

May 21, 2019

MEMORANDUM TO: Board of Directors

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

SUBJECT: Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996

Summary: In March 2017, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) submitted a report to Congress pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA report), in which they committed to reduce regulatory burden on community banking organizations. On October 27, 2017, the agencies issued a notice of proposed rulemaking (simplifications NPR or proposal) that would simplify certain aspects of the agencies' risk-based and leverage capital rules (capital rule).

This final rule would apply to non-advanced approaches banking organizations, which would include most FDIC-supervised institutions and would simplify regulatory capital treatment for: mortgage servicing assets (MSAs), certain deferred tax assets arising from temporary differences (temporary difference DTAs), and investments in the capital of unconsolidated financial institutions. The final rule also would simplify the calculation for the amount of capital issued by a consolidated subsidiary of a banking organization and held by third

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parties (minority interest). The final rule would make technical amendments to the capital rule for both non-advanced approaches banking organizations and advanced approaches banking organizations. Revisions to the definition of high-volatility commercial real estate (HVCRE) exposure in the capital rule are being addressed in a separate final rule.

Recommendation: Staff recommends that the FDIC Board approve this final rule and authorize its publication in the *Federal Register* with an effective date of October 1, 2019 for the technical amendments to the capital rule (and the option for early adoption of the technical amendments by banking organizations) and an effective date of April 1, 2020 for the simplifications to the capital rule. The April 1, 2020 effective date is necessary to coincide with the agencies' issuance of amendments to the Consolidated Reports of Condition and Income (Call Reports).

Discussion:

I. Background

The capital rule adopted by the agencies in 2013 addressed weaknesses that became apparent during the financial crisis of 2007-08.¹ The capital rule instituted more stringent requirements for regulatory capital instruments, capital deductions, and increased the risk-sensitivity of the capital rule.² The capital rule requires that MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions above certain thresholds be deducted from regulatory capital,³ and limits the amount of capital that can count toward

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 part 324.

³ 12 CFR 324.22.

regulatory requirements in cases where an organization's consolidated subsidiary has issued capital that is held by third parties (minority interest).⁴

Since the issuance of the capital rule in 2013, banking organizations (including FDIC-supervised institutions) have raised concerns regarding the regulatory burden, complexity, and costs associated with the capital rule. In addition, in connection with the EGRPRA report, for which the agencies sought comment through *Federal Register* notices published in 2014 and 2015, the agencies received in response over 230 comment letters. The agencies also received numerous oral and written comments from panelists and the public at outreach meetings that the capital rule is unduly burdensome and complex. The agencies, in response to comments,⁵ highlighted their commitment to meaningfully reduce regulatory burden, especially on community banking organizations, while at the same time maintain safety and soundness and the quality and quantity of regulatory capital in the banking system.

II. Simplifications NPR

A. Current Capital Rule's Treatment of Certain Regulatory Capital Items

Historically, the agencies have limited the inclusion of intangible and higher-risk assets in capital due to the relatively high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions. The capital rule requires that a banking organization deduct from common equity tier 1 capital the amount of MSAs, temporary difference DTAs, and significant investments in the capital of unconsolidated financial institutions in the form of common stock that, for each category,

⁴ 12 CFR 324.21.

⁵ 82 FR 15900 (March 30, 2017).

exceeds 10 percent of the organization's common equity tier 1 capital⁶ (with an aggregate deduction for all such items that exceeds 15 percent of common equity tier 1 capital).

The capital rule further requires that a banking organization deduct from its capital any amount of the non-significant investments in unconsolidated financial institutions⁷ that exceeds 10 percent of the banking organization's common equity tier 1 capital. Significant investments in unconsolidated financial institutions not in the form of common stock must also be deducted from capital in their entirety.

B. Simplifications Proposal

Consistent with the 2017 EGRPRA report, the agencies issued the simplifications NPR with the aim of simplifying the capital rule and reducing regulatory burden for certain banking organizations. Specifically, for non-advanced approaches banking organizations, the simplifications proposal would have eliminated: (i) the 10 percent common equity tier 1 capital deduction threshold, which applies individually to holdings of MSAs, temporary difference DTAs, and significant investments in the capital of unconsolidated financial institutions in the form of common stock; (ii) the 15 percent common equity tier 1 capital deduction threshold, which applies to the aggregate amount of the foregoing items; (iii) the 10 percent threshold for non-significant investments, which applies to holdings of regulatory capital of unconsolidated financial institutions; and (iv) the deduction treatment for significant investments in the capital of

⁶ A significant investment in the capital of an unconsolidated financial institution is defined as an investment in the capital of an unconsolidated financial institution where the banking organization owns more than 10 percent of the issued and outstanding common stock of the unconsolidated financial institution. *See* 12 CFR 324.2.

