MEMORANDUM TO: Board of Directors

FROM: Christopher J. Spoth, Acting Director
Division of Supervision and Consumer Protection

SUBJECT: Advance Notice of Proposed Rulemaking Regarding *Risk-Based Capital Guidelines; Capital Maintenance: Domestic Capital Modifications*

Proposal: That the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) approve the publication of the attached Advance Notice of Proposed Rulemaking regarding *Risk-Based Capital Guidelines; Capital Maintenance: Domestic Capital Modifications* (ANPR) in the Federal Register for a 90-day comment period. The ANPR would be issued on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (collectively, the Agencies). The ANPR requests comment on various modifications to the existing framework for calculating risk-based capital requirements for U.S. banking organizations. The modifications under consideration are designed to:

- Modernize the risk-based capital rules to ensure that the framework remains a relevant and reliable measure of the risks present in the banking system,
- Minimize potentially material differences in capital requirements that may arise between banks that adopt Basel II and those banks that remain under the existing rules,
- Maintain an operationally feasible capital framework that is relatively simple to implement for banking organizations subject to the existing capital rules, and
- Use currently available data to implement required changes with the intent of minimizing the burden associated with these modifications.

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

Concur:

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William F. Kroener, III

General Counsel

I. Introduction

The FDIC Board of Directors is being asked to approve for publication in the Federal Register the attached interagency ANPR seeking comment on various modifications to the existing capital rules for the purpose of modernizing the risk-based capital framework. Further, the Agencies are considering various modifications to the existing capital regulations with the intent of minimizing the potential for competitive inequities that could arise from the domestic implementation of Basel II[1] by a limited number of large banking organizations. In addition, the Agencies believe that these various modifications would promote a greater degree of risk sensitivity and would better align capital requirements with credit risk. This initiative is being undertaken with the intent of minimizing the burden on the affected banks.

The Agencies will be guided by five general principles in the development of revisions to the existing rules. Specifically, a revised framework should (1) promote safe and sound banking practices, (2) maintain a reasonable balance between risk sensitivity and operational feasibility, (3) avoid undue regulatory burden, (4) encourage appropriate incentives and risk reduction techniques, and (5) minimize differences in capital requirements that give rise to competitive imbalances between large and small banking organizations.

The Agencies are focusing their revisions on exposures that are common to the vast majority of the almost 9,000 banking organizations operating in the United States. On a larger scale, the agencies are considering an expansion of the existing risk bucket system as a way of developing a more robust means of calculating risk-weighted capital for credit risk. In addition, the Agencies would provide banking organizations with

[1] The Agencies are considering the domestic implementation of the advanced approaches for determining minimum risk-based capital requirements for credit and operational risk as described in the Basel Committee on Banking Supervision's "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Basel II). The complete text for Basel II is available on the Bank for International Settlements Web site at http://www.bis.org. For the proposed domestic implementation of Basel II, see the Basel II ANPR, 68 FR 45900 (August 4, 2003).

greater incentives for mitigating credit risk through the recognition of a broader array of collateral types and independent third-party guarantees.

The Agencies are considering various revisions to the existing capital treatment of specific asset classes, such as residential mortgage loans, externally-rated loans and securities, small business loans, and commercial real estate, and are seeking comment on a range of other exposures that will enable the agencies to develop well-constructed proposals based on relevant risk factors common to a particular business line, exposure, or bank activity. The Agencies are also considering new and revised capital requirements on defaulted assets, certain types of short-term commitments, and securitizations of revolving exposures with early amortization features to remedy shortcomings in our present capital framework.

II. Modernizing the Risk-Based Capital Rules

Consistent with our broad objective of modernizing the risk-based capital rules, the Agencies seek to advance the goal of promoting greater risk sensitivity without imposing undue burden. The Agencies identified the following areas for potential modification, as changes in these areas would be both operationally feasible and sufficiently risk sensitive to determine the appropriate capital requirements based on an institution's given level of risk:

- Increasing the number of risk-weight categories to which credit exposures may be assigned, specifically adding risk weights of 35, 75, 150, and 350 percent;
- Expanding the use of external credit ratings as an indicator of credit risk for externally-rated exposures;
- Expanding the range of collateral and guarantors that that may be recognized when applying lower weights;
- Using loan-to-value ratios and other broad measures of credit risk for assigning risk weights to residential mortgages;
- Modifying the credit conversion factor for various commitments

including those with an original maturity of under one year;

- Requiring that certain loans 90 days or more past due or in non-accrual status be assigned to a higher risk-weight category;
- Modifying the risk-based capital requirements for certain commercial real estate exposures;
- Increasing the risk sensitivity of capital requirements for other types of retail, multifamily, small business, and commercial exposures; and
- Assessing a risk-based capital charge to capture the risks inherent in securitizations backed by revolving retail exposures with early amortization provisions.

