "the agencies") comprehensively revised and strengthened the capital rules applicable to banking organizations (the "capital rules"). The current capital rules allow banking organizations to phase-in certain risk-based capital treatment and capital deductions through the end of calendar year 2017. Staff now is seeking the approval of the FDIC Board of Directors ("FDIC Board") to publish the attached interagency final rule ("final rule") that extends certain transition provisions in the capital rules that currently are scheduled to end on December 31, 2017. The final rule is applicable only to banking organizations that are not subject to the advanced approaches framework, Subpart E of the capital rules ("advanced approaches"). In general, advanced approaches banking organizations are banking organizations that have more than $250 billion in consolidated assets or more than $10 billion in consolidated on-balance sheet foreign exposures; or are a subsidiary of such a banking organization.

Recommendation: Staff recommends that the FDIC Board approve the final rule and authorize its publication in the *Federal Register* with an effective date of January 1, 2018.

Concur:

Charles Yi
General Counsel

Discussion

The capital rules adopted by the agencies increased the quantity and improved the quality of regulatory capital, thereby strengthening the ability of banking organizations to absorb losses in times of market and economic stress.[1] In part, the quality of capital was improved through the implementation of more stringent requirements for regulatory capital instruments and for revisions to certain items on the balance sheet that are deducted from regulatory capital because they have limited ability to absorb losses. Specifically, the capital rules include limits on the amount of capital issued by consolidated subsidiaries and not owned by the parent banking organization that banking organizations can include in regulatory capital ("minority interest").[2] The capital rules also require that mortgage servicing assets ("MSAs"), deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks ("temporary difference DTAs"), and investments in the capital of unconsolidated financial institutions above certain thresholds be deducted from regulatory capital.[3]

The capital rules currently include transition provisions that phase-in the foregoing capital deductions over several years in order to give banking organizations sufficient time to adjust and adapt to such requirements.[4] These transition provisions end on December 31, 2017. For example, the capital deduction treatments for investments in the capital of unconsolidated financial institutions, MSAs, and temporary difference DTAs are subject to transition provisions that become fully effective on January 1, 2018.[5] In addition, starting on January 1, 2018, the risk weight for MSAs, temporary difference DTAs, and significant investments in the capital of

[1] The FRB and the OCC issued a joint final rule on October 11, 2013 (78 FR 62018) and the FDIC issued a substantially identical interim final rule on September 10, 2013 (78 FR 55340). In April 2014, the FDIC adopted the interim final rule as a final rule with no substantive changes. 79 FR 20754 (April 14, 2014).

[2] 12 CFR § 324.21.

[3] 12 CFR § 324.22(c)(4), (c)(5), and (d)(1).

[4] 12 CFR § 324.300.

[5] 12 CFR § 324.300(b)(4) and (d). *See*, Tables 7 and 9 in 12 CFR 324.300.

unconsolidated financial institutions in the form of common stock that are not deducted from regulatory capital will increase from 100 percent to 250 percent. Similarly, the minority interest limitations in the capital rules become fully effective on January 1, 2018.

Since the agencies' issuance of the capital rules in 2013, banking organizations and others have raised concerns regarding the regulatory burden, complexity, and costs associated with treatment of the above referenced items in the capital rules, particularly for community banking organizations. Consistent with statements in the Federal Financial Institutions Examination Council's March 2017 Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act, the agencies published on October 27, 2017, a proposed rule to simplify certain aspects of the capital rules ("simplifications NPR"). The goal of the simplifications NPR is to provide meaningful capital relief for community banking organizations while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system for smaller and less complex banking organizations. The simplification NPR proposes (among other items) that non-advanced approaches banking organizations would apply a simpler capital treatment for: (i) MSAs; (ii) temporary difference DTAs; (iii) investments in the capital of unconsolidated financial institutions; and (iv) minority interest.

In advance of the issuance of the simplifications NPR, the agencies issued on August 25, 2017, a proposal to extend the transition provisions in the capital rules for: (i) MSAs; (ii) temporary difference DTAs; (iii) investments in the capital of unconsolidated financial institutions; and (iv) minority interest that the simplifications NPR would also propose to modify for non-advanced approaches banking organizations (transitions NPR).