⁷ A non-significant investment in the capital of an unconsolidated financial institution is defined as an investment in the capital of an unconsolidated financial institution where the institution owns 10 percent or less of the issued and outstanding common stock of the unconsolidated financial institution. *See* 12 CFR 324.2.

unconsolidated financial institutions that are not in the form of common stock.⁸ Under the NPR, non-advanced approaches banking organizations would no longer need to apply distinct treatments to significant and to non-significant investments in the capital of unconsolidated financial institutions. Rather, the regulatory capital treatment for an investment in the capital of unconsolidated financial institutions would be based on the type of instrument underlying the investment.

Instead of the current capital rule's complex treatments for MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions, the simplifications proposal would have required non-advanced approaches banking organizations to deduct from common equity tier 1 capital any amount of MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions that individually exceed 25 percent of common equity tier 1 capital (the 25 percent common equity tier 1 capital deduction threshold). The simplifications proposal would have required a banking organization to apply a 250 percent risk weight to MSAs or temporary difference DTAs that are not deducted from capital once the capital rule was fully implemented and phased in. For investments in the capital of unconsolidated financial institutions, the simplifications proposal would have required a banking organization to risk weight each exposure that is not deducted according to the risk weight applicable to the exposure category of the investment.

Second, the simplifications NPR would have introduced a significantly simpler methodology for non-advanced approaches banking organizations to calculate minority interest limitations.⁹ The existing capital rule's limitations for common equity tier 1 minority interest,

⁸ 12 CFR 324.22(c) and (d).

⁹ 12 CFR 324.21.

tier 1 minority interest, and total capital minority interest are based on the capital requirements and capital ratios of each of the banking organization's consolidated subsidiaries that have issued capital instruments held by third parties. The proposal would have simplified the minority interest limitations for non-advanced approaches banking organizations by basing such limitations on the parent banking organization's capital levels rather than on the capital ratios of its subsidiaries. Specifically, under the proposal, a non-advanced approaches banking organization would have been allowed to include common equity tier 1, tier 1, and total capital minority interest up to 10 percent of the banking organization's common equity tier 1, tier 1, and total capital (before the inclusion of any minority interest), respectively.

Third, the simplifications proposal would have replaced the existing HVCRE exposure category as applied in the standardized approach with a newly defined exposure category called high volatility acquisition, development, or construction (HVADC) exposure. Subsequent to the proposal, on May 24, 2018, section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)¹⁰ became law, which provides a statutory definition of a high volatility commercial real estate acquisition, development, or construction (HVCRE ADC) loan.¹¹ On September 18, 2018, the agencies published a proposed rule to conform the capital rule with the statutory definition of HVCRE ADC loan, which superseded the simplifications proposal to replace the HVCRE exposure with HVADC exposure.¹² The agencies are finalizing the revisions to the capital rule's definition of HVCRE exposure in a separate rulemaking.

Under the simplifications proposal, advanced approaches banking organizations would not have been permitted to apply the simplified treatment for MSAs, temporary difference

¹⁰ Pub. L. 115-174 (May 24, 2018).

¹¹ 12 U.S.C. § 1831bb.

¹² 83 FR 48990 (Sept. 28, 2018).

DTAs, investments in the capital of unconsolidated financial institutions and minority interest. These banking organizations would continue to apply the more risk sensitive treatments included in the capital rule.

The simplifications proposal also would have made certain technical changes to the capital rule, including some changes to the advanced approaches, to clarify certain provisions, update cross-references, and correct typographical errors.

C. Summary of Comments on the Simplifications Proposal

Collectively, the agencies received nearly 100 comment letters on the simplifications proposal from banking organizations, trade associations, public interest groups, and individuals. This summary excludes any comments pertaining to the proposed revisions to the definition of HVCRE exposure in the capital rule, as such comments are being addressed in a different rulemaking.