III. Minimizing Competitive Inequities

The Agencies recognize the concerns raised by several institutions and trade groups in comment letters to the Basel II ANPR and in Congressional testimony regarding the potential competitive inequities that could arise between those banks that adopt a Basel II framework (Basel II banks) and those banks that remain on the existing risk-based capital framework (general banks). Some commenters suggested that if Basel II is implemented, then further changes need to be considered to the existing capital framework to enhance its risk sensitivity and to address any competitive equity concerns associated with a bifurcated framework. The Agencies believe that these concerns warrant a thorough review and have developed this ANPR as the first step toward considering revisions to the existing capital regulations.

To assist in quantifying the effects of Basel II, the Agencies conducted a quantitative impact study during late 2004 and early 2005, commonly referred to as QIS-4. The study is a comprehensive effort completed by 26 of the largest U.S. consolidated banking organizations largely based on their own internal estimates of the key risk parameters driving the capital requirements under the Basel II framework.

The QIS-4 results (see Chart 1) provide some indication of the possible implications of a bifurcated capital framework on U.S. banking organizations. Material reductions in the minimum capital requirements conferred to one segment of the banking community could impact the operations of the remaining institutions subject to the existing rules. Specific concerns raised by institutions, trade groups and other interested parties with respect to the potential competitive inequities include:

- Loss of business opportunity as Basel II banks will have lower capital requirements that will enable them to price products lower than general banks,
- Migration of risk as general banks will have higher capital requirements and must generate likewise higher rates of return to remain competitive in the marketplace, and
- Increased levels of acquisitions of general banks by Basel II banks.

Possible modifications have been developed in those areas where competitive inequities are particularly acute and where factors used to measure the risk associated with a given product or exposure are well defined. Possible modifications for various key bank exposures are shown in the attached Chart 2. This chart also shows the estimated effect that Basel II could have on these exposures. The Agencies recognize that this ANPR represents the first attempt toward achieving greater risk sensitivity in the existing capital rules and have solicited comments that will enable us to advance a wider range of proposals covering a greater number of bank exposures in a future rulemaking.

IV. Maintaining an Operationally Feasible Framework

The existing risk-based capital rules are applied to approximately 9,000 U.S. banking organizations of varying sizes, business operations, and exposure types. As the Agencies consider more risk-sensitive capital rules that align capital with risk in a more granular fashion, consideration of multiple capital regimes appears reasonable.

The universe of banks that are not likely to adopt the advanced approaches of Basel II is still quite large and diverse. Of the institutions that are currently expected to be subject to the modified capital rules in the ANPR over the long term, 8 institutions are greater than $50 billion, 512 institutions are greater than $1 billion, and 4,045 institutions are less than $100 million in assets. (see Chart 3).

To remain competitive with Basel II banks, a more risk-sensitive capital framework will be crucial for a sizeable number of banking organizations. However, smaller banking organizations with capital ratios well above regulatory minimums may not find significant benefit in increased risk sensitivity and may find the additional requirements to be burdensome.

Consistent with our principles and objectives, the Agencies are soliciting comments in the ANPR on the implications of the proposals with respect to regulatory burden. The Agencies are also considering the feasibility of allowing certain banking organizations, especially smaller community banks and thrifts, to remain on the existing framework, thus relieving these banking organizations of any burden associated with adopting the revised capital requirements.

As required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), the Agencies are requesting comments on any outdated, unnecessary, or unduly burdensome requirements in their regulatory capital rules. The Agencies specifically request comment on the extent to which any of these capital rules may adversely affect competition and whether: (1) statutory changes are necessary to eliminate specific burdensome requirements in these capital rules; (2) any of these capital rules contain requirements that are unnecessary to serve the purposes of the statute that they implement; (3) the compliance cost associated with reporting, recordkeeping, and disclosure requirements in these capital rules is justified; and (4) any of these capital rules are unclear.