The agencies received 36 unique comment letters from banking organizations, trade associations, public interest groups, and private individuals on the transitions NPR. The agencies also received nearly 200 uniform letters signed by different banking organizations and bank employees. Numerous commenters supported the proposal to extend the 2017 transition provisions in order to reduce operational burden, complexity, and cost of the capital rules, particularly for community banking organizations. Some commenters stated that the proposed rule would promote lending and increase shareholder equity. Other commenters criticized the proposal stating that the transitions NPR and simplifications NPR do not go far enough. Some commenters argued that the agencies should have proposed additional transition provisions. Also, some commenters criticized various provisions of the capital rules beyond the revisions proposed by the transitions NPR.

Several commenters argued that the transitions NPR should apply the proposed changes to all banking organizations and expressed the concern that limiting the transitions NPR's provisions to non-advanced approaches banking organizations would result in calculations of capital that are arbitrarily based on a banking organization's size. Some commenters criticized the use of the advanced approaches size thresholds and recommended that other thresholds, such as the systemic indicator score for global systemically important banking organizations be used. Some of these commenters suggested that certain advanced approaches banking organizations are predominantly engaged in traditional banking activities and therefore should not be deemed riskier than smaller non-advanced approaches banking organizations. Other commenters urged the agencies to revisit the size thresholds for advanced approaches more generally.

In response to these comments, in the preamble to the attached final rule, the agencies note that there are other examples where the capital rules differentiate the treatment and the effective date of adopting certain provisions across different types of banking organizations. Such differentiation has generally reflected the variation in the size, complexity, and risk profile of different banking organizations as well as considerations around implementation costs and operational burden.

One commenter argued that the proposal appears to be inconsistent with section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Collins amendment),[6] which, in the view of the commenter, suggests that the agencies must establish generally applicable risk-based and leverage capital requirements that treat all exposures consistently across all banking organizations regardless of a banking organization's size or total foreign exposure.

In response to this comment, in the preamble to the attached final rule, the agencies note that the Collins Amendment requires each of the agencies to establish minimum capital requirements for certain supervised banking organizations and authorizes the agencies to establish more stringent capital requirements.[7] Under the proposal, all banking organizations would have been subject to a minimum capital requirement, as required by the Collins Amendment but the proposal applies the more stringent requirements for regulatory capital instruments and for deductions from regulatory capital to be fully phased-in beginning January 1, 2018 for advanced approaches banking organizations.

After considering the public comments received, FDIC staff believes it is appropriate to adopt the transitions NPR as final and without change. The final rule provides capital relief for non-advanced approaches banking organizations by retaining the 2017 transition provisions for

[6] Codified at 12 U.S.C. 5371.

[7] 12 U.S.C. 5371(b).

the above referenced items in the capital rules until any changes proposed by the simplifications NPR are finalized. Specifically, the final rule extends the capital rules' 2017 transition provisions for the regulatory capital treatment of the following items: (i) MSAs; (ii) temporary difference DTAs; (iii) investments in the capital of unconsolidated financial institutions; and (iv) minority interest exceeding the capital rules' minority interest limitations. The transition provisions for these items are provided in Tables 7 and 9, respectively, in 12 CFR 324.300. The phase-in in calendar year 2017 of the capital treatment for these items is presented below.

Table 7 to § 324.300	
Transition period	Transitions for deductions under § 324.22(c) and (d)—Percentage of additional deductions from regulatory capital
Calendar year 2014	20
Calendar year 2015	40
Calendar year 2016	60
Calendar year 2017	80
Calendar year 2018 and thereafter	100

Table 9 to § 324.300	
Transition period	Percentage of the amount of surplus or non-qualifying minority interest that can be included in regulatory capital during the transition period
Calendar year 2014	80
Calendar year 2015	60
Calendar year 2016	40
Calendar year 2017	20
Calendar year 2018 and thereafter	0

The final rule requires that non-advanced approaches banking organizations include 20 percent of any surplus minority interest in regulatory capital. Additionally, non-advanced approaches banking organizations continue to deduct 80 percent of the amount of investments in the capital of unconsolidated financial institutions, MSAs, and temporary difference DTAs that are not includable in regulatory capital. Further, such banking organizations continue to apply a 100 percent risk weight to any non-deducted amounts of MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions in the form of common stock, and continue to apply the current risk weights under the capital rules to such unconsolidated investments.

The final rule does not extend the 2017 transition provisions to advanced approaches banking organizations. Therefore, beginning on January 1, 2018, advanced approaches banking organizations are required to apply the capital rules' fully phased-in regulatory capital treatment for minority interest, investments in the capital of unconsolidated financial institutions, MSAs, and temporary difference DTAs.

Conclusion

FDIC staff recommends that the FDIC Board approve the attached final rule and authorize its publication in the *Federal Register* with a January 1, 2018 effective date.

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