Commenters generally supported the simplifications proposal. Several commenters, however, requested that the agencies apply the proposed simplifications to a broader set of banking organizations. A number of commenters believed the proposed simplifications were insufficient with respect to the threshold deductions for MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions. Some commenters favored increasing or removing the 25 percent common equity tier 1 capital deduction threshold while other commenters disagreed with the proposed 250 percent risk weight for these exposures. While commenters expressed general support for the simplifications proposal's simpler regulatory capital limitations for minority interest, a few commenters asserted this revision could result in unintended consequences. The agencies also received a few comments related to the proposed technical amendments to the capital rule, many of which are outside the scope of this

rulemaking. Some of the commenters' suggestions were addressed in rulemakings that were issued subsequent to the publication of the simplifications NPR.

III. Simplifications Final Rule

Consistent with the EGRPRA report and the simplifications NPR, the final rule would adopt the simplification proposal's revisions to (i) the current regulatory capital treatment for MSAs, temporary difference DTAs, and investments in the capital of unconsolidated financial institutions; and (ii) the calculation for the amount of minority interest that can be included in a banking organization's regulatory capital. In addition, the final rule would make various clarifications and technical amendments to the agencies' capital rule, including the advanced approaches capital rule. Staffs of the agencies believe that it is important to limit the inclusion of MSAs and temporary difference DTAs in regulatory capital. In addition, staffs of the agencies believe that the uncertainty regarding the ability of banking organizations to realize value from MSAs and temporary difference DTAs warrants an elevated risk weight for the amount of these assets not deducted from regulatory capital.

Staffs of the agencies have determined that the treatment of MSAs under the final rule is sufficiently conservative, given the 25 percent common equity tier 1 capital deduction threshold for MSAs in addition to the requirement that any non-deducted MSA exposures be risk weighted at 250 percent. Similarly, staffs of the agencies believe that the revised 25 percent common equity tier 1 capital deduction threshold for temporary difference DTAs, together with a 250 percent risk weight for non-deducted temporary difference DTAs, will continue to protect banking organization capital against the possibility that such organization would need to establish or increase valuation allowances for DTAs during periods of financial stress.

The final rule would adopt, for non-advanced approaches banking organizations, the NPR's treatment for the investments in the capital of unconsolidated financial institutions (i.e., non-significant investments in the capital of unconsolidated financial institutions, significant investments in the capital of unconsolidated financial institutions that are in the form of common stock, and significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock). Commenters generally supported the proposed removal of these distinctions. In order to avoid adding complexity and regulatory burden, the final rule provides flexibility for non-advanced approaches banking organization to determine what investments to deduct and which it must risk weight in cases where the banking organization exceeds the 25 percent common equity tier 1 capital deduction threshold for investments in the capital of unconsolidated financial institutions. Such risk weighting would be in accordance with the relevant capital treatment for the exposure category of the investment.

The final rule would simplify, for non-advanced approaches banking organizations, the calculations limiting the inclusion of minority interest in regulatory capital by including: (i) common equity tier 1 minority interest comprising up to 10 percent of the parent banking organization's common equity tier 1 capital; (ii) tier 1 minority interest comprising up to 10 percent of the parent banking organization's tier 1 capital; and (iii) total capital minority interest comprising up to 10 percent of the parent banking organization's total capital. In each case, the parent banking organization's regulatory capital for purposes of these limitations would be measured before the inclusion of any minority interest and after the deductions from and adjustments to the regulatory capital of the parent banking organization described in sections 22(a) and (b) of the capital rule. Staffs of the agencies continue to have the view that removing the current complex calculation for the amount of includable minority interest will reduce

regulatory burden without reducing the safety and soundness of non-advanced approaches banking organizations.

For purposes of the final rule, staffs of the agencies have identified typographical and technical errors in several provisions of the capital rule that warrant clarification or updating. In addition, the final rule corrects several incorrect or imprecise cross-references in an effort to better clarify the capital rule's requirements, as well as other changes to references necessary to implement the simplifications proposal. The final rule differs from the proposal in minor ways to conform with changes to the capital rule related to the implementation and transition of the current expected credit losses methodology for allowances, which were implemented subsequent to the simplifications proposal.

Conclusion: FDIC staff recommends that the FDIC Board approve the attached interagency final rule and authorize its publication in the *Federal Register* with an effective date of October 1, 2019 for the technical amendments to the capital rule (and the option for early adoption of the technical amendments by banking organizations) and an effective date of April 1, 2020 for the simplifications to the capital rule.

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