

June 14, 2011

MEMORANDUM TO: Board of Directors

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

SUBJECT: *Final Rule 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 Final Rule (final rule) titled, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor*. If approved, the final rule would be published jointly in the *Federal Register* by the FDIC, Board of Governors of the Federal Reserve System (FRB), and Office of the Comptroller of the Currency (OCC) (together, the agencies).

By notice in the *Federal Register* dated December 30, 2010, the agencies issued a notice of proposed rulemaking¹ to implement 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 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. Collectively, the agencies received 16 comments on the proposal from both domestic and international trade associations, and from individual financial institutions, including insurance companies.

After considering the comments and determining that the proposed rule is consistent with section 171(b)(2) of the Act, the agencies are issuing the proposed rule text as a final rule without change. The final rule removes the transitional floor periods in section 21(e) of the advanced approaches rule, and sets the generally applicable risk-based capital requirements as a permanent floor for the advanced approaches. Consistent with the proposed rule, the final rule also would amend the agencies’ general risk-based capital rules to allow the FRB the flexibility to address low-risk nonbank assets for certain institutions, including insurance companies, in a manner consistent with the Collins amendment.

Concur:

Michael Krimminger, General Counsel

¹ 75 Fed. Reg. 82317.

Recommendation: That the Board approve publication of this final rule in the *Federal Register* with an effective date that is 30 days after publication in the *Federal Register*.

Background and Proposed Rule

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 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. A bank's risk-based capital requirement during 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,³ 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 and currently, 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 approaches rule explicitly allows for the possibility that the risk-based capital requirements of an institution using that rule would be lower than if the institution 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 approaches rule could operate without any risk-based capital floor after completing these transitional periods.

This aspect of the advanced approaches rule 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 171.⁴ Under section 171, 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. Thus, the generally applicable risk-based capital requirements do not currently serve as a floor for the advanced approaches rule.

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 12 CFR part 325, Appendix A.

⁴ 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." These requirements are found at 12 CFR part 325, Appendix A in the case of state nonmember banks, and are referred to as "the general risk-based capital rules."

Consistent with section 171(b)(2), in December 2010 the agencies proposed to replace the “transitional floors” in section 21(e) of the advanced approaches rules with a permanent floor equal to the minimum capital requirement computed using the agencies’ general risk-based capital rules. Importantly, the preamble to the proposed rule stated that the generally applicable risk-based capital rules may be amended in the future, but as specified by section 171, these rules 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 preamble also stated that 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 envision performing a quantitative analysis designed to ensure any future amendments to the generally applicable 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.

The preamble also noted that 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. To allow for an appropriate capital requirement for low risk nonbank assets without creating new opportunities for capital arbitrage, the agencies proposed 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 proposed treatment would allow the FRB to assign an appropriate risk weight to certain low-risk exposures of nonbank financial institutions in a manner consistent with section 171 of the Act.

Finally, for bank holding companies subject to the advanced approaches rule, the proposal stated that in calculating their risk-based capital ratios, these organizations may include certain debt or equity instruments issued before May 19, 2010, as described in section 171(b)(4)(B) of the Dodd-Frank Act. This means that these organizations need not immediately begin deducting from tier 1 capital their Trust Preferred Securities and other instruments that are ineligible for insured banks, and may not include in their tier 1 capital any such ineligible instruments issued after May 19, 2010. The agencies expect the full scope of application of section 171(b)(4)(B) of the Act will be addressed in a subsequent rule.

Comment Summary

The agencies solicited public comment in regard to five aspects of the proposal: (1) the potential impact on banking organizations subject to the advanced approaches rules, (2) the effect on applications by foreign banking organizations, (3) the proposed capital treatment for certain nonbank exposures, (4) quantitative methods for comparing frameworks, and (5) the costs and

benefits of the proposal. Collectively, the agencies received 16 comments from domestic and international trade associations; individual financial institutions, including insurance companies; and a financial reform advocacy organization.

Groups representing large banking organizations generally objected to the proposed permanent capital floor, saying that it would place large U.S. banking organizations at a competitive disadvantage relative to international banking organizations, increase costs, undermine the risk sensitivity of the advanced approaches capital rule, and encourage banks to invest more in higher risk assets, and distort decisions regarding capital allocation. While some of these commenters expressed a preference for alternative approaches to implement section 171 of the Act, including a Pillar 2 supervisory approach under the New Accord, most of them acknowledged that the agencies were acting in response to a statutory requirement.

Some commenters criticized the proposal for retaining two regulatory capital regimes while other commenters asked the agencies to clarify how the proposal would interact with any future Basel III-based capital requirements, prompt corrective action, and other Dodd-Frank Act provisions relating to capital adequacy. In contrast, commenters representing community banks and a financial reform advocacy organization expressed strong support for the proposed capital floor. These commenters were concerned that internal models would allow large banks to reduce their capital levels and give them a competitive advantage over community banks, and could also increase negative procyclical outcomes.