Chart 1

QIS 4 Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II

Portfolio	% Change in Portfolio MRC	Median % Change in Port. MRC	Share of Basel I MRC	Share of Basel II MRC
Wholesale Credit	**(25%)**	**(24%)**	**44%**	**38%**
Corporate, Bank, Sovereign	(22%)	(30%)	34%	30%
Small Business	(27%)	(27%)	5%	4%
High Volatility CRE	(33%)	(23%)	2%	1%
Incoming Producing RE	(41%)	(52%)	4%	3%
Retail Credit	**(26%)**	**(50%)**	**31%**	**26%**
Home Equity (HELOC)	(74%)	(79%)	6%	2%
Residential Mortgage	(61%)	(73%)	11%	5%
Credit Card (QRE)	66%	63%	6%	12%
Other Consumer	(7%)	(35%)	6%	6%
Retail Business Exposures	(6%)	(29%)	1%	1%
Equity	7%	(24%)	1%	2%
Other assets	(12%)	(3%)	10%	10%
Securitization	(18%)	(40%)	8%	8%
Operational Risk			**0%**	**10%**
Trading Book	0%	0%	5%	6%
Portfolio Total	**(13%)**	**(24%)**	**100%**	**100%**
Change in Effective MRC*	**(15%)**	**(26%)**		

* This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is data as of August 17, 2005 for the twenty-six participating QIS-4 institutions, and caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies are completing additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

Chart 2

Comparison of Capital Approaches for Key Bank Exposures

Issue	Domestic Capital ANPR Possible Modification	Basel II QIS-4 Exercise Results
Capital for corporate and sovereign debt.	Assign debt to risk weights based on external ratings	The median change to capital was a **30% decrease**. The range was a 55.7% increase to an 80.2% decrease.
Capital for residential mortgages and HELOCs	Assign mortgages and HELOCs to risk weights based on LTV ratios or on a combination LTV/credit assessment matrix	The median change to capital for residential mortgages was a **73% decrease**, with a range of a 17.8% decrease to a 98.6% decrease. The median change to capital for HELOCS was a **79% decrease**, with a range of a 91.9% increase to a 99.0% decrease.
Capital for other retail exposures (including credit cards, auto loans, etc.)	Solicit comments and suggestions and possibly assign risk weights on a combination LTV/credit assessment matrix	The median change to capital for credit cards was a **63% increase**, with a range of a 416.2% increase to a 90.4% decrease. The median change to capital for other retail exposures was a **35% decrease,** with a range of a 93.8% increase to a 97.7% decrease.
Capital for commercial real estate (CRE) exposures	Increase capital for some CRE exposures, such as acquisition, development and construction loans	The median change to capital was a **23% decrease**, with a range of a 110.3% increase to a 59.8% decrease.
Capital for other commercial exposures (such as small business lending)	Solicit comments and suggestions	The median change to capital for small business loans was a **27% decrease**, with a range of a 30.3% increase to an 80.7%.

Chart 3

Asset Size and Capital Ratios
For Non-Basel II Banks*
As of June 30, 2005

Asset Size	Number of Institutions	Average Total Risk-Based Capital Ratio	Average Tier 1 Risk-Based Capital Ratio	Average Leverage Ratio
> $50 billion	8	11.70	9.53	7.31
$10 billion – $50 billion	62	14.80	13.09	8.28
$1 billion – $10 billion	450	14.26	13.02	9.36
$500 million – $1 billion	571	14.96	13.73	9.37
$250 million – $500 million	1185	15.21	14.06	9.46
$100 million – $250 million	2519	16.87	15.76	10.18
< $100 million	4045	27.30	26.21	13.51

* Defined as non-QIS 4 participants

Concur:

Jodey C. Arrington
Chief of Staff

RESOLUTION

WHEREAS, the International Lending Supervision Act of 1983 requires each appropriate Federal banking agency to cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods as the Federal banking agency deems appropriate; and

WHEREAS, section 38(c)(1) of the Federal Deposit Insurance Act prescribes that the capital standards of each appropriate Federal banking agency include leverage and risk-based capital requirements; and

WHEREAS, the regulations of the Federal Deposit Insurance Corporation (the "Corporation") in Appendix A to 12 C.F.R. Part 325 set forth the Corporation's risk-based capital requirements for insured state nonmember banks in its Statement of Policy on Risk-Based Capital; and

WHEREAS, the risk-based capital requirements in Appendix A to 12 C.F.R. Part 325 are based on an internationally based framework that was developed by the Basel Committee on Banking Supervision ("BSC") in 1988 ("1988 Capital Accord") and have been adopted by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the Corporation (the "Agencies"); and

WHEREAS, since the issuance of the 1988 Capital Accord, the BSC has determined that the world financial system has become significantly more complex due to various factors including the development of new financial products and the related risks to the financial system; and

WHEREAS, in April, 2003, the BSC released for public consultation a document entitled "The New Basel Capital Accord" that sets forth proposed revisions to the 1988 Capital Accord ("New Capital Accord"); and

WHEREAS, the New Capital Accord was based on three "pillars," i.e., (1) minimum regulatory capital requirements, (2) supervisory capital requirements, and (3) market discipline; and

WHEREAS, on August 4, 2003, the Agencies issued an Advance Notice of Proposed Rulemaking ("Basel II ANPR") in the Federal Register, 68 Fed. Reg. 45,900, concerning internal ratings-based approaches for the calculation of minimum regulatory risk-based capital requirements, which sought industry and public comment on all aspects of the implementation of the proposed new regulatory capital framework in the New Capital Accord; and

WHEREAS, in June, 2004, the BSC issued a revision to the New Capital Accord "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (the "Basel II framework"); and

WHEREAS, for purposes of their consideration of the implementation of the Basel II framework for large, internationally active banking organizations in the United States, the Agencies conducted a Quantitative Impact Study (the "QIS-4") during late 2004 and early 2005 of twenty-six banking organizations; and

WHEREAS, the results from the QIS-4 indicate that material reductions in the minimum capital requirements under the Basel II framework could occur for the surveyed banking organizations; and

WHEREAS, a Congressional hearing conducted by the Committee on Financial Services of the U.S. House of Representatives on May 11, 2005 (the "Congressional hearing"), and comments provided in response to the Basel II ANPR indicated concerns arising from the QIS-4 results with respect to potential competitive inequities that could arise between banking organizations that would adopt the Basel II framework and those banks that would remain under the current risk-based capital framework; and

WHEREAS, in response to the Congressional hearing, industry comments on the Basel II ANPR, and to comments provided in an industry forum sponsored by the Agencies on July 27, 2005, the Agencies believe that changes need to be considered to the existing risk-based capital requirements to enhance the risk sensitivity of those capital requirements and to address any competitive equity concerns that could arise from the U.S. implementation of the Basel II framework; and

WHEREAS, the Agencies believe that the aforementioned concerns presented regarding the Basel II framework and the need to enhance the risk sensitivity of the existing risk-based capital requirements warrant a thorough review and have developed an Advance Notice of Proposed Rulemaking (the "Domestic Capital Modifications ANPR") to request public comment on various potential modifications to the current risk-based capital requirements; and

WHEREAS, the Agencies believe that the Domestic Capital Modifications ANPR should include a request for comments on any outdated, unnecessary, or unduly burdensome requirements in the existing risk-based capital rules as required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996.

NOW, THEREFORE, BE IT RESOLVED, that the Board of Directors of the Corporation (the "Board") hereby authorizes the Executive Secretary, or his designee, to cause the attached Domestic Capital Modifications ANPR to be published in the Federal Register jointly with the other Agencies, in a form and manner acceptable to the Executive Secretary, or his designee, and the General Counsel, or his designee.

BE IT FURTHER RESOLVED, that the Board hereby delegates authority to the Executive Secretary and the General Counsel to make technical or nonsubstantive changes to the text of the attached Domestic Capital Modifications ANPR to ensure that the Corporation and the other Agencies can issue jointly this document in the Federal Register, and to make any other changes to this document that the Executive Secretary and the General Counsel deem necessary or appropriate to fulfill the Board's objectives in connection with its publication for public comment.