Commenters representing insurance companies generally supported the proposed revisions to the general risk-based capital rules for certain nonbank assets, arguing that insurance companies have different risk profiles and their liabilities and assets are of different durations compared to banks. However, several of these commenters said that applying capital requirements for banking organizations to insurance companies without taking the differences between the two types of organizations into account is overly simplistic and may lead to distorted incentives, undermine efficient use of capital, curtail insurance underwriting capacity, and negatively impact insurance markets. Other insurance industry commenters stated that assignment to a risk category should be based on the risk of the asset and not on the underlying authority to own the asset.

Most foreign banking organizations asserted that extending U.S. capital requirements to a foreign banking organization operating outside of the United States would not be appropriate and would be inconsistent with the supervisory practice of the FRB regarding the recognition of home country capital regulations. Several commenters noted that subjecting a foreign banking organization to the proposed rule contradicts the language of the Act, which excludes foreign banking organizations from the requirements of section 171. However, some commenters supported applying the proposed rule to the U.S. operations of foreign banking organizations operating in the United States to be consistent with requirements for domestic banking organizations.

The agencies received only a few comments on how to evaluate changes to the general risk-based capital requirements to ensure they are not “quantitatively lower” than the generally-applicable capital requirements in effect as of the enactment of section 171 of the Act. The commenters generally supported looking at industry-wide aggregate capital levels to conduct the

analysis rather than basing the calculation on an item-by-item comparison of capital requirements for each class of exposures.

Several commenters expressed concern regarding the operational expense and burden of determining compliance with two sets of capital rules. One stated that requiring two sets of capital rules would result in permanently higher operating costs for banking organizations under the advanced approaches rules.

Commenters generally indicated that determining regulatory capital requirements under two sets of capital regulations (the advanced approaches rules and the generally applicable risk-based capital rules then in effect) was preferable to making such determination under three capital rules (the above two capital regimes and the Basel I general risk-based capital rules in effect on July 21, 2010).

Comment Analysis

As described in the preceding section, a number of the commenters expressed opinions about the appropriateness of the policy underlying section 171 of the Act. The final rule preamble notes that the agencies are required by law to comply with the Act and, accordingly, sought comment on how to implement certain requirements of section 171 and mitigate burden in meeting those requirements.

A number of commenters suggested that foreign banking organizations operating under the advanced approaches rule could hold less capital and, therefore, have a competitive advantage compared to U.S. banking organizations. The preamble notes that the agencies agree that a foreign banking organization that uses the advanced approaches rules and is not subject to a capital floor could theoretically operate with lower minimum risk-based capital requirements than a U.S. banking organization that is subject to the permanent capital floor. The preamble also notes that the agencies will consider these competitive equity concerns when working with the Basel Committee on Banking Supervision and other supervisory authorities to mitigate potential competitive inequities across jurisdictions, as appropriate.

In response to the comments on how the proposed rule should be applied to foreign banking organizations, the preamble acknowledges that section 171 does not apply to foreign banking organizations. Rather, the question on capital equivalency and comparability determinations sought views on practical ways to administer such determination in the context of certain applications given the proposal's requirements and the Federal Reserve's longstanding supervisory practice. The preamble states that it is important to take into consideration the competitive issues highlighted by commenters, and that the Federal Reserve will continue to evaluate equivalency issues on a case-by-case basis, taking into consideration the comments received.

Generally commenters supported the proposed amendment to the general risk-based capital rules to address the appropriate capital requirement for low risk assets that non-depository institutions may hold and for which there is no explicit capital treatment in the general risk-based capital rules. As stated in the preamble to the final rule, the FRB will consider the risk characteristics

for such assets on a case-by-case basis in consideration of potential changes to the bank holding company rules.

The proposal also sought comment on how the agencies should, in the future, evaluate changes to the general risk-based capital requirements to ensure that they are not “quantitatively lower” than the generally-applicable capital requirements in effect as of the enactment of section 171 of the Act. Commenters generally supported looking at industry-wide aggregate capital levels rather than an item-by-item comparison of capital requirements for each class of exposures. The preamble notes that the agencies agree with commenters that comparing capital requirements on an aggregate basis is an effective way of conducting the “quantitatively lower” analysis and anticipate that this method, where appropriate, will be considered in future rulemakings. For purposes of implementing section 171, the preamble notes that the agencies anticipate performing quantitative analyses to ensure that any future capital framework is not quantitatively lower than the generally applicable capital requirements in effect as of the date of enactment of the Act. The agencies are currently considering how that analysis may be performed.

In response to comments on the burden of maintaining two systems to calculate capital requirements under both the general risk-based capital rules and advanced approaches rules, the preamble notes that banking organizations are currently reporting their capital requirements under both sets of rules, and that banks using the advanced approaches capital framework did not anticipate reporting capital calculations under two capital frameworks beyond the transitional floor arrangement. However, the preamble also notes the final rule is consistent with the requirements under section 171(b)(2) of the Act

Final Rule

After considering the comments on the proposed rule, staff has decided to recommend that the Board issue the proposed rule text as a final rule without change. The effective date for the final rule will be 30 days after publication in the *Federal Register*.

Recommendation

Staff recommends that the Board approve the publication of the attached final rule in the *Federal Register* with an effective date that is 30 days after publication in the *Federal Register*.

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